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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 89/111

10:00 a.m., August 28, 1989

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
	C. Enoch
	Shao Z., Temporary
	D. C. Templeman, Temporary
	J. Prader
E. T. El Kogali	
E. A. Evans	S.-W. Kwon
	R. J. Lombardo
	M. A. Fernández Ordóñez
R. Filosa	
M. Finaish	S. K. Fayyad, Temporary
M. Fogelholm	M. Pétursson
	A. Gronn, Temporary
M. R. Ghasimi	
G. Grosche	
	E. Kiriwat
	L. E. N. Fernando
A. Kafka	
M. Massé	
	N. Toé, Temporary
Y. A. Nimatallah	
	D. Marcel
	G. P. J. Hogeweg
K. Yamazaki	S. Yoshikuni

L. Van Houtven, Secretary and Counsellor
M. Primorac, Assistant

Also Present
European Department: M. Russo, Director; M. Guitián, Deputy Director. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; T. Leddy, Deputy Director; J. P. Pujol, M. Shadman-Valavi. External Relations Department: D. M. Cheney. IMF Institute: O. B. Makalou. Legal Department: R. H. Munzberg, Deputy General Counsel; H. Elizalde. Middle Eastern Department: M. Zavadjil. Research Department: M. Goldstein, Deputy Director; P. Isard, D. J. Mathieson. Secretary's Department: C. Brachet, Deputy Secretary. Treasurer's Department: G. Laske, Treasurer; D. S. Batten, P. B. Clarke, D. Gupta, I.-S. Kim. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: M. Al-Jasser, M. B. Chatah, J.-L. Menda, P. O. Montórfano, A. Raza. Assistants to Executive Directors: J.-F. Cirelli, A. Fanna, J. Gold, S. Gurumurthi, A. Hashim, Hon C.-W., L. Hubloue, M. E. F. Jones, K.-H. Kleine, C. Y. Legg, R. Marino.

1. INTERNATIONAL LIQUIDITY, SYSTEMIC ROLE OF SDR, AND SDR ALLOCATIONS - FURTHER CONSIDERATIONS

The Executive Directors considered a staff paper on further considerations relating to international liquidity, the systemic role of the SDR, and the question of an SDR allocation (SM/89/158, 8/2/89). They also had before them a paper on the use of SDRs in foreign exchange market intervention (SM/89/164, 8/9/89).

Mr. Kafka made the following statement:

The paper before us considers various aspects that may be relevant to the question of a resumption of SDR allocations. It concentrates on the contribution that an increased volume of SDRs could make to the functioning of the international monetary system, specifically in two respects: better coordination of the policies of major countries, and improvement of the adjustment process, particularly in indebted developing countries. This approach to determining potential need to supplement existing reserve assets is entirely reasonable. The need for reserve supplementation is a subtle and multifaceted concept, and Article XVIII, Section 1(a) in fact refers implicitly to the allocation or cancellation of SDRs in terms of the improvement of the functioning of the international monetary system.

Turning now to the role of the SDR in strengthening the surveillance and policy coordination process and thereby improving the functioning of the international monetary system, the question is posed in the paper whether the SDR, if it were to become the principal reserve asset of the international monetary system, would contribute to increasing discipline as well as symmetry between relative shares of reserve currencies in financial portfolios; and in this connection the paper examines whether increased symmetry would be helpful to the functioning of the system.

One question is whether increased discipline could be achieved by the establishment of substitution accounts and asset settlement mechanisms. This was an idea that died as soon as it was proposed, for several reasons. It was obvious that an asset settlement system could not be introduced without the establishment, simultaneously, of a substitution account (or some other mechanism) that would relieve the world of the dollar overhang. It is unlikely that the reduction of the relative importance of the dollar in international reserves since 1980 has been sufficient to allow an asset settlement system to be brought about without the creation of a substitution account or some other mechanism to deal with the dollar overhang. If the creation of a substitution account or other, equivalent, mechanisms were found to be necessary even today, the same problem that existed in 1980 would reappear: the question of who should be responsible for any exchange losses that the account might suffer as a result of the fluctuation in terms of the SDR of the value of the currencies paid into it, which would constitute the account's liabilities. It should be said at once, however, that the reason why an asset settlement system may still be rejected today, as it was in the past, may be far more basic than the problem of the potential exchange losses of a substitution account--although the paper hints, mysteriously, that this problem could be solved more easily today than in 1980--namely, the desire of the major countries to escape discipline.

The paper also analyzes other ways in which discipline over economic policies could be strengthened through increased surveillance and policy coordination among the major countries, in the absence of an asset settlement system with or without a substitution account. This would imply greater symmetry for reserve centers and other countries in terms of the international currency system. It would also mean a less mechanical discipline than under an asset settlement system. It is conceivable that a loose kind of discipline might be acceptable where the mechanical kind of discipline inherent in an asset settlement system might not.

Two proposals are discussed to strengthen discipline with the help of increased coordination of policies and surveillance through an increased availability of SDRs. The first one is Mr. de Groote's proposal to form an SDR pool through additional SDR allocations, to be used to make possible massive interventions, which would make it possible in turn to maintain exchange rates within ranges considered acceptable by the international community. Insofar as increased exchange market intervention is considered useful, one cannot object to the SDR pool idea. One question is what kind of discipline even massive intervention could bring about.

An SDR pool is, of course, by no means the only way in which massive intervention could be brought about. A host of legal and other questions would have to be answered before an SDR pool could be established. One of these questions, which is adumbrated in the staff paper, is the possibility of making pool resources available to any member country only conditionally in order to avoid replacing necessary adjustment by large scale intervention. Obviously, conditional use of the pool would have to be agreed for a lengthy period before the need for use of the pool arose. Another question that the pool idea raises is that of a member country's monetary autonomy if pool resources could be used to acquire its currency without its consent.

The second idea, to use increased availability of SDRs to increase discipline among the major countries, would be a two-stage allocation process with the first stage decided as at present, while the actual delivery of SDRs to each member country would be made dependent on an assessment by the Executive Board of the country's policies. Such a process would be clumsy in the extreme. For a lengthy period, after the first stage of the allocation process had been completed, the Board would have to devote itself to the discussion of the policies of each one of its members. After the end of this period of examination, conditions in those countries that had been discussed at the beginning of the period could well have changed so as to lead to a different judgment on whether the country was entitled to receive its allocations. Alternatively, different countries would have to receive their allocations at different times, which could hardly be acceptable to those that had been made to wait. Finally, while the major countries would necessarily be careful not to deny each other an allocation, because of possible retaliation, the smaller countries, including all the developing countries, could very well be treated with a degree of "objectivity" that in the circumstances could be, and would indeed be, likely to be violently discriminatory. This whole idea should be discarded.

The paper examines under the same heading the possibilities by which a wider market for SDR-denominated instruments could be developed. It is suggested, though it is not stated explicitly, that such a market could be developed through increasing the stock of SDR-denominated private financial instruments. If a certain threshold is passed, transactions in private SDRs would presumably facilitate and make more attractive the use of the official SDR. Further, presumably increased usefulness of the official SDR would increase potential demand for it. In this way, a greater readiness would be created in the international financial community to accept increased allocations of official SDRs and use them as well as "private" SDRs for interventions. But such a development would still be pointless insofar as major countries do not want more discipline, even if it were not of the mechanical kind inherent in an asset settlement system.

The paper then takes up the use of the SDR to promote growth-oriented adjustment, indicating that adjustment programs can be damaged by lack of liquidity. Moreover, it shows that access to liquidity, taking owned and borrowed liquidity together, may be maldistributed to the detriment of developing countries with debt-service problems. The question of distribution of owned liquidity is discussed exclusively in terms of non-gold reserves. While the usability of gold reserves is not as clearly established as that of non-gold reserves, gold reserves at anywhere near current prices would still add an enormous amount of owned liquidity to that presently available to major country groups. The principal beneficiaries in relative terms would be the group of oil exporting countries and developed countries as a whole. However, no figures are given for the distribution of gold holdings for countries with or without debt-service problems, and it might be interesting at some point to look at that.

The question is asked whether increased allocations of SDRs could help to remedy this situation and what mechanism should be used to avoid discouraging abuse of the additional allocations; the paper rightly states that such abuse is in any case unlikely. If increased allocations were to be used to provide liquidity to countries presently not having an appropriate access to liquidity, the paper establishes three general conditions: a case-by-case approach, strong adjustment programs, and avoidance of replacing credit from private entities by official SDRs. These conditions raise a very serious question, for they would amount to transforming the SDR, in part at least, into a form of conditional liquidity. Moreover, we cannot know whether such a partial transformation would not lead to additional restrictions on the unconditional use of SDRs allocated according to the Articles of Agreement such as, for example, a very high reconstitution requirement. With these doubts, let us examine the various mechanisms discussed in the paper for the purpose of making increased allocations available to countries meeting the three general conditions for receiving discretionary additions to allocated SDRs.

There are three proposals. First, the de Groote proposal, under which some countries would transfer--in an appropriate fashion--some of the SDRs allocated to them by the Fund, which would use them to reinforce the liquidity of other countries meeting the three general conditions. Another proposal, made by Mr. de Maulde, would have each country that was prepared to do so lend SDRs directly to other countries desiring to borrow them, but subject to an appraisal by the Executive Board of the Fund. The third proposal, Mr. Sengupta's, would transfer the SDRs without any conditionality but subject to an appropriate reconstitution requirement. Apart from the general criticism voiced earlier, we might wish to ask why the same reinforcement of reserves could not be achieved by member countries borrowing from the Fund and the Fund obtaining additional resources through quota increases, instead of additional allocations of SDRs. This alternative is least relevant to the Sengupta proposal, but in the other two cases, a very artificial attempt is made to create a reason for allocating SDRs.

Another set of proposals for increased use of the SDR has been made: to finance set-asides that could be used for debt or debt-service reduction. Two proposals are discussed. The French proposal, first voiced by President Mitterrand, was for an allocation from which the share of the industrial countries would be set aside for the purposes mentioned. The maximum allocation discussed in the paper--that is, one necessary to bring the volume of SDRs up to the same proportion of non-gold reserves as existed at the end of the first basic period--would at most, if used for collateralizing interest payments, permit a 24 percent reduction, which is even less than the amount saved by Mexico under its recent agreement. The proposal of the Institute of International Finance (IIF) would be even more modest as it would merely double present allocations and permit them to be used to collateralize the issue of new debt in substitution of present debt.

Of the proposals made, that for the two-stage allocation process is important and the others, except Mr. Sengupta's, are in different degrees potentially harmful to the functioning of the international monetary system, and some of them are highly artificial. None of them are likely to come near making a substantial impact on the system or on the system's most important problem: the debt overhang. Irrespective of the extent to which new allocations could be helpful in improving the system, the mere advisability of maintaining SDRs in existence would argue for at least modest allocations. It is also clear that liquidity is presently maldistributed in relation to need, and that a post-allocation redistribution, at least of the Sengupta kind, could be helpful.

Mr. Templeman made the following statement:

The issues raised in the staff paper have been discussed on a number of occasions over past months and years. Today, I would like simply to review briefly my authorities' views on these issues.

The emergence of greater equality in the relative economic size of a number of major economies has had clear implications for the operation of the international monetary system. This basic reality lies at the very heart of the economic policy coordination process and underlies the recognition that the responsibility for external adjustment is shared by deficit and surplus countries alike. My authorities regard policy coordination as the key to a growing and financially stable world economy. Achievement of this fundamental objective is, in turn, the best assurance of a necessary degree of stability in exchange markets. Such exchange rate stability can, in turn, exert some discipline over national economic policy, but the main causal relationship must work in the opposite direction. Of course, members of currency areas are free to adopt relatively more fixed exchange rate relationships with correspondingly greater external discipline, if they so choose.

In this context, it is not very clear to us that the SDR has a significant role to play in contributing to strengthened multilateral surveillance. The staff paper states on page 8 that "the present international monetary system does not exert adequate discipline over reserve currency countries." And, it is suggested that the SDR might play a role to instill greater discipline and to foster greater symmetry and portfolio diversification. With regard to discipline, my authorities believe that the most appropriate and effective way for member countries to encourage one another to take into account the international effects of their policies is through peer pressure exercised through international economic policy coordination and through Fund surveillance. As to symmetry and portfolio diversification, the development of the policy coordination process itself provides evidence of greater symmetry, and the evolution of a multiple reserve currency system and of portfolio diversification through market mechanisms does not point toward a need to use the SDR for these purposes.

In addition, my authorities do not share the view that the United States, as a reserve currency country, receives exorbitant benefits from the international role of the dollar. We would acknowledge that the United States can finance its external deficits in its own currency, whereas most others cannot. This does lessen the exchange risks faced by the United States. But the dollar itself and dollar-denominated instruments must compete in world markets. Neither official nor private holders are obliged to accept dollars. The dollar's reserve currency status was not bestowed from above, but evolved to reflect the strength and size of the U.S. economy and the depth and resilience of U.S. capital markets. Indeed, if the benefits from the dollar's reserve currency status are really so one-sided, one must wonder why other countries have not worked harder to carve out a greater reserve role for their own currencies. The answer may well be that the dollar's reserve currency status has in some ways circumscribed U.S. policy independence, in particular monetary and exchange rate policy. For example, despite the staff's suggestion on page 9 that other central banks have acquired dollars as part of an "accommodating behavioral pattern to promote exchange rate stability," it must be observed that a concurrent rationale could have been the desire to avoid dollar depreciation against their currencies.

Also, the paper leaves one with the impression that, despite the problems cited on pages 8 and 9, the staff views with some sympathy mechanisms that impose external discipline on reserve currency countries, such as substitution accounts and asset settlements. We would note, however, that some years ago when these ideas were being explored, it became apparent that all participants in the international monetary system had a stake in the system and should share responsibility, including associated risks such as exchange rate risks from substitution accounts and asset settlement mechanisms. In any case, the staff's preference for exerting discipline over reserve currency countries seems to lead it in the direction of the two proposals for using SDRs that are aimed at imposing discipline through surveillance.

Regarding these proposals, first, we believe that existing resources and arrangements in place to conduct intervention operations are adequate and consistent with our desire to foster greater stability of exchange rates. The Belgian proposal would seem to create an artificial intermediary role for the SDR--one that could already be achieved on the basis of existing voluntary arrangements--in a manner that simply alters the exchange risks among the major countries. Second, as the staff suggests, pooling of SDRs for intervention purposes could delay adoption of policy adjustments, including exchange rate adjustments in some cases. Third, with regard to the two-stage allocation proposal, one might ask whether the withholding of SDR allocations from member countries, including reserve currency countries that are already large net holders of SDRs, might not undermine the monetary character of the SDR, and whether this approach might not further complicate reaching any agreement on SDR allocations themselves.

My authorities have no problems with the natural evolution of the private market in SDRs. But, given our skepticism about the scope for using the SDR as a means of strengthening surveillance and the international monetary system, the utility of active official promotion of the SDR is not evident. More specifically, it is not likely that the Treasury Department would find attractive the idea of issuing SDR-denominated securities. However, we would be interested in the staff's views as to why the SDR has not apparently attracted the interest of traders and investors.

Regarding the role of the SDR in promoting growth-oriented adjustment, let me simply reiterate some of my authorities' long-standing views. We recognize that the behavior of private financial markets has not been without problems, as we have often discussed in our reviews of the debt strategy. Nevertheless, we continue to believe that for many developing countries, the lack of access to international capital markets reflects not the imperfections of the private markets but the loss of creditworthiness. The use of the SDR, which is an unconditional source of liquidity, to address those countries' financing problems could undermine the fundamental monetary character of the SDR.

The staff paper also reviews many of the post-allocation proposals that we have discussed in recent years, which are aimed at attaching a degree of policy conditionality to SDR use. This idea, while responding to one objection, raises others.

Notably, it raises the question of why Fund-supported adjustment programs should be financed by SDR creation, instead of from quota-based resources. Currently, the Fund is in a very strong liquidity position, its access policy is generous, it has created the structural and enhanced structural adjustment facilities and the compensatory and contingency financing facility, it has adapted its financing to strengthen the debt strategy, and it is now conducting a quota review. Therefore, we see no need to use the SDR in a way that would circumvent, or even undermine, the quota-based nature of the Fund.

Lastly, let me turn to the quantitative section on SDRs. Table 5 of the staff paper suggests that international reserves have risen and that current ratios of non-gold reserves to imports are consistent with the historical averages for all categories of countries, except the developing countries with recent debt-servicing problems. In passing, I would note the absence of the usual column of data for developing countries without recent debt-servicing problems. We believe that such data are useful in providing a balanced view of the situation.

As my authorities have repeatedly emphasized, these data are not conclusive in and of themselves. Indeed, the staff points to the anomaly that countries with limited access to credit may actually have, or at least aim for, higher reserves than those with ready access. In any case, the data do not, in my authorities' view, satisfy the criterion that there exists a long-term global need to supplement existing reserve assets.

Mr. Prader made the following statement:

The staff paper provides us with various data on the international demand for reserves and liquidity to illustrate what the impact of an SDR allocation on the reserve holdings would be, but not to demonstrate that there is a global need to supplement the existing stock of reserves with a new allocation. Such an attempt would indeed have been futile since it is now widely acknowledged that the need for reserve supplementation cannot be demonstrated in purely quantitative terms. The discussion on the global need requirement is therefore correctly held within the framework of the systemic functions that reserves are supposed to fulfill and submits the question whether an expansion of the SDR would lead to a better performance of the present payments system. Any positive conclusion that emerges from this discussion should invite us to give serious consideration to the possibility of a new allocation decision. To our constituency, the validity of such a decision has long since been established and the staff once again adequately summarizes all arguments on which the large consensus needed for an allocation decision could in good faith be based.

Let me briefly comment on some of the proposals that have recently been submitted to promote a better understanding on the potential contribution of an SDR allocation to the present system.

On the role of the SDR in strengthening surveillance and policy coordination, the staff correctly concludes on page 9 of the staff paper that it would probably be against the mainstream to reinforce the discipline and symmetry of the present system by imposing rigid solutions such as substitution or asset settlement. This preoccupation also underlied Mr. de Groote's proposal at EBM/89/28 (3/3/89) on the creation of a pool of SDR holdings that countries could mobilize for financing coordinated exchange market interventions. The basic raison d'être of this proposal is to facilitate and support the discipline that is already increasingly obtained from the present system's reliance on policy coordination and closer exchange rate cooperation. This would be fully in line with ongoing developments in countries' exchange rate policies and the management of SDR holdings, because intervention is already increasingly used by the major industrial countries as a valuable tool for supporting their stabilization efforts and because voluntary arrangements have replaced designation as the principal mechanism for transferring SDR holdings among participants. Moreover, the companion paper (SM/89/164, 8/9/89) makes it clear that voluntary arrangements would surmount most of the objections that might be raised against financing interventions with SDRs mobilized through designation. In sum, the proposal combines a number of aspects of countries' reserve management practices that are already well established and, by assigning the Fund a central role in the operation of the proposed scheme, aims at reinforcing the functioning of the reserve system as a whole.

In response to the staff's preoccupation with the appropriate use of intervention resources mobilized under the scheme, let me make the following preliminary remarks, to which we might return in more detail on a future occasion. First, it can be expected that the existence of a pool of intervention resources of sufficient size will improve the markets' perception that the authorities will successfully offset undesirable exchange rate developments, so that capital flows will mostly act in a stabilizing way and therefore reduce the need for intervention or other offsetting measures. The risk of recurrent policy conflicts between external and internal stabilization objectives will thus be reduced and the available arsenal of monetary instruments will be more freely usable for internal stabilization purposes. From this point of view, it can thus be expected that the establishment of an SDR pool for intervention purposes should encourage rather than discourage sound policy implementation.

Second, I would submit that the issuance of SDR liabilities and SDR claims whenever the resources of the pool are mobilized will place the participating countries in a better position to discuss appropriate corrective actions if the imbalances created in the pool are not reversed within a reasonable period of time. Whether automatic triggers for the implementation of such actions should be established from the outset can be discussed at a later stage. In any case, it may be expected that the change of SDR positions in the pool will already of itself stimulate the discussion on corrective policies because it will be easier to isolate exchange rate disturbances that are not reversible from those that have a purely reversible character and because the persistence of certain imbalances in SDR positions will over time create the expectation that actions will be taken to eliminate those imbalances.

Third, by providing the Fund with an appropriate instrument to support the largest countries' stabilization efforts with intervention means of sufficient size, the validity and force of the Fund's recommendations on desirable exchange rate policies would be enhanced. Whether these recommendations should take the form of a new type of conditionality, as suggested by the staff, is not certain. A better avenue might be to explore the possibility of linking activation of the pool to the exercise of the Fund's surveillance activities. This linkage, which is already suggested by the staff in connection with countries' actual receipt of their allocation, could in my view usefully be applied to the situation of countries seeking SDR funding for their intervention needs.

While the Articles of Agreement of the Fund do not seem to pose any major obstacles to an expansion of the SDR for financing exchange market intervention, serious limitations impede the use of the SDR as a vehicle for effectively intervening in the markets. The first difficulty that stems from the limitations on the entities entitled to hold official SDRs does not seem insuperable: the Coats 1/ and Polak schemes both indicate that mechanisms can be put in place to circumvent these limitations by using official SDRs to back up the issuance of private SDR instruments. The other two difficulties, namely, the limited effectiveness of the SDR in interventions among G-5 countries and the limited interest so far shown by the private markets for SDR instruments in general, are more serious. The staff submits a number of useful steps that could be taken by public sector institutions to promote the creation of a private SDR market in ways similar to those that led to the expansion of the private ECU market.

1/ W. Coats, "The SDR as a Means of Payment," IMF Staff Papers, Vol. 29, No. 3, 1982.

Apart from the fact that such steps would probably already have been taken by the market participants, whether public or private, if they had been perceived as serving their interests, I have two more general questions in mind on which the staff might wish to comment. First, is the expansion of the private use of the SDR a necessary condition for the sound development of the official SDR or can the official SDR be successfully promoted without taking parallel steps to improve its attractiveness as a private asset? Second, should the Articles' objective of making the SDR the principal reserve asset be understood in quantitative terms, implying that we should try to expand the use of the SDR by all means, or should we understand it to be a qualitative statement, inviting us to use the SDR for the reinforcement of a reserve system that will continue to be predominantly based on currency assets?

I have two brief comments on the role of the SDR in promoting growth-oriented adjustment. On page 15 of the staff paper, the staff mentions the importance of countries' access to appropriate reserves and liquidity in order to protect their adjustment against unanticipated payments shocks. I would propose that we keep this notion under close consideration whenever we discuss the potential role of the SDR in the debt strategy. Its validity has been illustrated only recently when, during the initial negotiations on the Mexican financing package, the banks seemed reluctant to make available new loans that Mexico would partly use to replenish its official reserves in order to better protect the country's adjustment against oil price fluctuations. The possibility that the banks may no longer consider it within the realm of their activities to supply liquidity for countries' legitimate reserve needs considerably reinforces, in my view, the argument for a new allocation.

Finally, on the role of the SDR in supporting debt reduction operations, the question arises whether these proposals are still relevant now that the Fund has decided to commit its general resources to support such operations more actively. On the basis of last Friday's discussion on the debt strategy (EBM/89/110, 8/25/89), I would respond positively to this question. Already now it should be clear that a first round of debt reductions may not suffice to grant debtor countries payment relief of sufficient size and duration to make an early return to the markets possible. Additional initiatives might in due time have to be taken into consideration. These could include a second round of negotiations to collateralize debts that have so far not been converted, or to obtain additional concessions on debts that have already been partly collateralized on the first occasion or even the initial enhancement of the new bank loans, which should replace the reliance on exceptional financing techniques once a sufficient reduction in the debt overhang has been obtained. The redistribution principle that underlies most of the proposals aimed at enhancing the role of the SDR in the growth-oriented debt strategy remains, in our view, entirely relevant in case the need for such initiatives should arise.

Extending his remarks, Mr. Prader said that he would welcome further comment by Mr. Kafka on his objection to Mr. de Groote's proposal because it would require guarantees. If it was industrial countries that would be primarily using SDRs for intervention purposes, he did not consider that guarantees would be needed. And if industrial countries would be willing to give guarantees for debt enhancement schemes, they should also be willing to do so for intervention purposes.

Mr. Kafka clarified that he had no objection to Mr. de Groote's first proposal to establish an SDR pool, but he did have a problem with making pooled resources available only conditionally. On the question of guarantees, he considered that conditionality would create a problem in that if the pool was to be useful, its potential users had to have a guarantee that they could use that pool without conditionality.

Mr. Prader welcomed Mr. Kafka's explanation. He added that it was surprising that the U.S. reaction to Mr. de Groote's proposals had not been more positive, since the United States would have been among the candidates to benefit from potential beneficiaries of such a proposal.

On the role of the SDR in promoting growth-oriented adjustment, the staff mentioned on page 15 of the paper the importance of countries having access to appropriate reserves and liquidity in order to protect their adjustment against unanticipated payment shocks, Mr. Prader noted. He would propose that that notion be kept under close consideration whenever the Board discussed the potential role of the SDR in the debt strategy.

Finally, on proposals that the SDR be used to support debt reduction operations, Mr. Prader commented that the mere fact that the Fund had decided to commit its general resources to support such operations did not imply that such proposals had become obsolete. Recent developments had shown that the need would become even stronger, and he considered that Mr. de Groote's proposal and the Mitterrand proposal, as well as others, were not mutually exclusive but complementary.

Mr. Kiriwat made the following statement:

I welcome this opportunity to review the adequacy of international liquidity and the role of the SDR, as well as to discuss once again the allocation of SDRs, before the Interim Committee meets next month.

Before the evolution of a more fully developed market for privately issued SDRs, I believe it is premature to talk about using SDRs as a vehicle for intervention. Furthermore, I tend to agree with the staff that the use of SDRs for intervention would not be effective in meeting the exchange rate objectives of the G-5 countries. The role of the SDR in the foreign exchange market would, therefore, remain principally as a means of financing intervention. In this regard, I tend to support Mr. de Groote's proposal to create a pool of existing SDRs that can be lent to countries wishing to finance intervention. I would therefore call for a further study of this suggestion and a careful examination of its legal and operational issues. I believe the plan would eventually serve the diversification needs of most countries, and also contribute to, and enhance, the Fund's surveillance role.

This chair has always supported this institution's endeavor to make the SDR a principal reserve asset, and we therefore welcome the measures proposed by the staff to encourage a further development of the private SDR market. For the market to reach a critical mass and take off on its own, I believe the Fund and relevant official authorities have to exert more effort than they have in the past. While the sharp contraction of the private SDR market in the early 1980s can be attributed to many factors, it was also due in part to the lack of enthusiasm by the relevant authorities. The proposals to establish a clearing house mechanism and for the issuance of SDR certificates by official authorities and public sectors backed by official SDRs seem promising to me.

The staff has examined in much detail the possible role of the SDR in the Fund's management of the debt situation. Such a discussion should be held in the context of discussing the debt strategy rather than in the present setting of considering an allocation of SDRs. The proper focus for the evaluation of an allocation of SDRs should be the need for additional and supplemental reserves by the developing countries, including the 15 heavily indebted countries facing servicing problems, as well as other developing countries that have so far avoided servicing problems. In any event, the amount that the 15 heavily indebted developing countries are supposed to receive under a normal allocation plan would be too little to have any significant effect on their reserve position.

In order for the SDR to be a useful component of the debt strategy, the Mitterrand proposal has to be invoked. I believe this proposal is one of the least costly and most politically palatable options that the industrial countries have for directly channeling their resources to help the heavily indebted countries. Although I welcome and support the Mitterrand proposal, I would like to see its discussion deferred until, or held in conjunction with, the consideration of the debt strategy, so as not to complicate the issue and divert attention from the important discussion of a renewed allocation of SDRs to all countries. In this connection, I would like to reiterate my belief that there is a strong and legitimate case for providing additional resources to augment the reserve positions of all developing countries. This argument is confirmed by the data in the staff paper indicating that the variability in the reserve position of developing countries has risen without a commensurate increase in the ratio of non-gold reserve to imports. I would, therefore, urge the Board once again to give its careful consideration to a substantial allocation of SDRs in the current basic period.

Mr. Massé made the following statement:

The Board has previously discussed issues relating to the role of the SDR and international liquidity at some length. The position of my Canadian authorities has not changed much during that period. On the whole, they do not find the arguments in favor of a new allocation of SDRs compelling. However, as on previous occasions, the other members of our constituency continue to take a more favorable view on the issue.

In the paper, the staff summarizes the many complexities involved in measuring international liquidity and concludes that it would be difficult to determine whether there is a need for a further distribution of SDRs on the basis of global need. The staff reviews a range of other considerations that might warrant a further allocation, primarily the role that the SDR could play in policy coordination and surveillance; in easing the maldistribution of international liquidity; and in promoting growth-oriented adjustment. In the view of my Canadian authorities, these arguments do not yet justify a further allocation.

With regard to the role of the SDR in policy coordination and surveillance, my Canadian authorities feel that the potential for an effective role is limited for the time being. As noted in the paper, a move to an international monetary system based on the SDR rather than individual currencies would not necessarily exert much additional discipline: the reserve currency countries would not be constrained from running large fiscal deficits or international payments imbalances. Also as noted, other difficulties arise with respect to substitution accounts and asset settlement mechanisms.

With respect to the de Groote proposal that a mechanism could be developed through which countries could mobilize their official SDRs for exchange market intervention, we note the similarities with the ECU in the EMS. While such a mechanism may be useful, it is not clear that there is yet much of a demand for it. As noted in the paper on the use of SDRs in foreign exchange market intervention (SM/89/164, 8/9/89), countries may already sell SDRs for reserve currencies (by agreement) in order to finance intervention. Although a de Groote-type facility might make the process more efficient, it should be noted that the creation of such a mechanism is not contingent on an SDR allocation.

The two-stage allocation process, whereby a country's receipt of its allocation would be subject to Executive Board surveillance, is of some value, but perhaps somewhat limited. Any individual country allocation would likely be small and thereby provide only a relatively minor incentive to adopt appropriate policies. Moreover, in the case of countries that have access to credit markets, it is difficult to see why an SDR allocation would be much of an incentive. On the other hand, in the case of countries with limited or no access to credit markets, an SDR allocation could provide some inducement for countries that would in any case undertake adjustment programs, but it is not likely to be much of an incentive for countries that have thus far been reluctant to adopt appropriate policies.

The staff states that large-scale use and holding of SDR-denominated instruments by private entities would greatly facilitate making the SDR the principal reserve asset. To that end, the staff suggests that public sectors and official institutions take the first step by issuing SDR-denominated debt in order to help catalyze private financial intermediaries to resume dealing in SDR-denominated instruments. However, as we know, public sectors and official institutions have refrained from so doing up to now, and we wonder how they would be incited to do much more. This is additional evidence that there is little demand for such instruments in the market.

With regard to the maldistribution of liquidity, we are not sure that the suggested approach is appropriate. The poor distribution reflects the fact that certain countries have limited, if any, access to capital markets. This is arguably a result of inappropriate domestic economic policies, which in most cases is a sign that markets are working as they should, rather than a sign of market failures as implied by the staff paper. In our view, this problem is best tackled through the use of conditional liquidity in support of adjustment rather than through an increase of nonconditional SDRs in global liquidity. In some cases--but very few, only one or two come to mind--we would have to agree that there has existed a problem of contagion, reflecting some market imperfections.

With respect to the role of SDRs in growth-oriented adjustment, we continue to have a number of reservations about schemes that link SDR allocations with the debt strategy. The use of SDRs does not represent a costless way in which to address the debt crisis, but in effect represents a transfer of risk from the private to the public sector. Moreover, given that the Brady plan is still in its early stages, it would perhaps not be appropriate at this time to increase the resources available to finance debt and debt-service reduction. This might well only encourage banks and countries to hold out for still greater resources and delay debt reduction negotiations. Finally, it has still not been demonstrated that there are any inherent advantages to using SDRs in such schemes--although one not inconsiderable advantage may be that it obscures from the general public in creditor countries the fact that it is also bearing the actual or contingent cost of any post-allocative redistribution of SDRs for debt purposes.

With regard to the paper on the use of SDRs in intervention, we generally concur with the staff's approach of distinguishing between the use of SDRs as the vehicle for intervention and the use of SDRs in financing intervention. We also concur, for the most part, with the conclusions drawn. In particular, we agree that in order for the SDR to be used as a vehicle for intervention, there must be a sufficiently deep and broad private market for SDRs. However, notwithstanding the fact that the Articles of Agreement envisage the official SDR becoming the principal reserve asset, an objective which has perhaps less immediate relevance in today's world, we see little merit in forcing the development of a market for private SDRs. While we grant that there may be a bit of a "chicken or egg" problem, the fact remains that there is at present very little demand for SDR-denominated assets. Moreover, there is little apparent need to use SDRs as a vehicle for intervention. It has not been demonstrated how exchange market intervention would be improved through the use of SDRs.

To conclude, I would note that considerations that influence a decision to make new allocations of SDRs evolve only gradually. Consequently, we would suggest that there be fewer reviews of the question of SDRs until there is a more receptive view for a change in present positions.

Mr. Fernández Ordóñez made the following statement:

On the question of regular allocation of SDRs during the Fifth Basic Period, which of all the decisions that we should take is the most overdue, the studies on international liquidity prove that there is no evidence of a general reserve or liquidity shortage. However, the same studies serve to prove that neither is there evidence of a general reserve or liquidity excess. Nobody can say that an allocation of SDRs will increase international liquidity. If international liquidity is demand determined, an allocation of SDRs could change only the composition of that liquidity. An allocation of SDRs will increase the weight of "multilateral liquidity" versus "nonmultilateral liquidity" within total liquidity. This means that we cannot avoid adopting a political decision: that is, the weight we want assigned to multilateral instruments within international liquidity.

Multilateralism is a delicate plant that grows rapidly in the aftermath of crisis. This is a historical law, and we are not going to change it. We are not now in a crisis or at least there is no sensation at all of crisis. We cannot pretend today to be advancing toward making the SDR, a multilateral instrument, the principal reserve asset in the international monetary system. This is too ambitious an objective for this period. We have to be more pragmatic and modest in our objectives and, as Mr. Kafka says: "allocations should be maintained annually in order not to destroy the SDR machinery prematurely." What we can do, and we should do, is to water regularly this delicate plant, to keep it alive. With a regular allocation, we will not make the SDR the principal reserve asset, but we will avoid a progressive deterioration of the role of the SDR as an international asset.

During these discussions, some have taken what I would call a short-term perspective on the question of an SDR allocation. It seems as if they want to assign an anticyclical purpose to the allocation of SDRs, implying that "if you convince me that there is need for liquidity, I would agree to approve an allocation." But the SDR was born with a more structural purpose, and we should therefore avoid "fine-tuning" the allocation of SDRs. We could discuss the adequate rate of increase of the stock of SDRs, but we should maintain a long-term approach that is constant in the face of the current cyclical situation.

The staff paper deals again with the interesting issue of what we could do to increase discipline in reserve currency countries. The first thing that we should clarify is, as has been suggested many times, whether the lack of discipline in certain countries is explained by their national currencies' being reserve currencies. I do not see clearly the evidence to support this theory. Lack of financial discipline is not a rule in reserve currency countries, but rather the opposite is true. Lack of discipline can also be found in a number of nonreserve currency countries. This point is important because if being a reserve currency country is not the cause of the lack of discipline, progress toward a system based on a multilateral asset is not going to solve the problem, as the staff says.

But the fact that an international monetary system having the SDR as the principal reserve asset would not discipline some countries should not be used as an argument against this kind of system. To be a member of the Fund is not a guarantee that one adopts appropriate economic policies. The Fund can exert adequate discipline neither on reserve currency countries nor on the rest of the membership, as we can see every day. But this is not an argument against the Fund. In this sense, the paper seems to close very early the dossier on substitution accounts and asset reserve mechanisms, which I am not sure that we should do now. One of the arguments against the SDR is that its allocation gives countries a kind of windfall profit. This claim has led to the study of a number of formulas, like the two-stage allocation process, which are directed toward rewarding the adoption of appropriate policies.

The sounder sources of reserves are those that come from current account adjustment. They are the consequence of an effort made by countries that adopt appropriate policies, with reserves or liquidity increasing automatically in the absence of any external decision. The problem with regular allocations is that reserves then increase without any effort on the part of the country, while other allocation formulas increase reserves based on a judgment about the country's efforts. That is why we should continue to look for formulas in which the increase in the stock of SDRs is produced automatically and is related to the efforts of each country.

We support the idea of experimenting with some of the many suggestions made in the paper for increasing the use and holdings of SDR-denominated instruments by private entities, and for enhancing the use of official SDRs. Some proposals, such as Mr. de Groote's second proposal, would need a more thorough study of their operational and legal requirements. Others are relatively easy to adopt, like encouraging public sector and official entities to create SDR-denominated instruments, not to mention what our sister institution, the World Bank, should do in this connection.

It has been said that there is no private demand for SDR-denominated instruments and that it would not be wise to try to artificially increase that demand. My feeling is that there is not a problem of demand for SDR-denominated instruments, but rather a problem of lack of demand in this Board for enhancing demand for SDR-denominated instruments.

I will now comment on the potential role of the SDR in the debt strategy and, in particular, on the Mitterrand proposal. I want to clarify, however, that we do not consider this to be an alternative to regular allocations, but rather, another proposal worth studying.

Since our last Board discussion on the role of the SDR (EBM/89/29, 3/6/89), many important developments have taken place that could allow us to have a fresh look at these new ways of using the SDR. If I understood well, the main opposition at that time to the Mitterrand proposal was that it could go against the "monetary character" of the SDR. But since then, we have approved a debt strategy that permits the use of resources of the General Resources Account for debt and debt reduction operations. It is true that some members, before and even during the Interim Committee meetings, raised the issue of the monetary character of the General Resources Account as an argument against using such resources for debt and debt reduction operations. But our debt strategy has been decided unanimously and we all agree now that the monetary character of that Account's resources has not been affected. Consequently, if we apply the same requirements to the use of SDRs to guarantee debt and debt reduction operations that we apply to the General Resources Account, we cannot say now that this goes against the monetary character of the SDR.

Another argument was that such use of SDRs would increase international liquidity, which I doubt, because this case is similar to the use of the resources of the General Resources Account. But let us suppose that it would do so. I would say that this would be a good source of international liquidity. It is better that international liquidity grows because a country applies a sound adjustment policy than that international liquidity increases because a reserve currency country does not apply appropriate policies and has public sector and trade deficits.

Finally, turning to the paper on the use of SDRs in foreign market intervention, the most important conclusion of the paper is that the operational constraints are minimal and that, nevertheless, the amount of SDRs available for intervention is crucial. This reinforces what was said about the importance of increasing the weight of SDRs in total international liquidity.

Second, the paper stresses the importance of the development of a market for private SDRs if we want the SDR to play a role in foreign market intervention. What is important is that when the question of the use of SDRs is seen from the point of view of only one concrete purpose--foreign market intervention--the prescriptions are more or less the same as when we made the general study.

Mr. Nimatallah made the following statement:

It seems that we have several objectives to realize: first, to make the SDR play a leading role; second, to secure adequate international liquidity to sustain growth without inflation; third, to secure adequate owned reserves for developing countries that have adopted good policies; and fourth, to enhance discipline in industrial countries to adopt appropriate policies instead of resorting to building up international reserves out of their national currencies.

The impression the staff paper gave me was that making the SDR the dominant reserve asset would realize all of these objectives, and in particular, would deprive the industrial countries of the privilege of using their national currencies as international reserves, enabling them to avoid adjustment. I am not sure that the SDR can do all of that, at least not in the near future.

I think that the role of the SDR can be improved gradually by improving private market demand for it. I am all for doing all that can be done to familiarize the private market with the SDR as early as possible.

The objective of securing adequate international liquidity to sustain growth without inflation is being realized satisfactorily through decontrolled capital markets.

The objective of securing adequate owned reserves for developing countries can be realized mainly by continued implementation of appropriate policies that will encourage not only the return of flight capital but also the inflow of foreign investment, spontaneous borrowing, and possibly even the resumption of modest allocations of SDRs.

The objective of enhancing discipline of industrial countries to adopt appropriate policies can be realized if these countries are aware of the threat of domestic and external imbalances in case of failure to adhere to fiscal discipline, and the threat of inflation if monetary policies are not targeted and flexible. In addition, industrial countries have to pay due regard to the supply side in the form of adequate savings, removal of various market rigidities, and, of course, the maintenance of orderly commodity markets. Fund surveillance and coordination in the Group of Seven are working rather well in improving the management of the economies of the industrial countries. It is true that the performance of the large industrial countries can be improved, but I am not sure that a dominant SDR would be the means, or even one of the means, for achieving that improvement.

As much as I wish that the SDR will some day become the major means of payment, I am realistic enough to realize that it is difficult for this wish to become true. However, it is clear to me that the SDR can play two helpful roles in the system. First, it can stand by as a safety net, and second, it can be used as an anchor for the system. The role of safety net might require some modest allocations from time to time, with the proviso that members have to agree to reconstitute their SDR reserves; and for the role of anchor, the SDR basket will have to be supported by an SDR price index, as I explained in my statement at EBM/89/28 (3/6/89).

Based on this conclusion, I believe that the SDR can play a modest role in intervention transactions, but that modest role can be gradually strengthened if private markets become more familiarized with the SDR through dealing in SDR-denominated instruments.

Finally, I am not yet sure that the two-stage allocation proposal would be helpful in securing discipline to sustain the implementation of appropriate policies, simply because this is halfhearted conditionality. I think that SDR allocations should involve either full-fledged conditionality or none at all. My experience with the inability of the Fund to convince its members in arrears to adopt desperately needed reforms has created doubt about the workability of the two-stage allocation proposal. But that does not mean that the proposal should not be kept alive; it should be kept under consideration in case conditional SDR redistributions or allocations become acceptable.

To sum up, we should concentrate on making the SDR more familiar to the private markets, thereby helping to encourage its modest official use in intervention transactions. In the meantime, Fund members may want to re-examine the possibility of introducing conditionality and reintroducing the reconstitution requirement. This might encourage modest allocations from time to time, thus keeping the SDR standing by as a safety net; at the same time, it would supply developing countries that adopt good policies with some unconditional reserves, of which they are sometimes badly in need.

Extending his remarks in response to a question from the Chairman, Mr. Nimatallah said that he considered that for the SDR to fulfill its role as safety net, it would have to grow somewhat. As it was, the SDR was shrinking in importance. The minimum objective would be to not kill the SDR, which had been created with great difficulty, but he would like to see more than that; he would welcome occasional modest allocations together with conditional reconstitution. Then, if members were one day convinced to accept proposals such as that of Mr. de Groote, there would be sufficient SDRs available to reduce the maldistribution. If, in the meantime, demand by the private sector increased, the allocations could be increased so that the supply of SDRs grew in tandem with the size of the world economy.

Mr. Marcel made the following statement:

The staff paper strikes us as a well-balanced piece of work that could set the stage for specific decisions aimed at strengthening the role of the SDR.

Given the potential role of the SDR in the economic surveillance and coordination process, we continue to support the idea that the SDR should become a key reserve instrument in the international monetary system in accordance with the Fund's Articles of Agreement. Thus, we share the view expressed at our last discussion on the SDR, in particular by Mr. Cassell, on the persistent risks involved in using a national currency as a primary reserve instrument in the international monetary system. We also share the staff's view that the current supply of SDRs is insufficient for countries wishing to diversify their reserves.

The staff paper mentions two proposals for reinforcing the role of the SDR in the economic surveillance and coordination process. Mr. de Groote's proposal calls for establishing a pool of SDR holdings to finance interventions on the exchange market. This proposal contains a number of interesting features; as the staff pointed out, there is a danger that the pool of resources could be used inappropriately to support interventions as a substitute for policy adjustment, which raises the problem of a conditionality being attached to this kind of operation. Such a scheme could also prove not easy to manage, if only for practical reasons. In any event, I can only stress that in my authorities' view, the present system of surveillance and intervention mechanism within the G-7 countries works well.

The second proposal consists of making a country's receipt of its SDR allocation conditional upon the judgment of the Board as to the country's economic policies. We wonder whether this implementation might not generate major conflicts between the Fund and the member country concerned, and even between member countries, if the Fund were to refuse to grant the SDR allocation.

We are interested in the ways and means suggested by the staff for promoting the use of SDR-denominated instruments: issuance of SDR claims by public institutions, and exchange market intervention using SDR-denominated instruments--although SM/89/164 does point out the limits of this latter option, and we encourage the staff to consider other specific proposals. We would like to emphasize, however, that these mechanisms cannot be fully effective unless the international financial community is clearly convinced of the determination of the Fund and its members to consolidate the role and the position of the SDR, particularly through regular SDR allocations. In much the same way, it is rather clear that sustained political determination has been a crucial factor in the success of the ECU.

We are still strongly in favor of an allocation of SDRs. The figures supplied by the staff clearly show that such an allocation is essential. We find it a clear anomaly that there has been no general allocation of SDRs since 1981, while the share of SDRs in total world non-gold reserves is no more than 4 percent. While it is probably very difficult to make any overall assessment of the adequacy of world liquidity for the needs of the economy, it appears rather obvious that the distribution of international liquidity is unsatisfactory. Since the beginning of the 1980s, some developing countries have been prevented from gaining spontaneous access to capital markets because of their high relative indebtedness. The reserves and reserve/import ratios of debt-burdened developing countries are continually shrinking. These countries are therefore facing a strong liquidity constraint, which could be deemed unrealistic if judged by the magnitude of the adjustments that the countries would in principle have had to make had specific arrangements not been made by their creditors. The compelling need faced by these countries to replenish their reserves forces them to increase their debt or to intensify their adjustment, with the risk of affecting the world economy through a reduction in imports. Furthermore, recourse to private capital markets raises the issue of the lender-of-last-resort responsibilities in the event of a financial crisis.

An allocation of SDRs could hardly be seen as promoting a new round of world inflation. In fact, inflation is down to historically moderate levels. In addition, an SDR allocation could in no sense be specifically inflationary insofar as the volume of liquidity to be injected into the world economy would not be comparable with the existing stock. Likewise, events and creditors of all kinds exert too much pressure today for a modest increase in reserves to undermine by itself the adjustment efforts undertaken by developing countries. On the contrary, this modest supplement would help turn the SDR into a useful "safety net" for contingencies.

We think therefore that an allocation of at least SDR 20-30 billion--a relatively modest sum--beginning in the Fifth Basic Period, as the Managing Director had requested last year, would be entirely appropriate. The coming months offer an opportunity that should be seized; otherwise, we may soon have to draw up a death certificate for the SDR and face the consequences.

Finally, we believe that the SDR can play a major role in the debt strategy without sacrificing its monetary character, provided that due regard is shown for the three principles set forth on page 19 of the staff paper. I will not dwell again on the main characteristics of the Mitterrand proposal. We continue to think that such a mechanism would facilitate the access of heavily indebted middle-income countries to financial packages providing for a reduction of external debt, without diminishing their share of responsibilities and efforts toward the debt strategy.

In response to a question from the Chairman, Mr. Marcel stressed that the Mitterrand proposal was still on the table.

Mr. Yamazaki made the following statement:

As this chair has stressed on previous occasions, changes in the international monetary system have made it necessary to redefine international liquidity and explore ways of measuring it. I welcome the staff's efforts in this connection, as evidenced by the various papers, including the one before us. At the same time, however, we think that to redefine and measure international liquidity would require a thorough review of the international financial situation and would not be an easy task. Furthermore, we should not jump to a premature conclusion solely to justify the new allocation of SDRs. With these remarks, I would like to comment briefly on each topic.

First, on the measurement of international liquidity, I fully agree with the staff's conclusion that it is not possible to come up with a single objective indicator for the total amount of international liquidity. Accordingly, any decision on international liquidity should be based upon a comprehensive, judgmental consideration, including various indirect approaches. That being said, I would also stress that such an approach should include sufficient quantitative analyses, with which the staff has not, up to now, provided us. For example, the staff rejects the proposal of using national monetary aggregates as a basis for constructing a measure of international liquidity, stressing the difference between national and international liquidity. While I fully recognize the difference between these two concepts of liquidity, I also consider the aggregate of money supply of convertible currencies a useful "first approximation" for broadly defined international liquidity, given the high degree of substitution among major convertible currencies, as well as the need to include the borrowing ability of the monetary authorities in international liquidity. At any rate, we encourage the staff to provide us with a number of time series data, which could be used as a proxy for international liquidity as a first necessary step toward establishment of a new definition of international liquidity.

Next, concerning the role of the SDR in strengthening the surveillance and policy coordination process, the paper presents two rationales for the use of the SDR for this purpose, namely, strengthening the discipline of reserve currency countries and diversifying their international portfolios. As regards the former point, I would question whether such use of the SDR, which is supposed to ensure the discipline of the reserve currency countries, in itself would be practicable without the latter point--discipline of the reserve currency countries.

As regards the two proposals in the paper, the Belgian proposal does not seem to directly ensure discipline, since the role of the SDR is no more than a financing vehicle for intervention. Also, the proposal by the staff, namely, the conditional use of the SDR in the context of Article IV consultations, does not seem to be very effective, since the reserve currency countries can easily acquire international liquidity without the SDR. Having said this, I would add that diversification of reserve currencies would be an effective way of maintaining a stable international monetary system, as well as ensuring the discipline of major countries.

On the other hand, we are generally supportive of promoting SDR-denominated transactions in the private financial market as well as of increasing voluntary SDR transactions among official institutions. In this connection, I would point out that the operation of the ESAF Trust has enabled various official institutions, such as the Japan Export-Import Bank, to engage in SDR-denominated transactions. We urge the staff to explore further the possibility of implementing various proposals for promoting SDR transactions. In this connection, we would encourage the staff to explore the possibility of increasing the number of holders of SDRs.

Next, on the potential role of the SDR in growth-oriented adjustment, we should first bear in mind the fact that SDRs offer unconditional liquidity and would therefore undermine the incentive for adjustment if they were provided without constraint.

The various proposals described in the paper attempt to solve this fundamental problem by imposing certain kinds of conditions on the use of SDRs reallocated for specific purposes. In other words, these proposals virtually call for the creation of conditional liquidity through SDR reallocation. It should be noted, however, that we are just in the process of reviewing the necessary level of the conditional liquidity provided by the Fund in the context of the Ninth Review of Quotas and the review of access policy. If we seriously consider the proposals, therefore, we need to clarify at the outset the rationale for the creation of conditional liquidity outside the general resources of the Fund. Also, I wonder whether a conditional use of the SDR would not undermine the monetary character of the SDR.

Finally, as regards the use of the SDR in debt and debt-service reduction, it should be considered in the context of the strengthened debt strategy. I would just point out here that the many technical problems should be solved before they are formally considered.

Mr. Toé made the following statement:

We welcome this opportunity to further discuss issues related to the concept and functions of international liquidity, the role of the SDR in the international monetary system, and the question of an SDR allocation. Obviously, these are closely interrelated issues and we would hope that the clarifications provided in the staff paper on the concept and functions of international liquidity and the strong case made by the staff on the need to supplement existing reserve assets would elicit broad support from members of the Board, not only for the resumption of SDR allocations but also for the initiation of concrete steps to reinvigorate the SDR and make it the principal reserve asset in the international monetary system.

While the staff recognizes the difficulties of measuring international liquidity and the problems connected with the determination of its adequacy, it asserts without ambiguity that the functions of international liquidity are to promote the same objectives that are in the Fund's purposes. The paper also asserts that under the present monetary system characterized by rapid expansion of financial markets, increased internationalization and integration of these markets, and the availability of official bilateral and multilateral credit arrangements, creditworthy countries are supplied with reserves and liquidity at relatively low costs. At the same time, noncreditworthy countries, comprising the vast majority of the Fund's membership, have virtually no access to these sources of liquidity and are induced to hold inadequate levels of reserves relative to those dictated by the scale and variability of their international transactions. This indicates clearly the existence of a severe maldistribution of international liquidity among member countries, which needs to be addressed.

Another conclusion that can be drawn from the paper as well as from previous papers on the international monetary system and the SDR is that the present system, by relying on a few national currencies as reserve assets, is fundamentally asymmetric and prone to encouraging loose financial discipline on the part of the reserve currency countries, which can delay the implementation of necessary corrective measures.

We believe that the SDR could play a useful role in addressing many of the identified inconveniences of the present system if it were allowed to become the principal reserve asset as mandated by the Articles of Agreement. In particular, we feel that a system based on an asset settlement mechanism would achieve more desirable policies and performance by the largest industrial countries than is the case currently. The various potential roles that the SDR could play, namely, strengthening the surveillance and policy coordination process and reinforcing discipline, achieving portfolio diversification and debt-service reduction, and promoting growth-oriented adjustment, are well described in the paper. We have no problem with the subsequent specific proposals made to that effect and we feel that all of them are worth exploring. However, we would urge the staff to pursue actively the proposals for using SDR allocations to enhance our debt strategy. In the same vein, we are of the view that, in addition to the methods described in the paper for making the SDR a prominent reserve asset, other methods such as those discussed at EBM/86/128 and 86/129 (8/4/86) merit further consideration as soon as an agreement is reached on the resumption of SDR allocations. We have in mind, inter alia, the enhancement of the usability of the SDR and further promotion of voluntary transfers.

The staff's ingenuity and imagination have once again been put to the test to demonstrate the existence of a global need for reserve supplementation; and we think that, as previously, the staff has brought convincing arguments and new perspectives in the papers before us. We feel that altogether, these justify the resumption of SDR allocations during the remainder of the Fifth Basic Period.

In view of the numerous potential roles that SDR could play, both from the perspective of reinforcing discipline in the system and of providing liquidity to support growth-oriented adjustment programs, including debt and debt-service reduction, we are of the view that any SDR allocation should, as a minimum, aim at restoring the share of SDRs in non-gold reserves to the level of 8.4 percent reached at the end of the first basic period. With these considerations in mind, we support an annual allocation of at least SDR 12.7 billion.

Mr. Enoch made the following statement:

In response to requests at our earlier Board discussions on this topic, the staff has provided us with two interesting papers that cover a great deal of ground, and offer a new perspective in a number of areas.

Following on from the Board's earlier discussions on the difficulty of measuring liquidity, the staff paper before us considers how well the functions of liquidity are being performed as an indicator of the adequacy of liquidity. I am not sure that this linkage is entirely valid. A failure of liquidity to perform does not necessarily imply that this is due to a shortage of such liquidity. While a clear measurement of liquidity is difficult, and probably not unambiguous, liquidity still remains conceptually a useful variable. Article XVIII, which is the basis for Fund decisions in this area, refers to reserves as the measure of liquidity. In addition, traditional measures, such as the ratio of reserves to imports, provide useful information. Beyond this, as I have argued on previous occasions, the growth of the potential for creating international assets through private capital markets can only have added to international liquidity, whatever separate problems are caused through its possible suboptimal distribution or its volatility.

The staff paper raises, but then seems to dismiss, the option of aggregating national monetary aggregates to assess international liquidity, regarding national monetary aggregates as relevant only for national liquidity. I think the issue is not clear cut. At least as far as reserve currencies are concerned, ensuring adequate national supply may be important to international liquidity. Thus, when the U.S. dollar was the reserve currency after 1945, it was essential that the supply of dollars be adequate. Nowadays, the more financial markets become internationally integrated, the less clear is the distinction between national and international liquidity. On the other hand, there remains the basic distinction that monetary assets are legal tender, or exchangeable for legal tender assets, domestically, but not internationally. Internationally acceptable reserve assets are only reserve assets because they are acceptable, which again is not necessarily a datum but may be a function of supply. For instance, we can imagine two extreme hypothetical scenarios, the first in which, say, the United States runs large current account deficits for the next ten years, and dollars accumulate in central banks around the world. In the second scenario, the United States runs surpluses, and central banks run down their dollar holdings. The first of these scenarios would indicate a more liquid world than the second, as international reserves would be higher. But in this first scenario the dollar may ultimately not be an acceptable asset, so liquidity in the second scenario may in fact be the greater. This fact would not be picked up simply by looking at aggregate figures.

The staff paper looks at the success of policy coordination among the industrial countries. The Board has recently considered the workings of the international monetary system and, in this context, the potential reserve asset role of the SDR in imposing discipline on countries. One major, and perhaps insurmountable, difficulty in achieving this, as the staff points out, is that discipline would not be guaranteed unless the SDR were the only reserve asset and its issue was exogenously determined. Furthermore, in the paper on foreign exchange intervention, the staff notes the inefficiencies associated with SDR intervention related to one of its constituent currencies.

As for the role of the SDR in international portfolio diversification, the increasing sophistication of markets offers the private sector considerable opportunity for reallocation. There is ever greater scope for made-to-measure portfolios that can better reflect an individual's or firm's currency needs. Central bank holdings of currencies may indeed not always be optimal, although this would probably be seen largely as an incidental cost of the policy decision that led to the associated intervention. While these costs are probably regarded as of a second order at this stage, a time may come when there is renewed interest in substitution accounts and in allowing off-market sales of a currency while avoiding unwelcome downward pressure on that currency.

Of the various suggestions covered in the staff paper regarding possible refinement of the uses of the SDR, there could be interest in further technical analysis of the pool proposal of Mr. de Groote. This could indeed lead to a more efficient use of the existing stock of SDRs, and could perhaps be seen as a major elaboration of the same-day loan facilities that have been devised to enable quota payments to be made in SDRs. But as the staff paper recognizes, further work on the operational and legal implications would be necessary before one could form a judgment on whether to take the proposal further.

The section in the staff paper on methods for promoting the use of SDR-denominated instruments is generally useful. In particular, the section considers the relative fall-off of interest in SDR-denominated instruments since the early 1980s, and looks for ways to counter this on the demand side. This approach seems appropriate. It follows then that, while increased use of the SDR would be welcome, increasing SDR allocations at this stage would have only a very limited effect.

Supply would not create its own demand. To some extent the demand deficiencies are inherent in the concept of the SDR. For instance, as the SDR covers all the major trading currencies, unlike the ECU, asset holders might not consider it efficient to hold SDRs if they are seeking to diversify out of one of these major currencies. However, some scope for enhancing the role of the SDR certainly remains. The United Kingdom provides some of the most significant facilities for the Fund to buy and sell SDRs, and we continue to encourage other members to instigate similar arrangements. Practical studies to consider ways to promote demand for the SDR may be appropriate, including examination of an international clearinghouse.

Turning now to the role of the SDR in growth-oriented adjustment, I have little new to say. If it is considered that international liquidity and reserves are adequate globally, but that there are shortages in particular areas, simply adding to liquidity does not represent a lasting solution. As the staff paper notes, a country's access to liquidity may influence its ability to implement a strong adjustment plan. But adding to liquidity in an unconditional fashion may result only in delays in implementing required adjustments. It is not difficult to argue that the problems affecting many countries today derive from access to excessive liquidity. The Fund has a range of facilities available to meet individual members' liquidity needs, and recourse to these facilities would seem to be the preferable way to meet these needs.

The staff paper notes that any allocation requires careful analysis of both the costs and benefits. In this context, it is perhaps unfortunate that the paper did not examine the inflationary risks of adding to international liquidity at a time when liquidity is globally already adequate. Given the upsurge in inflation recently in many industrial as well as developing countries, it might be thought especially unwise to risk adding to inflationary pressures at this stage.

Evidence that SDR allocations do not resolve problems of reserve maldistribution is starkly presented in Table 8 of the staff paper; cumulative allocations of SDRs have consistently been transferred from the developing countries, and in particular those with debt-servicing problems, to the industrial countries. The staff's comment that various post-allocation schemes could resolve this problem by requiring SDRs made available to be pledged in one form would seem to violate the principle that SDRs be allocated unconditionally. Again, this would seem to be an attempt to devise a function for SDRs that could more appropriately be met by borrowing through the Fund's regular resources.

In conclusion, my authorities remain unpersuaded of the desirability or the need at this stage for a renewed allocation of SDRs, or for any associated reallocation scheme. Prudential allocations of SDRs in order to keep the mechanics in operation do not seem necessary; the mechanics involved remain in existence, and could be built up very quickly to any required scale. There may be scope at this stage for further technical study of the use of SDRs in official intervention and of the causes of the low level of interest in SDR-denominated instruments, as part of the Fund's continuing monitoring of the international monetary system. But given that it would be difficult to implement any major changes in this field quickly, I concur with those Directors who have indicated that further work on questions of SDR allocation should not be given a high priority.

In response to a question from the Chairman, Mr. Enoch confirmed that he included, among the questions that could usefully be considered not to have the highest priority, the suggestions of Mr. de Groote.

Mr. Grosche made the following statement:

We do not detect many new findings or developments in the staff paper that are of such a magnitude as to warrant a change in our position on the resumption of SDR allocations. We still do not perceive a general shortage of unconditional liquidity.

On the systemic role of the SDR, I would summarize my view by stating that none of the alleged shortcomings of the SDR appears significant enough to justify the major effort that would be needed for amending the Articles of Agreement. The SDR was created for the quantitative control of international liquidity. It has been used successfully to supplement reserves in case of a long-term global need. Up to now it has not been used to better control excess liquidity--a job that it was also meant to do. But attempts to cancel SDRs would not find general support, I am afraid. The conceptual difficulties of determining precisely the optimal level of international liquidity certainly have something to do with these difficulties, which should however not lead us to do away with the established allocation criterion and to look for other approaches. Attempts to invigorate the SDR and to provide it with a new role should not blind us to the very problems that we are facing in today's international monetary system. The creation of additional liquidity should not be taken as a panacea for the system's imperfections. We could be trapped by a seemingly easy solution which tends to cure only symptoms and not the disease itself, and which would exacerbate problems of the future.

Having said this, and since my views on the SDR are very well known, I will just briefly touch upon some of the issues raised in the staff paper. First, we are not impressed by the staff's continued attempts to replace the concept of "reserves" by the broader concept of "international liquidity." If one uses the broader definition one can, of course, for many countries detect a shortage of international liquidity. But in looking closer at the difficulties that arise for many countries in financing their balance of payments deficits, one can see that most of those countries are in need of medium- to long-term financing to tackle deep-seated structural problems and to develop their economies. The adjustment and developmental needs of those countries should not be mixed up with temporary liquidity constraints. The lack of longer-term capital or, for that matter, of creditworthiness cannot be overcome by purely monetary means.

These comments should also make clear our position on a possible contribution of SDR allocations to the resolution of the debt problem; we have serious misgivings about all ideas that have been put forward to that effect.

Second, the staff gave some thought to the potential of using the official SDR to directly promote the surveillance and policy coordination process. The results are very interesting. If anything, they confirm our doubts whether major industrial countries can, indeed, be "pressured to exercise greater discipline over their policies" through an SDR allocation.

The staff itself admits that substitution accounts and asset settlement mechanisms do not seem to be effective devices to strengthen discipline of the reserve currency countries. And the other two suggestions--a pool for exchange market interventions, and a two-stage allocation process--do not seem very practical either, as the comments of many previous speakers also have shown.

Third, we do not really see a need for transactions among private and official entities in SDR-denominated instruments. An international reserve instrument like the SDR does not have to have more characteristics than those that are required for transactions between monetary authorities and the Fund. As far as private entities are concerned, there are, to my knowledge, no obstacles in many industrial countries to active use of SDR-denominated instruments. But despite such opportunities, no significant SDR market has developed, raising some doubts in my mind whether there is a genuine demand for SDR-denominated instruments.

In addition, it seems somewhat odd that the staff encourages official institutions to denominate new debt issues in SDRs. Does this not imply an exchange rate risk that--for good reasons--the Fund itself tries to avoid for its own operations?

The Chairman said that he was somewhat surprised by Mr. Grosche's clear implication that the SDR could not help countries to reduce their exchange risk when borrowing. In some cases, countries would have been extremely well advised to adopt SDR-denominated instruments. For example, the SDR could have played a role in reducing the exchange rate risk for Indonesia, whose external debt was primarily exclusively denominated in yen. Of course, the cost of that country's external debt would have been a little higher, but in exchange its current debt situation would have been much different.

Mr. Grosche remarked that the staff, in wanting to promote the use of SDR-denominated assets, had suggested that industrial countries, for example, issue instruments in SDRs, and thereby had also suggested that those countries take over a certain exchange rate risk. He had only wanted to make the point that when the Fund borrowed, it wanted to have the loans denominated in its own currency--in SDRs--in order to reduce the exchange rate risk, and rightly so.

The Chairman noted that Mr. Grosche was implicitly agreeing that a basket of currencies could help many countries in managing their exchange risk, just as the ECU had done for member countries of the European Communities.

Mr. Grosche remarked that a country that had great problems in maintaining a strong currency might be interested in incurring debt in other than its own currency. But for a country like Germany, borrowing in instruments other than those denominated in deutsche mark would introduce an exchange rate risk, either negative or positive, which would be unacceptable.

Mr. Templeman said that his authorities viewed the issue in the same fashion as the German authorities. That did not mean that a borrowing country should not or could not do what it wanted in terms of using the SDR, but certain other priorities might be more important than the possible gains. The United States, for example, chose to eschew any possible exchange rate gains for certainty; that simplified to some degree the already complicated budget process.

The Chairman remarked that while Germany and the United States were in similar positions, other member countries might be more interested in a borrowing instrument that protected them somewhat against exchange risk.

Mr. Grosche then continued with his statement:

> Fourth, we remain skeptical about any new proposals for linking the reserve creation mechanism to development objectives. I do not want to repeat our arguments at length. Let me only say that, in our view, the developing countries do not need primarily short-term monetary liquidity but rather long-term capital, the more at concessional terms the better. It does not seem appropriate for them to monetize their balance of payments

deficits with the reserves of other countries in exchange for SDRs. Incidentally, we should not let donor countries off the hook by suggesting seemingly easy solutions to the financing problem of developing countries.

Fifth, we know from experience that reimposing a reconstitution requirement does not prevent the prolonged net use of SDRs. We remain doubtful, therefore, whether the reconstitution requirement is a useful and practicable approach to keep SDRs in the reserves of member countries.

In conclusion, I believe that the SDR will have to play a useful role if and when the need arises. For example, the need for providing a safety net for the international monetary system can arise fairly quickly. But I do not believe that prophylactic allocations are necessary or serve a useful purpose. Finally, I would like to support Mr. Massé's suggestion not to have regular and repeated discussions on this issue. These discussions, I feel, have become repetitive, if not boring, and I am afraid that we are getting so tired of this subject that we might overlook or miss the opportunity for a fruitful discussion when the situation in the world economy changes.

Mr. Lombardo made the following statement:

The staff paper provides us with new and valuable elements for the discussion of international liquidity. Our previous meetings on this subject seemed to have led to a circular discussion on whether or not it is necessary to increase international liquidity. This chair, together with others, has underlined the necessity of increasing international liquidity as a means for resolving the serious problems of lack of financing that most of the developing countries are facing at this time. On the other hand, other chairs have doubts about that necessity and have asked for a clear measurement of international liquidity before going on with the discussion.

In this sense, I think that an important point for ending this vicious circle has been provided by the staff in its assessment of the difficulties of constructing a meaningful quantitative measure of international liquidity. Indeed, the staff suggests that the only way to evaluate the adequacy of international liquidity is through indirect means.

That distinction brings us again to focusing almost exclusively on the question of how well the functions of international liquidity are being performed. The staff has done well in presenting in its report the relevant objectives of maintaining international liquidity in line with the Fund's purposes. It is clear that the Fund's functions of contributing to relieving balance of payments difficulties, promoting economic expansion without inflation, promoting the elimination of restrictions on international transactions, and reducing exchange rate instability are being seriously compromised by the delay in achieving a comprehensive solution to the debt problem, and by the adjustment fatigue that this causes. Nobody can deny the difficulties with international liquidity that several countries are experiencing at this time.

Therefore, the lack of an objective way to measure international liquidity leads us again to concentrate on the main point that we have addressed in previous meetings--international liquidity as a comprehensive subject. It is not possible to deal with indebtedness, trade, and developing countries vis-à-vis developed countries without considering international liquidity. As we have stated before, we understand the concern over the damage that could have been done to several countries facing adjustment during the first developments of the debt crisis if an increase in international liquidity would have been undertaken at that time. However, seven years later, with strong adjustments already made and a general acknowledgment of their necessity, we see no reason for continuing with this attitude.

I think that the recent meeting of the Executive Board on debt strategy has been very useful in underlining the difficulties faced by debtor countries, in spite of the goodwill of other countries, the banks, and the multilateral institutions, and in spite of the encouraging progress recently achieved. What is happening is that the problem is not only a commercial and political one, but also a structural problem that has to do with international liquidity and its distribution.

In addition, we welcome the other ideas presented by the staff in its paper, in particular those related to the importance of the SDR in the process of coordination and ways to strengthen the role of the SDR as a reserve asset.

Therefore, we need to go further to understand the importance of an increase in international liquidity. I hope that the present situation and the worthwhile staff paper dealing with the ways of increasing the role of the SDR in the international economy can lead to a more realistic approach in order to permit further progress on this subject.

Mr. El Kogali made the following statement:

Our position on the subject matter of our discussion today is already on record and we can hardly add anything to it. I do not believe that the issue of a new allocation of SDRs can be resolved by further technical arguments or additional evidence to justify the existence of the global liquidity need required for such an allocation. Nor is it useful to ask the staff to come up with new justifications to convince those who oppose SDR allocations. As others have already said, the issue is one of political will. I would therefore be brief.

I found the staff argument linking the function of international liquidity and the objectives of the Fund together with the systemic role of the SDR interesting. The potential role of the SDR in strengthening surveillance over the policies of industrial countries and in enhancing discipline and policy coordination among the major economies is a valid reason for promoting the SDR as a reserve asset. This is so because the role of the reserve stock in exerting discipline over macroeconomic policies of the reserve currency countries has diminished with the increased possibility of "liability financing" by these countries of their international transactions. With the emergence of national currencies as international reserve assets, there has been less or no incentive for the reserve currency countries to make the necessary adjustment to address their domestic and international imbalances. Such weaknesses of the present system may be reduced by enhancing the role of the SDR, which is controlled by the collective will of the international community rather than by the national interest of a specific country.

On the two methods discussed by the staff for making the SDR a more prominent reserve asset, each has its own merits and both involve operational and legal problems. Mr. de Groote's proposal has the advantage of making official SDR holdings more usable through financing intervention transactions. However, its effectiveness in strengthening surveillance and imposing discipline over the policies of reserve currency countries will be limited if no conditionality is attached to the use of SDRs. To what extent such conditional use of the SDR by the reserve currency countries will be acceptable to those countries remains to be seen.

The two-stage allocation proposal also raises many questions. First, subjecting a country's receipt of its allocation of SDRs to Executive Board surveillance is contrary to the spirit of SDR allocations, which traditionally have provided unconditional resources to member countries. Second, withholding an allocation from a reserve currency country will have only a minimal disciplinary impact on its policies, if any, because the country can easily overcome this problem by expanding "liability financing" of its international transactions since its currency is held as an international reserve asset.

On the measures discussed in the staff paper to promote the use and holding of SDR-denominated instruments by private entities as a means of enhancing the attractiveness of the SDR as an official reserve asset, several cost-effective methods can be found to encourage the use and holding of SDR-denominated instruments by private entities. However, I have serious doubts on whether improvements in the attractiveness of SDRs or encouragement of wider use of SDR-denominated assets will have any significant effect in promoting the SDR as a major reserve asset in the absence of a new and substantial SDR allocation.

I share the staff analysis on the potential role of the SDR in promoting growth-oriented adjustment in developing countries. The quantitative indicators reviewed in the staff paper regarding the demand for international liquidity, and the availability and distribution of such liquidity, as reflected in reserve/import ratios and the share of the SDR in non-gold reserves, indicate unambiguous symptoms of a severe shortage of liquidity of exactly the type that the SDR system was invented to cope with, for the majority of Fund members. The symptoms of liquidity shortages for the majority of developing countries are manifested in the widespread debt-servicing problems, buildup of arrears, repeated devaluations, compression of imports, and extended periods of austerity measures that continue to hamper growth-oriented adjustment efforts of these countries. A substantial SDR allocation will no doubt help to ease these constraints and enhance sustained adjustment with growth.

In conclusion, I would like to reaffirm this chair's strong support of a resumption of SDR allocations during the present basic period. We are also in support of a substantial magnitude of allocation that will be sufficient to restore the reserve/import ratios of capital-importing developing countries with recent debt-servicing problems to their average levels before 1980.

Mr. Fayyad made the following statement:

It is perhaps not an exaggeration to say that over the many years that have elapsed since SDRs were last allocated, virtually all the evidence supporting, and arguments in favor of, a resumption of SDR allocations have been all but exhausted in previous staff papers and Board discussions. Without reciting those arguments today, let me just say that although they are, in our view, very compelling and by far outweigh the reservations against new allocations, they unfortunately have not so far led to bringing about the needed support for a resumption of allocations. This, of course, reinforces the view--now widely held--that agreement on the need for new allocations is unlikely to result from the strength of the argumentation. In this connection, the staff paper asks those of us who would favor an SDR allocation to indicate on which scale allocations should be resumed. To this let me say that we will cross that bridge when we get to it. The real question at this stage continues to be whether those who have for quite some time been opposed to the resumption of allocations are prepared to consider any allocation at all during the remainder of the Fifth Basic Period. But, for the record, we continue to favor a strategy of conducting regular allocations of SDRs at rates commensurate with the need to fulfill the Fund's obligation under the Articles of making the SDR the principal reserve asset of the international monetary system. Moreover, a meaningful allocation continues at this stage to be fully justified by the current situation and prospects of the world economy.

Turning briefly to some of the proposals summarized in the staff paper, the paper does provide a useful framework for analyzing and evaluating the potential systemic role of the SDR. Having steered away--with good reason, I might add--from attempting a quantitative assessment of the adequacy of international liquidity, and by focusing instead on how well the functions of international liquidity are being performed, the paper can fundamentally be seen as subscribing to the approach to assessing the need for reserve supplementation that was put forward during the formative stages of the SDR. That approach, it is to be recalled, involved making judgments "as to whether the functioning of the international monetary system and world economy could be improved by expanding the role of the SDR."

As regards the proposals for using the SDR to strengthen surveillance and the policy coordination process, it would be useful to look into both Mr. de Groote's proposal for establishing a pool of SDR resources as well as the proposal for a two-stage allocation process. I would note that the receipt of allocated SDRs under the second proposal is conditional. But, as the procedure would apply to all Fund members, it could at least in theory contribute to making the process of Fund surveillance more symmetric. Moreover, for a proponent of SDR allocations, the case for the proposal in question could be seen as the case against the alternative of having no allocation at all. Here again, the question is whether that proposal would not also allay concerns that additional SDRs could act as a disincentive to adopting appropriate policies. This is, of course, not to say that the proposal is without problems, some of which have already been covered by previous speakers.

While on this general question of the role which the SDR could play in strengthening policy coordination, let me add that I broadly share the staff's concluding observations in the paper on the use of SDRs in foreign exchange market intervention. I particularly concur with the staff that existing mechanisms would appear to provide for the efficient use of SDRs to finance the acquisition of intervention vehicles, and that therefore the extent to which the SDR can play a significant role in this regard depends on the amounts of SDRs available for intervention. It would indeed seem doubtful that factors other than the limitation posed by the relatively small amount of SDRs allocated to date constitute significant impediments to an expanded role of the SDR in foreign exchange market intervention.

As regards the proposals related to promoting growth-oriented adjustment, we have an open mind vis-à-vis the early proposals for post-allocation redistribution of SDRs (the Belgian proposal, the French proposal, and Mr. Sengupta's proposal). Finally, the proposals for debt or debt-service reduction (the Mitterrand proposal and the IIF) merit consideration as they both have a potentially constructive role to play in supporting debt operations, as well as adjustment with growth.

Let me conclude by emphasizing that consideration of the aforementioned proposals should not be a reason for delaying allocations of SDRs that are not conditional or subject to a reconstitution requirement.

Mr. Hogeweg made the following statement:

We continue to support in principle annual allocations of SDRs of a moderate magnitude as a contribution to maintaining the allocation mechanism with a view to possible future problems in the supply of reserves. Also, we support the efforts of the staff to enhance the role of the SDR as a reserve asset in the international monetary system.

Having said this, I want to stress that we disagree with many of the arguments put forward by the staff in favor of a resumption of allocations that emphasize reserve shortages and the financing needs of a specific group of countries. As we said at the last Board meeting on the role of the SDR (EBM/89/29, 3/6/89), for countries that have used liquidity provided by the financial markets in such a way that their creditworthiness has been impaired, a shortage of liquidity can be very acute without, however, pointing to a long-term global need, which is the only criterion in our Articles.

The continuous emphasis on the financing that SDR allocations may provide for balance of payments deficits is not at all conducive to us retaining our positive stance on SDR allocations. More generally, we do not think that a more active role of the Fund in the international monetary system, which we would of course warmly welcome, can be brought about by thinking up new functions for the SDR.

Let me make a few more specific comments on the staff paper and some of the proposals it cites. On page 4, it is said that much of the Fund's activity over the past decade has focused first on improving policy setting and implementation in the largest countries and, second, in assisting developing countries to cope with debt and balance of payments problems. The paper then examines potential roles of the SDR in strengthening surveillance and in promoting growth-oriented adjustment, including the debt strategy, in that context. I do not believe that this presentation does justice to the essential characteristic of the Fund as a multilateral institution--that its entire membership, large and small, industrial or developing, is subject to its surveillance and has access to its resources under adjustment programs if the need arises.

An international monetary system is a multilateral set of rules of the game to which all countries subscribe. Techniques cannot improve discipline. On the contrary, the willingness to accept discipline by all is the basis for an international monetary system. In such a context, the SDR may also find its place.

In opposing emphasis on the financing role for the SDR, I have implicitly commented negatively on most of the issues for discussion. Let me add only that we strongly oppose suggestions to allocate SDRs as a contribution to the implementation of the present debt strategy. This would amount to monetary--seemingly costless--financing in order to solve a problem that is fundamentally of a nonmonetary nature.

Finally, undoubtedly the existence of an active private SDR market would be positive for the role of the SDR in the system, but pressure to develop the market should come from the market itself, as was the case with the ECU. I do not think the Fund should encourage its members to issue debt denominated in SDRs. Implicitly this would mean that the Fund encourages its members to finance government deficits in foreign currencies rather than on the domestic markets of the countries concerned. On this point I support the remarks made by Mr. Grosche. I do not think that the consequences of such advice have been fully thought through.

Mr. Fernando made the following statement:

We do not wish to go into the question of long-term global need in considering the SDR in the context of international liquidity. This issue has been debated threadbare, and we may never achieve the full satisfaction of all parties, considering the difficulties in concept as well as of measurement. It may be recalled that even before the recent elaboration of concepts and techniques of measurement, the decision to allocate SDRs on each of the two previous occasions was based on a judgment of the circumstances. The judgmental character of the decision taken was reflected in the modesty of the allocation and limited period for its distribution.

Turning to the issues for discussion, we agree that the SDR has a potential role in the strengthening of surveillance and the policy coordination process among the reserve currency countries. In order to promote discipline in the pursuit of policies by these countries, a system based on the SDR rather than any one or a few currencies would be preferable. For this, the SDR should become a principal reserve asset.

On the modalities to reach this objective, we are not in favor of the two-step allocation process on the grounds that conditionality would be in conflict with the original character of SDRs. We are, however, open to consideration of the de Groote proposal of creating a pool of SDRs in the Fund to promote greater exchange market stability through official intervention. We noted with interest that this proposal is based on the premise that intervention is now seen as an essential instrument for protecting the adjustment policies of the largest countries from destabilizing market processes. Sustaining adjustment in the most efficient way is indeed at the core of the management of the international monetary system, thus reinforcing the argument that reserve supplementation through SDRs is equally important to protect the adjustment efforts of the rest of the world. We would agree that the SDR should be rendered attractive to be used as a vehicle for intervention as well as for reserve portfolio diversification. In the same vein, the SDR should be attractive to all users to hold as reserves and be capable of being "liquidized" when the need arises, especially because the yield is now at market levels.

The staff, while noting the drying up of the market for SDR-denominated instruments, comments on the possibility of private demand becoming strong and sustainable once the market transactions in such instruments exceed some threshold scale and a secondary market develops. This, in our view, is begging the question. The demand for SDR-denominated instruments would pick up, and a secondary market in such instruments would likely develop, if the Fund gives an unmistakable signal to the market of its own faith in SDRs by making a fresh allocation of SDRs and working on its other characteristics to make the SDR the principal reserve asset. In this connection, it is noted that the ECU has become operationally more relevant because of the strong backing it receives from the entities and governments that have created it. Let us remember that the market for SDR-denominated instruments was growing so long as the Fund was making fresh allocations of SDRs. The market started drying up once allocations stopped.

The question of distribution tends to get less attention than it deserves in the face of the perceived contribution of private financial markets to the overall supply of international reserves. Consequently, reserve-short countries are urged to gain or regain market access. The staff has rightly drawn attention to the unreliability of this source in the process of adjustment. Even in the period of intense credit activity, loan syndicates had a hard core of 10-20 banks that usually worked together, and there were less than a dozen such groups in the Euro-market, with a group often specializing in a specific geographical area. Thus, instead of thousands of banks facing thousands of potential borrowers in 160-odd countries, there were a few syndicated families of banks facing a few dozen clients in a dozen or so countries. This situation also resulted in countries with access to private financial markets maintaining adequate liquidity, while, quoting from the staff paper, "...other countries have been induced to accept reserve holdings that leave them significantly more vulnerable to external payments shocks than in the past."

This chair, as mentioned by the staff, has previously made proposals on post-allocation distribution, which need not be repeated in detail. In essence, the transfer of SDRs from the developed to developing countries would be in the nature of an overdraft; to allay concerns about retaining their monetary character, the proposal provides for reconstitution within a time frame, thereby ensuring that the users of SDRs would also be prepared to be holders. An important difference between this proposal and those of Mr. de Maulde and Mr. de Groote is that availability of the SDRs would not be conditional.

Turning to another issue, we are ready to recognize the validity of the staff arguments that the SDR provides an attractive and efficient way of obtaining additional resources for assisting countries in the design and implementation of effective adjustment programs. Clearly, the design should be such as to safeguard and sustain adjustment, and the contribution of SDRs to reserves would play a key role here. Finally, we reiterate our support for a resumption of allocations.

Even before consideration of such recent issues as improving surveillance and policy coordination, and facilitation of balance of payments adjustment in heavily indebted countries, we urged a substantial allocation. In my view, our long-term aim should be to raise gradually the ratio of SDRs to non-gold reserves to 8.4 percent, namely, the level that prevailed at the end of the First Basic Period. As a first step, we may aim at re-establishing the ratio of 6.5 percent that prevailed some eight years ago when the last SDR allocation was made. This would require allocation of SDR 8.2 billion during the remainder of this basic period. The final outcome would, of course, be influenced by whether or not we build in a post-allocation distribution and on what terms.

Mr. Gronn noted that the Nordic countries had long been in favor of giving the SDR a prominent role in the international monetary system. Thus, they maintained that the role of the SDR as a reserve asset should be enhanced, and that greater use of the SDR would contribute to increased stability in the international monetary system. Consequently, the Nordic countries continued to support moderate allocations of SDRs.

Such an allocation should not, however, be linked to economic adjustment in developing countries, nor should it be linked to the Fund's surveillance function in general, Mr. Gronn stressed. The application of any kind of conditionality for the allocation ran contrary to the attractiveness of the SDR as a reserve asset. With that in mind, he could not support the proposal of a post-allocation, nor could he support a two-stage allocation process. Likewise, he did not favor either the proposal set forward by President Mitterrand to link the use of allocated SDRs to debt or debt-service reduction, or the proposal introduced by the IIF, under which the indebted developing countries would use their share of a new allocation to collateralize the principal of either new debt or debt conversion.

However, a voluntary pooling of SDRs to mobilize resources for foreign exchange intervention, as proposed by Mr. de Groote, or Mr. Polak's proposal to promote the use of the SDR through issuance of SDR certificates backed by official SDRs were both ideas that could merit further study, Mr. Gronn continued. Nonetheless, in his opinion, the staff paper on the use of SDRs in foreign exchange market interventions did not give strong support to the view that the SDR, in any simple way, could evolve into a major vehicle of intervention. The use of the SDR for that purpose was fully dependent upon how attractive the SDR would become as a reserve asset.

Mr. Filosa made the following statement:

This chair has consistently advocated the need for moderate annual allocations of the SDR for reasons that are well known and clearly set out in the paper before us. However, it should be reiterated that the problem of an SDR allocation cannot be resolved if we limit ourselves to arguing that a global long-term need arises if and only if we are able to demonstrate, in strict quantitative terms, that a liquidity shortage exists.

A liquidity shortage could well arise if one component of the total liquidity suddenly and permanently disappears in case of a financial crisis. The debt crisis of 1982 and the more recent events in late 1987 are two clear examples of the fact that the system is more liable to liquidity crisis and instability if it relies heavily on borrowed resources. Even though the present multilateral reserve system shows that the original intention of making the SDR the principal reserve asset is too far reaching, further postponement of an SDR allocation would imply that we are also denying the SDR the more modest role of safety net.

In assessing the need for an SDR allocation, we should recognize the preventive role that should guide such an allocation. Unfortunately, data limitation does not allow us to know whether present total international liquidity is sufficient for a smooth functioning of the international payments system. We do know, on the contrary, that given the different characteristics of borrowed and unborrowed reserves, the present system suffers from serious shortcomings as far as its internal composition is concerned.

If the objective is to reduce reliance on borrowed reserves, as it should be, we should aim at regularly injecting SDRs into the system to allow an increase of the share of SDRs to non-gold reserves. It has been repeatedly affirmed that liquidity is demand determined, and I therefore maintain that an SDR allocation would mainly modify the composition of international liquidity and not so much the total.

As for the question of SDR allocation for adjustment purposes, this chair continues to see merit in the French proposal of an SDR allocation to facilitate the adjustment process of highly indebted countries in the context of the new debt strategy.

A post-allocation redistribution of resources might further enhance the positive results that we have achieved so far. I noted a few days ago that the possible extent of debt-service reduction might be limited by a lack of resources. If this is the situation, as it appears from some preliminary evaluation of the Mexican and Philippine cases, a post-allocation distribution among members might be useful to reduce the debt burden for indebted countries.

Finally, I would make some brief comments on the development of a private market for SDRs and on the use of SDRs for intervention purposes. The development of a primary market for SDRs and SDR-denominated claims is important and should receive renewed attention. A private market for SDR-denominated instruments would presumably allow private portfolios to share the benefits of greater stability associated with the currency basket of major currencies, although the large weight attributed to the U.S. dollar might limit interest in using SDRs as a hedge against U.S. dollar fluctuations. But again, I agree with the point expressed by the Chairman in the exchange with Mr. Grosche that even if this hedging procedure is not worthwhile for some countries, there are a number of countries that could benefit from such use of the instrument.

In any event, the development of a private market requires full official support and stimulus. A general acceptance of SDR-denominated financial instruments depends heavily on the extent to which the SDR regains importance as a reserve asset. There is little hope of substantially developing a private market for SDR-denominated instruments if countries are not prepared to give clear signs of the willingness to reinvigorate the SDR's official role, such as by increasing the share of SDRs in non-gold reserves. In this sense, I am implicitly responding to the question of the staff on the possible amount of an SDR allocation.

As for the use of SDRs for intervention purposes, I share the view expressed in the staff paper that such an instrument will prove to be a less effective means to achieve exchange rate objectives, given the fact that the main world currencies are included in the basket. It seems to me that the primary role of the SDR in foreign exchange markets should continue to be the financing of intervention. More important, however, we believe that policy coordination and coordinated foreign exchange intervention among major countries and Fund multilateral surveillance are the main avenues to greater exchange rate stability in the international monetary system.

Mr. Shao made the following statement:

We welcome today's discussion on international liquidity and the role of the SDR, and appreciate the staff's efforts in preparing such an informative and concise paper.

At the outset, I would like to reiterate our support for a resumption of SDR allocations, and for making the SDR the principal reserve asset in the international monetary system. Although we have discussed this subject on many occasions, regrettably little progress has been made. Today, I would like to make three brief points on the declining importance of the SDR's role in the world financial market, the decreasing ratio of SDRs to non-gold reserves, and the potential role of the SDR.

It is noted from the staff paper that the volume of private SDR-denominated bank deposits had contracted to SDR 2.2 billion by September 1985 compared with SDR 5.7 billion by end-1981; no SDR-syndicated loans have been made since 1982, and no private SDR bonds or notes have been issued since the end of 1981. These worrisome signs indicate the urgency of revitalizing SDR participation in the market. In this connection, we agree with promoting the large-scale use and holdings of SDR-denominated instruments in the markets.

As we stated last year during the discussion on the same subject, "with no resumption in the SDR allocation, the ratio (of SDRs to non-gold reserves) is projected to decline further to a range of 3.2-3.9 percent by the end of the Fifth Basic Period in 1991." According to the staff paper, the ratio of 4 percent for 1988 was the lowest since 1981. This would seem to contradict the interests of this institution and depart from the Fund's fundamental objective of making the SDR the principal reserve asset in the international monetary system. We would therefore urge a reversal of this trend through a new SDR allocation.

I would like to express my interest in the proposals to strengthen the surveillance and policy coordination process by exploring the potential role of the SDR. Although it will take time and effort to reach agreement, we support this idea. The potential role of the SDR in promoting growth-oriented adjustment is another important objective worth focusing our attention on. I do believe that with adequate SDR resources, member countries could further progress under their adjustment programs. We all hope that the SDR can play an important role in the international monetary system, but the question remains how we can promote and strengthen the position of the SDR within the system. The bottom line is when we can resume SDR allocation and by how much.

In conclusion, we would like to reiterate our consistent support of an early, and large-scale, SDR allocation.

The Deputy Director of the Research Department said that, with respect to the advantages of having conditional allocations, there was somewhat of a dilemma. On the one hand, given the other sources of borrowed reserves and conditional sources of liquidity, there were some advantages in the SDR remaining an owned reserve that was freely usable to obtain the proper mix between owned and borrowed reserves. At the same time, so long as the Fund continued to be concerned about adjustment, it had to ensure that any allocation that was not used to delay or postpone needed adjustment. That inevitably led one to the proposals for hybrid allocations. The staff continued to see some merit in countries having enough reserves to hold, as opposed to reserves to spend, since the former could be a valuable form of self-insurance for growth-oriented adjustment programs that might go off track because of unexpected developments. Accordingly, any proposal that ultimately increased the amount of reserves that countries had to hold had some advantage.

While the official use of SDRs could be promoted without parallel efforts to increase private use, that would be less effective, the Deputy Director remarked, because of the interdependencies between the various uses of a reserve asset. One of the primary considerations of countries when deciding in which form to hold their reserves was the possibility of using those reserves to intervene in exchange markets to achieve exchange market stability. Therefore, to the extent that countries found SDRs a less cost-effective vehicle for intervention, official use of the SDR was somewhat discouraged. There was therefore a complementarity to operating on the private SDR market as well as the official one.

Directors had raised the possibility that there was a maldistribution of reserves rather than a global shortage or surplus, and had asked under what conditions that maldistribution should be taken into account, the Deputy Director recalled. Two difficult issues emerged in that context. First, on the possibility of market failure, the staff shared the view of a number of Directors that, by and large, differential access to credit markets reflected differential policy performance, and that there should be an incentive for countries to improve their policy performance in order to earn re-entry into credit markets. At the same time, there were cases in which private markets were very slow to recognize the improved policy performance of countries. While the market was effective on average, then, there could be instances of market failure in which countries would not be fairly treated. Second, there was also the risk that a market failure in a given group of developing countries would have systemic implications, given the increasing interdependence of the world economy, and of capital markets in particular.

A number of Directors had suggested that the staff explore further quantitative measures of international liquidity, including those dealing with aggregate money supplies, the Deputy Director noted, and the staff would indeed do so. There had also been suggestions to explore further increasing the number of official holders of SDRs and SDR-denominated instruments, which the staff would also look into.

The inflationary consequences of SDR allocations was a legitimate concern, the Deputy Director considered. However, as long as there was no excess supply of total reserves and the SDR allocation was less than the increase in the total demand for reserves, as the staff calculations indicated was currently the case, there was less chance of the allocation having any inflationary implications.

On the question of countries issuing some debt in SDRs rather than national currency, the staff had not been suggesting a large-scale replacement of national currency-denominated borrowing by that denominated in SDRs, the Deputy Director of the Research Department commented, but rather, a show of support for the SDR much in the manner that some industrial countries had made with respect to the ECU. Even a modest effort in that direction could send a valuable signal about protecting the life of the SDR when the share of the asset had been falling for a number of years.

The staff representative from the Research Department said that during the staff's discussions with the banks that had issued ECU-denominated accounts, the staff had discussed the question of why the private use of SDR-denominated instruments had not expanded more rapidly. One explanation had been the fact that the ECU's basket was fundamentally different from the SDR's in that it did not include the U.S. dollar, which made it somewhat easier to take a position for or against the dollar while using the ECU. Of course, that could be a two-edged sword, depending on whether the dollar was appreciating or depreciating at the time.

A second reason suggested by the banks had to do with the concept of a market's critical mass, the staff representative continued, because of the cost associated with setting up settlement and payments mechanisms, which was especially costly without official support. To operate efficiently, a certain minimum volume of transactions was required. A problem that the banks faced with SDR-denominated instruments in particular was the lack of SDR-denominated assets that they could hold as offsets to the liabilities that they had in the form of deposits. This necessitated an "unbundling" of the funds that they received in SDRs and investment into a set of assets that matched the basket for the SDR, thus adding significantly to transaction costs. In contrast, it was possible to hold a variety of relatively safe ECU-denominated asset instruments, including official ones, to offset the ECU-denominated deposits.

Finally, while the banks had not specifically said so, the staff had received the impression that in the early stages of the SDR's life, a few large multinational corporations had been willing to borrow in SDRs and indeed had done so, but again the problem of scale came in, the staff representative from the Research Department remarked. Corporate treasurers had to have enough transactions in a particular denomination before they felt comfortable working with instruments denominated in that particular currency. The support of official institutions within the European Communities for creating a base of assets and transactions had been an important contribution to the development of the market for the ECU.

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

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LEO VAN HOUTVEN
Secretary