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IMMEDIATE ATTENTION

SM/88/117

May 25, 1988

To: Members of the Executive Board

From: The Secretary

Subject: SDR Transactions by Agreement

It is not proposed to bring the attached memorandum to the agenda of the Executive Board for discussion unless an Executive Director so requests by the close of business on Wednesday, June 1, 1988. In the absence of such a request, the draft decision that appears on page 5 will be deemed approved by the Executive Board, and it will be so recorded in the minutes of the next meeting thereafter.

Mr. Coats (ext. 8249) is available to answer technical or factual questions relating to this paper.

Att: (1)

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Department Heads

INTERNATIONAL MONETARY FUND

SDR Transactions by Agreement

Prepared by the Treasurer's Department
(In consultation with the Legal Department)

Approved by Gerhard Laske

May 25, 1988

I. Introduction

In the last few years, the amount of SDRs used in transactions by agreement has increased far more than has the amount of SDRs used for all other purposes, while the amount of SDRs used with designation has fallen steadily. Since August 1987, in fact, there have been no transactions with designation.

The growth in voluntary transactions and the reduction in transactions with designation are the consequences of a number of factors, but it seems reasonable to conclude that steps taken since the adoption of the Second Amendment of the Fund's Articles of Agreement to make the SDR more competitive with other reserve assets have contributed to these trends. 1/ This paper reports on recent developments that have significantly increased the SDR's liquidity in transactions by agreement and, hence, its attractiveness as a reserve asset. The paper also proposes a modification of the rule governing value dates for transactions by agreement that would bring the SDR's characteristics still more in line with those of other reserve assets. 2/

1/ These steps include raising the SDR interest rate to market levels, its calculation on a weekly rather than quarterly basis, abrogation of the reconstitution requirement, and the prescription of twelve operational uses of SDRs among participants and prescribed holders. The Second Amendment itself removed the requirement of a balance of payments need when using SDRs in transactions by agreement.

2/ Rule P-6 presently allows the parties to a transaction by agreement to agree on two- or three-day value, i.e., settlement on the second or third business day after initiating the transaction.

II. Recent Developments

In 1987, the amount of SDRs exchanged for currency in transactions among participants and prescribed holders was about 40 percent higher than in 1982, the first year after the SDR interest rate was raised to market levels. Of such transactions, transactions by agreement rose by a multiple of five while designated transactions fell by about two-thirds.

Table 1. Summary of Selected SDR Transfers

(In billions of SDRs)

	1982	1986	1987	1988*
Transactions among participants and prescribed holders	4.69	4.89	6.71	3.24
Consisting of: by agreement	1.16	3.39	5.61	3.24
by designation	3.53	1.50	1.10	--
GRA and SDR charges	2.20	3.12	2.48	0.82
Repurchases	0.75	1.47	2.34	0.74
Total transfers	12.22	15.68	17.84	6.88

* January-April.

The effective substitution of transactions by agreement for transactions with designation has been greatly facilitated, particularly in the very recent past, by the willingness of several members to stand ready to buy and/or sell SDRs in voluntary transactions. When a member wishes to sell SDRs and could do so in a transaction with designation, the staff generally seeks to arrange the sale by agreement if a voluntary buyer can be found for the intended value date. 1/ In practice, however, it was generally difficult to find holders that wished to buy SDRs on the same days that others wished to sell them,

1/ Since June 1983, the standard designation instructions sent to the Fund by a participant with a balance of payments need and wishing to sell SDRs immediately have allowed the Fund to substitute a transaction by agreement if it is able to do so. Cumulative transactions by agreement in lieu of designation amounted to SDR 104.6 million as of the end of April 1988, which was 12.2 percent of the amount of SDRs used with designation over the same period.

even when the amounts holders wished to sell roughly matched the amounts others wished to buy, on average, over longer periods of time.

In order to help bridge this mismatch of timing, the Austrian National Bank entered into an arrangement with the Fund in February 1986 that allowed the Fund, within limits, to arrange with the Austrian National Bank purchases or sales of SDRs as needed to match the desires of other holders to buy or sell SDRs on particular dates. 1/ The National Bank of Belgium entered into a similar arrangement in October 1986. In the Executive Board's discussion of "The SDR in the Reserve Management Practices of Monetary Authorities," a number of Directors encouraged the staff to seek to increase the number of such two-way (i.e., buying and selling) arrangements. 2/

Representatives of several countries have been approached by the staff regarding the establishment of two-way arrangements, and as a result, the central banks of six additional participants (Denmark, Finland, the Netherlands, Norway, Sweden, and the United Kingdom) have entered into two-way arrangements for the SDR.

Participants (and potentially prescribed holders) entering into such arrangements specify the terms and conditions under which the Fund may initiate transactions by agreement on their behalf. These include the range of SDR holdings within which transactions may be initiated, the currencies to be exchanged and whether transactions are to be settled in two or three business days. The two-way arrangements in effect at present provide for potential purchases or sales of slightly more than SDR 1 billion in the aggregate against U.S. dollars. Within this aggregate amount, purchases or sales are possible against Deutsche Marks for up to about SDR 650 million, against French francs or Japanese yen for up to about SDR 500 million, and against pounds sterling for up to SDR 200 million. The actual amount of purchases or sales that can be arranged at any particular time depends on the level of SDR holdings of those with two-way arrangements at that time. Two of the present arrangements require transactions to be settled in three days, one requires two-day settlement, and the others permit two- or three-day settlement.

The present arrangements have enabled the staff to satisfy with voluntary transactions every request to arrange a purchase or sale of SDRs that has been received since August 1987. As a result, there have been no designated transactions since that time. Those participants not having a balance of payments need to use reserves, or that may prefer not to represent such a need, and prescribed holders, which may

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1/ See "The Development of Voluntary Transfers of SDRs Among Participants and Prescribed Holders," SM/86/142, June 18, 1986.

2/ See "The SDR in the Reserve Management Practices of Monetary Authorities," SM/87/72, March 17, 1987.

not use SDRs with designation, were able to trade SDRs in amounts and at times desired. In addition, the existence of these arrangements has assisted the Fund in taking advantage of higher yields on short-term investments in SDR-backed accounts with the Bank for International Settlements and the World Bank on behalf of the SFF Subsidy Account, and the Special Disbursement Account (Structural Adjustment Facility), as such investments require assurance that the SDRs acquired by the BIS or World Bank can be sold when the investments are liquidated.

The availability of the two-way arrangements has facilitated Fund operations in other ways as well. For example, in order to keep the level of the Fund's SDR holdings within the range approved by the Executive Board, it is often desirable that creditors accept interest payments and loan repayments in SDRs. The ability to convert SDRs so received into currency, which can be assured as a result of the two-way arrangements, has facilitated the acceptance of SDRs by lenders in such payments. In addition, as a result of the two-way arrangements, the Fund has been able to accommodate a lender's wish to fund drawdowns by the Fund by selling SDRs on call dates, rather than by selling other assets in its reserve portfolio.

The willingness of the eight members to enter into two-way arrangements is to be welcomed, as it has been of substantial benefit to the SDR's liquidity, other members, and the management of Fund operations. Nonetheless, the arrangements presently in existence may not always provide sufficient scope to meet future needs, and the staff would consider it most desirable if additional members would enter into such two-way arrangements.

III. Choice of Settlement Dates

During the Executive Board's discussion of "The SDR in the Reserve Management Practices of Monetary Authorities," a number of Directors also endorsed the suggestion that parties to transactions by agreement be allowed, if both agree, to settle transactions on the day of the agreement or on any business day within three business days from that date. 1/ Foreign exchange market transactions and transactions in other reserve assets are normally settled after two business days, but with improved communications and processing technology they also often

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1/ Buff No. 87/144, July 27, 1987. An agreement by participants to a transfer of SDRs for currency at a specified future date more than three business days after the date of the agreement would not be a transaction, but a forward operation prescribed by the Fund under Article XIX, Section 2(c) for which participants are free, inter alia, to determine the exchange rate and the value date. See Decision No. 6337-(79/178)S, November 28, 1979, Selected Decisions, Thirteenth Issue, p. 343.

can be settled the next business day, or the same day if that is desired. There have been occasions on which participants have wanted to settle an SDR transaction in less than the two or three business days currently permitted. Allowing transactions by agreement to be settled the same day or the next business day as well as in two or three business days would thus appear to be responsive to members' desires and evolving market conditions, enhancing the SDR's competitiveness and attractiveness in comparison with other reserve assets. 1/

IV. Proposed Decision

Accordingly, the following decision replacing current Rule P-6 is proposed for adoption by the Executive Board:

Rule P-6, adopted April 1, 1978, is hereby replaced by the following:

"Transactions by Agreement Between Participants

P-6 (a) The exchange rate in a transaction by agreement between participants shall be determined under Rule O-2 as of the date of the agreement, unless the transaction is carried out at another exchange rate pursuant to authorization by the Fund under Article XIX, Section 7(b). Settlement shall take place on the date of the agreement or any business day within three business days from that date, as agreed between the participants.

(b) No participant shall levy any charge or commission in respect of a transaction under Article XIX, Section 2(b)."

1/ Rules governing the use of SDRs between participants also apply to use among participants and prescribed holders. "Terms and Conditions for the Acceptance, Holding, and Use of Special Drawing Rights by Other Holders prescribed under Article XVII, Section 3", Decision No. 6467-(80/71)S, April 14, 1980.