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To: Members of the Executive Board

From: The Secretary

Subject: The Potential Contribution of the SDR to Economic Stability

Attached for consideration by the Executive Directors is a paper on the potential contribution of the SDR to economic stability which has been scheduled for discussion on Wednesday, February 26, 1986.

Mr. Rhomberg (ext. 8976) is available to answer technical or factual questions relating to this paper.

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INTERNATIONAL MONETARY FUND

The Potential Contribution of the SDR to Economic Stability

Prepared by the Research Department

(In consultation with the Legal Department
and the Treasurer's Department)

Approved by Wm. C. Hood

January 28, 1986

This is the second of two papers prepared by the staff for the review of the role of the SDR conducted by the Executive Board at the request of the Interim Committee. 1/ The first paper, "Implications of Changes in the International Monetary System for the Role of the SDR," 2/ sketched the effects of the profound changes that had occurred in the international monetary system in the period since the SDR had been created on perceptions of the role that the SDR can and should play in that system. In this context, that paper recalled the increased attention given in the years since the first SDR allocation to the contribution of the SDR to the stability of the international monetary system and alluded to a number of ways in which such stabilizing effects might be exercised. The present sequel to that paper has the purpose of elaborating the considerations on which the view of a potential stabilizing role of the SDR is based. 3/

The need for greater stability and improved performance of the international monetary system has been recognized in the recent reports of the Deputies of the Group of Ten 4/ and the Deputies of the Group of Twenty-Four. 5/ The G-10 report noted that "while the process of liquidity creation has been made flexible and the scope for countries to manage

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1/ Communique of the Interim Committee of the Board of Governors of the International Monetary Fund, October 7, 1985, Joint Press Release No. 85/33, paras. 8 and 10.

2/ SM/85/340, December 27, 1985.

3/ A third staff paper, entitled "A Comparative Analysis of the Functioning of the SDR and the ECU," is being prepared by the Treasurer's Department for the current review of the role of the SDR conducted by the Executive Board.

4/ "The Functioning of the International Monetary System," EBD/85/154, Sup.1 (henceforth "G-10 report").

5/ "The Functioning and Improvement of the International Monetary System," EBD/85/228 (henceforth "G-24 report").

their international reserve position has generally increased, the working of the system has not been entirely satisfactory." 1/ The G-24 report argued even more strongly that

> The record of creation and management of international liquidity in the past decade has been unsatisfactory. During this period, the supply of international liquidity was uneven and grossly inadequate, especially for developing countries. 2/

While there is not yet agreement on any comprehensive international action that could improve the performance of the international monetary system, Fund members do aim, individually and collectively, at creating a more stable framework in which to pursue their objectives with respect to economic growth, external balance, and stable prices. This quest for a more stable economic environment is appropriately pursued within the Fund, whose Articles of Agreement encompass the objective of promoting a stable international monetary system. 3/

1/ G-10 report, para. 63.
2/ G-24 report, para. 17.
3/ Article I of the Fund Agreement provides in part:

> The purposes of the International Monetary Fund are:
> (i) ...
> (ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.
> (iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.
> (iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

Article IV of the Fund Agreement, entitled "Obligations Regarding Exchange Arrangements," provides in part as follows:

Section 1. General obligations of members

Recognizing that the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth, and that a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members

The achievement of stability in the world economy depends on a number of factors, most prominently on economic policies that combine to foster stable economic conditions, specifically sustainable economic growth, stable national price levels, and external equilibrium. Countries' economic policies can be importantly affected by various features of the international monetary system, which is the framework within which national policies are conducted. Two elements of the international monetary system are of particular significance in this context, namely, the obligations of countries with respect to exchange rate policy and the process through which reserves are made available to countries. The present paper deals chiefly with the second of these two elements, that is to say, with the international reserve system, its effects on countries' policies, and the way in which SDRs, as part of the reserve system, could influence these policies.

International reserves are held for the purpose of enabling countries to continue their policies even when encountering temporary disturbances which, in the absence of reserves, would have forced them to modify these policies. They thus permit continuity in a country's policy stance.

Insofar as countries' policies promote stable economic conditions--say, sustainable noninflationary growth--an adequate stock of reserves could be judged to exert a stabilizing influence by allowing these policies to continue. Moreover, ample reserves can have a favorable influence on the choice of a country's policies by providing a basis for the confidence needed to adopt a relatively free and open system of trade and payments, which can in turn have beneficial effects on economic growth and stability.

3/ (Cont'd from p. 2) to assure orderly exchange arrangements and to promote a stable system of exchange rates. In particular, each member shall:

(i) endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances;

(ii) seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions;

(iii) avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair advantage over other members; and

(iv) follow exchange policies compatible with the undertakings under this Section.

If there could be assurance that all countries invariably adopted policies promoting economic stability provided their reserves were adequate for that purpose, the reserve system could be designed so as to supply reserves relatively freely to satisfy any existing demand.

However, command over reserves permits the continuation not only of stabilizing but also of destabilizing policies. Moreover, an assured supply of reserves, at low or no cost, regardless of the character of the policies that are being pursued may tempt countries to move away from stabilizing policies. Since any resources that may become available to a country to be held as reserves are equally usable for the settlement of external deficits, an open-ended supply of free reserves could invite policies inducing such deficits and thereby reaping the advantages entailed in the free use of foreign resources.

To be compatible with economic stability, a reserve system must, therefore, fulfill a dual function: it must, on the one hand, permit and encourage the continuous pursuit of stabilizing policies in the face of domestic and external disturbances; but it must, on the other hand, avoid any undue inducement of policies that might destabilize the participating economies by fostering excessive external deficits. Various historical reserve systems, beginning with the gold standard, have met this dual requirement in different ways. This paper will not review in detail the features of these historical systems, but it will attempt to provide a perspective for the present reserve system and for a consideration of the role that the SDR can properly play in it.

The remainder of this paper is divided into three sections. Section I explores the strengths and weaknesses of the present reserve system, with special emphasis on the contribution of the mechanisms through which reserves are generated to the stability of the world economy and on perceived deficiencies in the reserve system that are, or could be, detrimental to economic stability. Section II considers the contribution that the SDR might be capable of making to world economic stability by providing a remedy for any alleged deficiencies in the reserve system as it would operate in the absence of the SDR. Section III provides a summary of the role that the SDR might be perceived to play in fostering economic stability.

I. The Reserve System and World Economic Stability

The availability of reserves and the cost of acquiring and holding them exert an influence on the economic policies of countries. Through these channels, a change in the reserve system can affect the performance and stability of the world economy. This section begins with a brief review of the relationship between the supply of reserves and the formation of economic policy. It continues with a description of the present multicurrency reserve system, the relationship between the supply of reserves and economic stability in that system, and alleged shortcomings in that relationship.

Reserve supply and choice of policies

The primary purpose of holding reserves is to provide a temporary "shock absorber" to mitigate the effects of sudden changes in a country's external payments position. To be sure, a country could, in principle, allow its external accounts to come into balance without ever using, or even holding, official reserves. To do so while avoiding undue exchange rate instability, a country would have to rely on two important elements: first, its policies would have to succeed in keeping the external accounts reasonably close to a path of equilibrium by responding quickly and flexibly to disturbances emanating from abroad as well as from within; and, second, private capital markets would have to be guided by stabilizing expectations with respect to the exchange rate and respond readily to any profit opportunities created, in the light of these expectations, by temporary payments imbalances. Some industrial countries, and a few developing countries as well, have at times allowed their exchange rates to be determined entirely by market forces, including responses to their own policies. However, countries have not seen fit to reduce or eliminate their official reserve holdings.

The inclination of countries to keep their official reserves intact in an international monetary system that permits the floating of exchange rates is not difficult to understand. When faced with the need to react to disturbances of the payments position by either financing part or all of an external deficit or allowing instant adjustment to take place, perhaps through a depreciation of the exchange rate, the use of reserves for balance of payments financing is a welcome additional policy instrument. Since the authorities always have the option of not using reserves held by them, that is to say, of not employing this additional policy instrument, the expected outcome of policymaking could hardly be worse, and may be considerably better, when reserves are available than when they are not. An appropriately timed temporary use of reserves is likely to foster economic stability, especially in two types of situation. First, use of reserves to finance a temporary payments deficit may avoid costly adjustments that would have to be reversed when the effects of the underlying temporary disturbances have passed. Second, when there are sudden disturbances that are believed to be permanent, a temporary use of reserves permits a more gradual, and thereby more balanced and less disruptive, adjustment.

The extent to which countries will wish to avail themselves of the option to use reserves for financing payments deficits, and indeed the amount of reserves they will decide to hold, depend on the costs and benefits of holding reserves. If countries attempt to add to their reserves by and large until the cost of an additional amount matches its benefits, they will be sensitive in their reserve policy, and therefore in their policymaking generally, to two types of change: first, to changes in the conditions on which international financial resources can be obtained (e.g., interest rates, interest spreads above basic lending rates, and the cost of the use of other policy instruments to achieve

external balance); and, second, to changes in factors affecting the potential benefits of reserve holdings (e.g., the volatility of a country's payments position, the size of capital movements, obligations with respect to exchange market intervention, and the availability and cost of access to alternative financial resources).

It is through policy responses to changes in these costs and benefits that a reserve system can exert an influence on global economic stability. The mechanism of the international gold standard provides an illustrative example as well as a comparator for the present reserve system. Under the gold standard, a country that expanded its economy faster than its trading partners might initially be able to finance resulting current account deficits through an inflow of capital but would in the end come to lose some of its gold reserves. At that point it would have to abandon its expansionary policies; in fact, a more contractionary policy stance would be the automatic consequence of the reduction in its monetary base caused by the loss of gold. In this way, the policies of individual countries were subject to the stabilizing discipline exercised by the system.

The discipline of the gold standard provided thus a kind of automatic surveillance over the balance of payments adjustment of countries that opted to follow the unwritten rules of that system. This automatic surveillance was, in principle, symmetrical in that payments surpluses generated expansionary pressure just as deficits generated contractionary impulses. Although countries could opt out of the system--and some did, for shorter or longer intervals--the stabilizing effect of the gold standard system on the world economy was assured as long as a substantial number of countries, including major trading countries, continued to adhere to it.

While this stabilizing tendency of the gold standard system took effect directly when at least some of the leading countries maintained stable economic conditions in their own economies, there was also a more roundabout mechanism that imposed discipline on all countries together by reining in any simultaneous expansion that would leave individual payments balances unaffected. If all countries attempted, through expansionary monetary and fiscal policies, to achieve faster growth than the resources of the world economy could accommodate, so that there was a tendency toward world inflation, the cost of gold mining would also rise relative to the price of gold, which was typically fixed in terms of major currencies for extended periods; gold production would consequently decline at the very time when the demand for reserves increased in line with a higher nominal value of trade and other international transactions. In trying to attract a larger share of gold reserves, some countries would switch to less expansionary policies and, by succeeding in their objective, would put additional pressure on others to do likewise.

This mechanism, which worked in a similar manner to counter world stagnation and deflation, entailed an automatic adjustment of the supply of reserves to global reserve demands generated at stable conditions of

the world economy. Any excess or shortfall of the world's gold stock would tend to be corrected by the effects of inflation or deflation on the current output of gold. 1/

To sum up: Reserves can have a stabilizing effect by insulating countries' policies from temporary disturbances and by permitting orderly adjustment, which may be time-consuming, to abrupt permanent changes affecting the balance of payments. Reserves held by a country also permit, however, the continuation of destabilizing policies for as long as the stock of reserves lasts. Appropriate arrangements with respect to the supply of reserves must be relied upon for limiting the effects of destabilizing policies on the countries pursuing these policies and on the world economy as a whole. Although the international gold standard is today only of historical interest, it provides an illustration of arrangements that limit the adverse effects of destabilizing policies in individual countries and in the world economy as a whole.

Reserves and stability in the multicurrency reserve system

There is little to add under this heading to the general description above of the potential stabilizing role of reserve holdings in individual countries. One feature of the present international monetary system to be noted in this context is not so much a characteristic of the multicurrency reserve system as an aspect of the entire economic and financial structure of the 1980s. This feature is the dominance in size of financial magnitudes--stocks and flows--over related real magnitudes. Exchange market transactions in a day or a week amount to values comparable to those of trade flows over a quarter or a year. As a result, the task of stabilizing the external sector of an economy through the use of reserves is more difficult than it was earlier, when financial flows were of relatively more moderate magnitude. For this reason, reserves must now be larger and access to international liquidity more ample relative to trade than, say, two decades ago, to accomplish the same tasks.

In the present international monetary system, many countries can increase their foreign exchange reserves quite freely at relatively low net cost, either by purchasing reserve currencies with national currency in the exchange market or by borrowing balances of reserve currencies in private capital markets. Other countries, however, find their ability to acquire reserves constrained by the absence of an international market for their national currencies and by limits on their access to credit markets. Apart from any SDR allocations or conditional credits that they

1/ In practice, the stabilizing effect of this automatic adjustment of the global supply of reserves was marred by the length of time it required, as well as by the uneven pace of gold discoveries and technical improvements in gold mining.

may receive, these countries have to provide themselves with reserves through surpluses in those accounts of the balance of payments that can be influenced by their policies, in particular the current account.

For countries not subject to these constraints, the present reserve system works, up to a point, quite satisfactorily. Countries that take timely action to adjust their economies to changes in the external environment, as reflected in their balance of payments positions, can ordinarily be confident in their ability to acquire and hold the reserves they desire. Moreover, the supply of reserves--or more accurately, the supply of liquid funds that can be accumulated as reserves or used to finance payments deficits--responds flexibly to changes in the demand for such funds by creditworthy countries. There are some respects, however, in which the present reserve system is less adequate, particularly, in the determination of the global supply of reserves and in the timing and the manner in which adjustment pressure is brought to bear on countries in deficit (or surplus).

The global supply of reserves depends mainly on decentralized decision making of numerous private financial institutions in several countries, generally acting in the interest of their shareholders. These decisions often constitute responses to developments that potentially affect the profitability of these institutions. The time lags in these responses, together with a tendency toward exaggerated reactions to stimuli in a group of competing agents, provide a decision pattern characterized by "overshooting," with periods of excessive expansion being followed by periods of inadequate expansion or even contraction.

The problem of instability in the mechanism generating reserves was noted in the G-10 report. The Deputies agreed on the existence of the problem, and some Deputies drew further conclusions with respect to the adequacy of the present reserve system:

> The Deputies agree that, while the process of liquidity creation has been made more flexible and the scope for countries to manage their international reserve position has generally increased, the working of the system has not been entirely satisfactory. The strong inflationary pressures of the seventies and the major external debt problems of the eighties suggest that during most of this period the supply of international liquidity has been ample, if not excessive. Instances of sharp contraction in the availability of international credit have also occurred. In the view of some of the Deputies this suggests that present arrangements for the provision of liquidity have not been optimal and that, while ultimately producing very powerful effects, they have not always been conducive to a gradual adjustment toward steady non-inflationary growth of the world economy. They believe that sudden and marked shifts in the terms and conditions on which international liquidity has been made available, late recognition of and abrupt response to changes

in creditworthiness, and the very limited access certain groups of countries have to market borrowing, are factors that cannot be ignored. Other Deputies emphasize that sharp shifts in liquidity have generally reflected inadequate underlying policies and that the stability of the system depends primarily on all countries pursuing sound policies to achieve sustainable non-inflationary growth. 1/

The vulnerability of an international monetary system relying on private capital markets for the generation of the bulk of official reserves lies, not primarily in reserves being held, but rather in reserves being spent. The danger is that some countries are enabled to finance growing external deficits through unchecked borrowing from these markets. This financing of payments deficits will raise the reserves of the surplus countries, which may at times react by pursuing more expansionary policies themselves. As a result, all countries may come to expand faster than permitted by the growth of labor and capital resources, without any of them incurring unsustainable external deficits.

In contrast to the gold standard, the multicurrency reserve system provides no global automatic constraint on the policies of all countries taken together in the situation just described. If all countries pursued unduly expansionary policies at the same time, resulting in world inflation but little change in countries' external payments positions, the additional foreign exchange balances that countries would wish to acquire so as to maintain the real value of their reserves intact would be readily available to them. As a result, the present reserve system, in contrast to the gold standard system, cannot ensure world economic stability in the circumstances just described. This shortcoming was acknowledged in a passage of the the G-10 report just cited, which concludes that "... the stability of the system depends primarily on all countries pursuing sound policies to achieve sustainable noninflationary growth." 2/

A second aspect of the present reserve system that should be noted in the context of economic stability has to do with the initially delayed, but ultimately quite abrupt, application of pressure on a country to undertake balance of payments adjustment. Comparison with the gold standard system can again illustrate the point. Under that system, a country with an external deficit will lose reserves steadily until the deficit is eliminated or reversed. As reserves decline, the need to adjust becomes more obvious and more pressing all the time. In the present system, by contrast, creditworthy deficit countries can prevent the decline in reserves through external borrowing, albeit at the cost of interest payments accruing on the new loans. The mounting indebtedness and the higher interest charges may induce adjustment action; but they

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1/ G-10 report, para. 63.
2/ Ibid.

may fail to do so, especially if the funds needed for making interest payments can themselves be borrowed. In that case, the deficit imposes no immediate real burden on the country in question and may be allowed to continue until the indebtedness reaches a level at which creditworthiness is suddenly lost and harsh adjustment measures must be taken.

From the viewpoint of the contribution of the reserve system to economic stability, the delay in the effective signalling of the need for adjustment measures is a systemic weakness. There are also some related weaknesses, which will be discussed below, that have to do with the difficulty of financial institutions in assessing country risks, which can lead to an unjustified loss of creditworthiness or prevent the timely restoration of creditworthiness once the conditions causing its loss have been reversed. But the phenomenon of loss of creditworthiness itself is not a weakness or flaw of the present reserve system. It constitutes a necessary signal in a system that otherwise lacks a clear indicator of the situation in question: it corresponds roughly to the point under the gold standard system at which a country is about to use the last of its gold holdings.

A third weakness of the current reserve system, with its reliance on private financial markets as the principal source of reserves, has to do with its ability to affect the supply of reserves to member countries on the basis of incorrect perceptions of their situations. Changes in the availability of reserves have often reflected shifts in market perceptions of creditworthiness that have been based in some periods on inappropriate or irrational considerations. Critics of the current system have noted that the late 1970s and early 1980s witnessed a tendency toward overlending. At the other extreme, the availability of credit to a country can be curtailed for reasons that do not reflect exclusively the conduct of its policy. For example, it has been suggested that private markets often evaluate the creditworthiness of an individual country in terms of its regional location or stage of development, rather than on a case-by-case basis. Thus, when one country in a particular group experiences difficulties in servicing its external debt, private institutions will suspend new credits to all countries that might have similar problems. While this could be a rational response of individual financial institutions to uncertainty and a lack of complete information, the resulting liquidity shortage could harm even prudent debtor countries and thereby destabilize the international monetary system. Debtor countries can also be harmed by changes in the availability of private credit that arise from changed conditions in financial markets of the industrial countries rather than from changes in the creditworthiness of the debtors.

An additional criticism has focused on the long lags and other difficulties of restoring creditworthiness after countries adjust their policies. Despite the vigorous adjustment policies pursued by many developing countries, which have led to a sizable improvement in their current account positions since 1982, their creditworthiness has not

always been restored. In fact, the expansion of bank lending to developing countries has continued to slow and has elicited proposals designed, in part, to reverse this decline. 1/

Critics of the current system also point out that private lending decisions, which determine the availability of borrowed reserves, are heavily influenced by nonmarket forces. It has been argued that commercial bank decisions regarding the creditworthiness of a particular country are influenced not only by an evaluation of a country's policies, but also by the attitudes of official agencies regulating banks and extending export credits. The imposition of special loan-loss provisions or the suspension of export credit insurance to any country or group of countries could more than offset the effects of the country's adjustment efforts on the market's perception of its creditworthiness. Thus, countries may not face an efficient and competitive financial market in attempting to satisfy their demand for reserves.

Perhaps the most serious deficiency of a system in which countries hold borrowed reserves is that their availability has been unreliable during periods of greatest need for reserves. At such times, as already noted, countries without access to international markets must often seek to acquire reserves through current account surpluses. The adjustments in policies and income needed to generate current account surpluses in excess of those required to service external debt positions can impose a high real cost on the acquisition of reserves. Uncertainties about the terms and conditions under which reserves would be available have led countries to try to increase their owned reserves even though this has often required a sharp contraction in imports.

It has been suggested that this additional adjustment undertaken in order to accumulate reserves may impose an unnecessary burden on the countries in question and on the world economy as a whole. Moreover, it has been noted that in attempting to improve their external payments position in order to acquire reserves, countries without market access have been confronted with movements in exchange rates, inflation, growth, and trade that have been affected as much by the domestic policies pursued in the major industrial countries as by those in their own economies. In addition, it has been argued that the policies of the major countries have not been internationally consistent and have led to levels of real interest rates and fluctuations in exchange rates that have affected the cost and availability of reserves without adequately promoting adjustment.

1/ On the occasion of the 1985 Annual Meeting of the IMF and the IBRD in Seoul, Korea, the Governor of the Fund and the Bank for the United States, Secretary of the Treasury James A. Baker III, outlined a program that included "increased lending by the private banks in support of comprehensive adjustment programs."

A further problem of the current reserve system arises because reserves are held in the form of financial assets denominated in a number of reserve currencies. This allows the value of reserves to fluctuate in the face of movements of exchange rates of these currencies. Decisions by countries to alter the currency composition of their reserves might in some circumstances destabilize exchange markets. This would most likely be the case where official actions are taken as evidence by private portfolio managers that official institutions have lost confidence in a currency.

II. Role of the SDR in the Reserve System

The preceding section has analyzed the potential effects on world economic stability of a number of shortcomings of the international reserve system. It is conceivable that economic stability could be enhanced by countering the effects of some of these shortcomings through arrangements involving the SDR. It is also likely, however, that there are some deficiencies of the reserve system that cannot be remedied by the use of SDRs. This section first seeks to identify those inadequacies of the current process of generating and distributing reserves that appear amenable to being remedied or mitigated through action using the SDR system. It then discusses SDR arrangements and procedures, including allocation and cancellation of SDRs, that could provide the intended remedy or mitigation.

Possible improvements involving the SDR

In the mechanism through which the current reserve system provides liquidity to its members, imperfections with potential adverse effects on stability are found both in the determination of the scale on which liquidity is made available to the system as a whole and in the distribution of liquidity among countries. This is an important distinction in the present context for two reasons. First, it may be more difficult to reach consensus about distributional shortcomings, which are often seen as favoring one country group while harming another, than about system-wide (or scale) deficiencies, which may at times harm all countries. Second, the SDR mechanism set out in the Articles of Agreement, which relies on uniform allocation of SDRs in proportion to members' quotas, 1/ is better fitted to counteract scale shortcomings than distributional ones.

In addition to these scale and distributional deficiencies in the provision of liquidity, the system also contains another source of potential instability, which has to do with the variability of the currency composition of existing reserve holdings. The contribution that the

1/ As well as uniform cancellation of SDRs in proportion of members' net cumulative allocations.

SDR could make to the alleviation of this instability problem has been extensively discussed at the time active consideration was given to a substitution account in which reserves denominated in U.S. dollars, and perhaps other currencies as well, could be deposited in an account administered by the Fund in return for claims denominated in SDRs.

The possible contribution of the SDR to the alleviation of these three stability problems--for brevity referred to as scale, compositional, and distributional problems--will be briefly discussed in turn.

As was argued in Section I, the major shortcoming of the current reserve system in determining the overall scale on which liquid funds are supplied is its viability to adjust that supply so as to exert a stabilizing influence on the world economy. Because it lacks an automatic "governor," the supply of liquidity expands freely at times on terms and conditions that do not prevent, and indeed contribute to, excess demand and inflation in the world economy; and at other times international liquidity may become unduly tight, with many countries finding their access to international credit severely curtailed and therefore forced to reduce the growth of their economies and to restrict external trade. Since the SDR was created for the purpose of supplementing existing reserves when needed, it seems worth considering whether it could play a stabilizing role through the mechanism of allocation and cancellation provided in the Articles of Agreement.

The inability of the reserve-generating process, which is based on decentralized private decision making, to provide stable growth at an appropriate rate in the supply of international reserves also suggests the question whether the SDR could possibly help to bring that process under better international control. For this purpose, the SDR would have to be able to play the role of an international base money that is itself under the control of the international community and through which other international monetary aggregates can be influenced.

Since the process of supplying reserves, as well as international credit in general, has shown evidence of overshooting, it is conceivable that the reserve system may, in particular circumstances, fail to provide even the minimum amount of liquidity necessary for conducting international trade and financial transactions at an acceptable level. Considerations of stability could then require quick action to make up the deficiency. SDR allocation--a process already in place--could provide the necessary supplementation of private credit and thereby provide a safety net for the world economy. In the same vein, a sudden tendency toward overexpansion in private lending could be remedied by the cancellation of SDRs, provided the stock of SDRs was large enough to permit the intended reduction in reserves. Of course, the notion of a safety net, implying some sort of world-wide breakdown of existing processes, is a subject discussed with considerable reluctance. All the same, it would be wise to explore it as part of normal contingency planning.

As regards the compositional problem inherent in a multicurrency reserve system with floating exchange rates, the SDR as a basket of major currencies can provide some protection for reserve holders against fluctuations in the value of their holdings as a result of exchange rate changes. Since reserve holders can, without undue difficulty, diversify their reserve portfolios so as to make up their own currency baskets, the importance for them of a voluntary SDR substitution arrangement would be marginal and extend primarily to the saving of certain transaction costs. To the world economy as a whole, as well as to some of the reserve-currency countries, the potential benefit of a substitution account lies in permitting currency substitution, when it is sought by holders, without the effect on market exchange rates that would accompany substitution through the exchange markets.

Turning to distributional shortcomings of the current reserve system, two different types must be distinguished at the outset. The first arises to the extent that some countries, in particular reserve-currency countries, have in certain circumstances easier or more extensive access to, or face a lower net cost of, international credit than do other countries. Possibilities for remedying this asymmetry with the help of the SDR are limited. Evidently, the solution cannot be to provide for all countries the advantages of easy access to liquidity that may be enjoyed by a reserve country 1/ even if it were possible to do so, since this would jeopardize global stability by weakening discipline throughout the international economy. The only possible remedy--not a very practical one in present circumstances--for the uneven incidence of balance of payments discipline would be the replacement of the reserve-currency system by an SDR standard with "asset settlement" instead of "liability settlement" for all countries, as elaborated in the reform discussions of the Committee of Twenty in the early 1970s. 2/

The second type of distributional shortcoming is found when some countries have less assured, or costlier, access to international private credit than do most other countries in similar circumstances. Examples have been given in Section I, including countries that may have lost creditworthiness for reasons other than their own inadequate policies or countries that may have failed to regain creditworthiness despite the pursuit of adequate adjustment policies for a sufficient length of time. Here, too, the SDR in its present structure does not appear to be an adequate instrument for remedying the situation because of the need to aim the remedy at specific countries. It would be unusual to find all countries of a major group--for instance, all developing countries--in a similar situation with respect to the adequacy of access to credit

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1/ There are also disadvantages of being a reserve country.

2/ IMF, International Monetary Reform: Documents of the Committee of Twenty, Washington, D.C., 1974; in particular, "Outline of Reform," para. 20, p. 14; and Annex 5, pp. 37-40.

markets. It would be more common for some countries to enjoy good access at reasonable cost while others, although deserving of the same status, have had their access abridged and yet others have rightly been judged to lack creditworthiness. It would seem difficult to employ the SDR mechanism for improving the position of the middle group without affecting the two other groups. Neither the allocation of SDRs nor a general link between SDR creation and development finance would seem to be particularly well adapted for directing the remedy to the intended recipients. Extension of credit through the Fund's General Department, which is of course also denominated in SDRs, would appear to be a more flexible instrument to use for the purpose under discussion. If their policies were, in fact, adequate and the absence of creditworthiness resulted from a collective error of private financial institutions, Fund assistance would not need to be subject to burdensome conditionality and might be less costly than credit from the capital markets.

Use of the SDR to improve economic stability

The general suitability of the SDR for alleviating instability problems of the current reserve system was reviewed earlier in this section. It remains to examine specific arrangements that could conceivably be helpful in the quest for economic stability. It is convenient to organize this discussion, not by reference to the problems identified in the preceding section, but in accordance with techniques through which the SDR can be employed for the purposes envisaged. Most attention will be devoted to techniques for which explicit provision is made in the Articles of Agreement, namely, allocation and cancellation of SDRs in specified circumstances. In commenting more briefly on some possible uses of the SDR that cannot be effected through allocation or cancellation in proportion to members' Fund quotas, reference will be made to possible arrangements that are not specifically provided in the Articles.

SDR allocation and cancellation. 1/ This mechanism could in principle be used for several purposes related to the stability of the world economy. SDR allocation could supplement the creation of other reserve assets when their supply is judged to be insufficient. (This is, of course, the purpose that was primarily intended at the time when the SDR was created.) Similarly, cancellation of SDRs could reduce the rate of growth in the overall supply of reserves if it were judged to be excessive. 2/ The allocation/cancellation mechanism could also provide safety-net facilities. Moreover, as will be argued below, steady SDR allocation over a longer period could in effect serve a substitution

1/ Allocation and cancellation of SDRs take place under the provisions of Article XVIII of the Articles of Agreement.

2/ Cancellation is limited to the existing stock of SDRs, and the achievement of a reduction in the rate of growth of reserve supply is thus dependent on the existence of a sufficient initial stock of SDRs.

function by gradually replacing borrowed currency reserves with owned SDRs and thus improving the overall quality of reserves. Finally, a substantial replacement of currency reserves through SDRs, which could make the SDR the main reserve asset in the international monetary system, could eventually create the basis necessary for attempting better international control of the process of reserve generation.

Use of the SDR through the allocation/cancellation technique for any of these purposes is subject to a number of requirements under the Articles as well as certain other considerations. According to Article XVIII, Section 1(a), decisions on allocation and cancellation of SDRs must be guided by the "long-term global need to supplement existing reserve assets." There has been considerable discussion of this provision in the Fund over recent years, and it is not necessary to review the various positions in detail. Generally, the requirement of a "global" need is taken to preclude allocation of SDRs to all Fund members for the purpose of meeting the reserve needs of a few of them. It is debatable how large a number of members must have a need for additional reserves to justify the judgment that this reserve need should be considered to be "global" under the provisions of Article XVIII. The presumption is that the need is global if the adverse consequences of not satisfying it would be global in the sense of affecting most or all countries or impairing the functioning of the international financial system.

The specification that the need for reserve supplementation must be of a "long-term" character is more difficult to relate to the various possible purposes of SDR allocation and cancellation mentioned above. This requirement is clearly intended to preclude allocation to satisfy a temporary need, say, one related to short-term business fluctuations. Beyond this consideration, the Articles do not give guidance on the length of the time horizon that is envisaged. Steady allocation to achieve a long-run increase in the amount of SDRs relative to that of reserve currencies in the reserves of member countries and to make the SDR the principal reserve asset in the system would appear to be in keeping with the requirement in question, provided, of course, that there was also a consensus that the allocation bringing about a change in the share of SDRs in total reserves was needed and that it could be accomplished in a manner that avoided "excess demand and inflation in the world," as required by the provision of the Articles cited earlier.

The question has also been raised whether the explicit requirement of a long-term need for reserve supplementation in the Articles of Agreement permits allocation or cancellation for the purpose of modifying the global rate of growth in the supply of reserves generated by private capital markets, provided that the rate appears to be deficient or excessive over a period of time judged to be of some substantial length. It appears to be widely agreed that the provisions envisaging decisions on SDR allocation or cancellation at basic intervals of five years, as well as Fund practice in the course of the first four basic periods showing repeated changes in the rate of allocation, imply an affirmative answer.

The question must also be considered whether an international financial emergency that is expected to be of limited, although uncertain, duration could be alleviated by an SDR allocation intended to provide a safety net and whether the decision to allocate could at the same time specify subsequent cancellation either on a fixed-time schedule or upon the occurrence of a specified condition. In this respect, the G-10 report expressed the consideration that one of the contingencies under which SDRs could be made available as a safety net would be "the possibility of private markets being unable to respond adequately to a legitimate long-term global need for international liquidity." 1/

Consideration is next given to the circumstances in which reserve supplementation for the purpose of promoting stability would be indicated. A variety of conditions identified in Section I above make the international monetary system vulnerable to adverse effects of sudden changes in international credit availability. This vulnerability could be reduced through greater reliance on owned rather than borrowed reserves 2/ and through a moderation of the exposure of the value of countries' reserves to changes in the exchange rates of reserve currencies and, more generally, to the economic policies of these countries. With a given long-term demand for reserves, a shift from borrowed to owned reserves could be achieved by steady periodic allocations at a moderate rate. 3/ The expectation of a steady rate of SDR allocation--generally a less costly source of reserves than funds borrowed in the capital markets--could lead to compensating adjustments in the long-run rate of growth of foreign exchange reserves so that total long-run reserve creation may be unaffected by the allocation of SDRs.

The effects of unexpected changes in the rate of allocation/cancellation are quite different, since they would alter economic and financial plans of governments and individuals made before these changes occurred. Such alterations in the rate of allocation could, therefore, be used to offset unwanted developments in the international reserve system. It also follows that these changes in SDR allocation might best be made for a temporary period and reversed when the circumstances that induced them have ceased. These considerations apply both to action intended to offset a rate of growth of private cross-border credit that may appear too low or too high and to the provision of a substantial injection or withdrawal of liquidity in the course of the activation of a safety net. Indeed, when SDRs are used as a safety net, allocations and (complete or partial) cancellations could be decided at the same time as part of the allocation/ cancellation program for a particular basic period.

1/ G-10 report, para. 72.

2/ Regular resort to cancellation of SDRs may, however, weaken their "owned reserves" character.

3/ G-24 report, para. 104.

Substitution. Ever since major exchange rates started to float, the idea has been discussed that the SDR could make a greater contribution to the stability of the reserve system if it were used to help insulate the values of reserve portfolios from the effects of exchange rate variability and to facilitate adjustments in the currency composition of official portfolios without generating exchange market effects. This could be accomplished through the substitution of SDRs or SDR-denominated instruments for foreign exchange reserves. Proposals to this effect were discussed most intensively in the periods 1973-74 and 1979-80, although the proposals for substitution in the period 1973-74 encompassed a broader set of changes in the structure of the international monetary system than the proposals in the period 1979-80.

During the earlier period, substitution was viewed as a means of reducing the strains on the international monetary system that might result if one or more of the reserve-currency countries were to be faced with demands for the conversion of existing balances into other currencies. Unless countries were offered the possibility of shifting a part of their reserves into SDR-denominated assets without going through the exchange markets, it was feared that official portfolio adjustments could result in extensive exchange rate changes. The perceived adverse effects of substitution in discouraging adjustment in reserve-currency countries were to be reduced by requiring that the currency balances surrendered to the substitution account be eliminated gradually by asset settlement on the part of the reserve-currency countries. In the discussions of 1979-80, in contrast, the proposed voluntary substitution account provided only for adjustments in the composition of reserve portfolios without the requirement of asset settlement. While voluntary substitution was viewed as having the potential to dampen exchange market pressures and to enhance the role of the SDR, 1/ it was recognized that the contribution to stability would be limited unless accompanied by appropriate macroeconomic policies in the reserve currency countries. 2/

Those opposed to the substitution proposals argued that the establishment of such accounts could augment rather than reduce instability. One concern was that voluntary official substitution could adversely affect expectations in foreign exchange markets regarding the strength of individual reserve currencies and thereby induce private speculative movements out of assets denominated in these currencies.

1/ In these discussions, it was argued that substitution provided a means, other than SDR allocations, for "making the special drawing right the principal reserve asset in the international monetary system" (a requirement set forth in Article XXII of the Articles of Agreement).

2/ A detailed discussion of the substitution account proposals can be found in "The Evolving Role of the SDR in the International Monetary System," in George M. von Furstenberg, International Money and Credit: The Policy Roles (International Monetary Fund, Washington, 1983), pp. 473-536.

The substitution account proposals were not adopted, principally because agreement could not be reached on how to make provision for any discrepancy in the values of the account's SDR liabilities and its reserve-currency assets that could arise because of differences in interest rates not compensated by exchange rate movements. This difficulty may suggest that there is relative merit in the type of gradual substitution through steady SDR allocation discussed earlier.

"Conditional SDRs." Shortcomings of the international reserve system that are of a distributional character cannot easily be remedied through global measures such as SDR allocation. The provision of resources must in these cases be aimed at the affected countries. It has been argued that the SDR could nevertheless make a contribution to the extension of Fund credit to individual countries seeking Fund assistance to offset the effects of imperfections of the reserve system as well as for other reasons. This contribution could be effected by tying the issuance of SDRs to the implementation of adjustment programs. 1/ Under this proposal, participants in the SDR Department would place all or part of their allocations at the disposal of the Fund. These SDRs would then be provided to countries in need of reserves in support of appropriate adjustment programs. These funds could be supplied to members for the purpose of providing assistance in the financing of payments deficits or, alternatively, to be accumulated as reserve holdings, with some understandings as to the circumstances under which these reserves could be used. It has been argued that such a program could strengthen the role of the SDR and would meet the criticisms that SDR allocations may weaken adjustment efforts and grant unconditional resources to countries that do not need them.

Some doubts have been expressed regarding the usefulness of conditional SDR allocations. The G-24 Deputies noted that "only an unconditional SDR allocation could provide the required reserve strength ... ." 2/ Moreover, it was suggested that these arrangements could blur the distinction between the SDR and conditional Fund credit. The thought was also expressed that Fund resources for conditional lending were sufficient for the foreseeable future.

"SDR link." Another proposal with distributional implications involving the SDR system has been discussed since the 1960s. Its aim is to link SDR creation to the provision of development finance by changing, directly or indirectly, the distribution of allocated SDRs in favor of developing countries. The proponents of such a link have argued that it would contribute to the liquidity and stability of the

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1/ This proposal was described more fully in EBS/84/191 (9/5/84), "Proposal of the Belgian Deputies of the G-10 for a Conditional Use of SDR Allocations."

2/ G-24 report, para. 105.

international monetary system by strengthening the positions of developing countries. The G-24 report noted, for example, that "... a link between allocations of SDRs and development would not only meet the unfulfilled absorptive capacity of developing countries but also reduce the pressures on the industrial countries to accommodate an improvement in the current account balances of developing countries." 1/

Those that have not favored linking SDR allocations with development assistance have generally argued that such a link has the potential to destabilize the international monetary system by leading to excess creation of international liquidity. Because of the large and urgent need for development assistance, liquidity creation should, in the view of these observers, be kept very strictly apart from the provision of international liquidity lest a link might induce a larger allocation of SDRs than would be consistent with the growth of the long-term global need for reserves. Moreover, since a link would in practice have to be arranged in accordance with a general formula for the distribution of SDRS, it would be difficult to direct SDRs to countries in accordance with their differentiated needs. Balance of payments support can be more precisely aimed at intended recipients through the use of "unconditional SDRs" or indeed of the Fund's general resources.

Control of international liquidity. The contribution of the international reserve system to the stability of the world economy could be greatly enhanced if it were possible to exercise a measure of international control over the processes through which reserves are generated and distributed. In particular, it would be useful if the supplies and availabilities that determine the state of international liquidity could be augmented whenever liquidity was less than adequate and reduced whenever liquidity was excessive. As has been discussed earlier in this paper, direct control over the liquidity-creating process is not feasible under the institutional arrangements of the present multicurrency reserve system. While movements in the adequacy of international liquidity could, in principle and to a limited extent, be offset by a judicious policy of SDR allocation and cancellation, by far the larger part of international liquidity is controlled by market processes and is apt to overwhelm the relatively small portion that is under control by the international community. In these circumstances, international surveillance over the policies of all members presents the only practical mechanism for control over international liquidity.

These considerations led both the G-10 and the G-24 Deputies to stress the importance of Fund surveillance as a means of fostering "policies consistent with a more stable evolution of international liquidity." 2/ It was noted in both reports that Article VIII, Section 7 of the Articles of Agreement calls on members to collaborate with the

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1/ G-24 report, para. 106.
2/ G-10 report, para. 66.

IMF and other members in pursuit of the objective of "better international surveillance of international liquidity." 1/ In particular, it was acknowledged that the surveillance of exchange rate policies and the surveillance of international liquidity should be closely integrated. 2/

III. Summary

This paper has discussed various ways in which the SDR can and does contribute to the stability of the world economy. Some of the functions of the SDR system adding to economic stability have been exercised since the SDR was first created more than a decade and a half ago. Others could be exercised under present provisions of the Articles of Agreement. Further contributions of the SDR to stability are conceivable but may be more difficult to achieve under present provisions and interpretations. Some of these uses of the SDR have nevertheless been addressed in this general discussion of the topic.

Present contribution of the SDR to stability

Although Fund members are not required to hold reserves in the present system, which permits free floating of exchange rates, reserves extend a country's policy options and can thereby add to the stability of its economy. Allocated SDRs, which form part of members' reserve holdings, can therefore contribute to economic stability in the world.

Moreover, SDR holdings are considered by holders as "owned reserves," at a time when many countries hold in their reserve portfolios funds derived from short-term borrowing in international capital markets, which are subject to periodic refinancing. The greater reliability of SDRs in providing assured command over resources can contribute to stability in the policies of some holders of SDRs and to the stability of the international reserve system as a whole.

As a basket of the major currencies entering into world trade and financial transactions and held as currency reserves by Fund members, the SDR provides a convenient unit of denomination that fluctuates less in value against each component currency than that currency does against some of the other component currencies. The SDR denomination therefore enables members, national and international institutions, and private parties to keep accounts and make contracts and other arrangements across borders in a more stable unit than would otherwise be available. One of the most important uses of the SDR as a stable international unit of account is the denomination of the Fund's own accounts, in particular its claims on and liabilities to its members. As members hold claims on the Fund as part of their reserves, the SDR denomination of these claims adds a further element of stability to the reserve system.

1/ G-24 report, para. 96; G-10 report, para. 66.
2/ G-10 report, para. 67.

SDR allocation at a steady rate consistent with world economic stability could over time build a stock of SDR holdings forming a substantial part of the total reserves of Fund members and nonmember countries that are authorized holders of SDRs. With this rate of allocation being adjusted, as it must be in conformity with the Articles of Agreement, to the collective willingness of Fund members to absorb SDRs in their reserve holdings under conditions of stable developments in the world economy, the share of SDRs in total reserves would gradually increase. This change in the composition of reserves would over time improve the quality of reserves and the stability of the reserve system. A substantial rise in the share of the SDR in members' reserve holdings, which might eventually be achieved, could present opportunities for better international control of international liquidity and thus for making more active use of the reserve system for international stabilization policy conducted by the international community.

These functions describe the role that the SDR plays, or could play, in enhancing economic stability in accordance with the present Articles of Agreement and the practices that have evolved under their provisions. There are other ways, which are discussed below, in which the SDR could, in principle, add to world economic stability by countering weaknesses in the present reserve system. Consideration of such new or extended functions would have to include addressing the question of their feasibility under the present Articles and interpretations, as well as their effects on existing functions of the SDR.

Possible extension in the stability role of the SDR

The principal extension of the contribution of the SDR to economic stability considered in this paper concerns the possible allocation or cancellation of SDRs in two circumstances: first, to counteract any tendency of international liquidity to be inadequate or excessive over a short-term or medium-term period; and second, to provide quick remedial action in case of a sudden development calling for the deployment of a safety net.

In both of these circumstances, the initial action may need to be reversed sooner or later, in particular, if the developments to be counteracted are pronounced deviations from a longer-term trend. Reversal must also be presumed to be the normal expectation in order to allow the initial action, say, a substantial allocation, to be taken without undue hesitation. A more active use of cancellation of SDRs could, of course, reduce the assurance with which the SDR has come to be regarded as part of countries' owned reserves in an era during which cancellation has, in practice, never been invoked.

In addition to the use of the allocation/cancellation mechanism for adjusting the scale on which international liquidity is made available to all member countries, allocated SDRs can also be used to alter the

distribution among countries of the supply of liquidity. This could be accomplished by amending the provisions on allocation and cancellation so as to allow deviations from the proportional pattern prescribed in the present Articles or by agreements under which some members donate allocated SDRs for the benefit of other members. Under an "SDR link," where the benefits flow to a specified group of members regardless of the circumstances of individual recipient countries, it is more difficult to achieve a stabilizing effect than under a system of "conditional SDRs," where the benefits can be directed at countries most in need of temporary balance of payments support or reserve supplementation.

Finally, related decisions on allocation and cancellation could hardly be taken independently--at different times--as long as they require an 85 percent majority of the total voting power. In these circumstances, a decision to allocate SDRs and subsequently cancel them, completely or in part, would have to be taken at the initiation of the sequence, even though the cancellation could later in effect be postponed, if circumstances suggested it, through a further decision to allocate and cancel.

At present, the small share of SDRs in total reserves precludes the use of the SDR for international control of international liquidity. If a larger SDR share in the future were to move such control within reach of the international community, thought will have to be given to increasing the flexibility with which the volume of outstanding SDRs can be influenced.