FOR AGENDA

SM/86/169

July 9, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Consideration of Alternative Approaches to Influencing the Share of SDRs in Members' International Reserves

Attached for consideration by the Executive Directors is a paper on alternative approaches to influencing the share of SDRs in members' international reserves, which is tentatively scheduled for discussion on Monday, August 4, 1986.

Mr. Mathieson (ext. 7662) or Mr. Isard (ext. 6640) in the Research Department, and Mr. Coats (ext. 8249) or Mr. P. B. Clark (ext. 7801) in the Treasurer's Department are available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

Consideration of Alternative Approaches to Influencing the Share of SDRs in Members' International Reserves

Prepared by the Research Department and Treasurer's Department

Approved by Wm. C. Hood and David Williams

July 8, 1986

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Consideration of Alternative Approaches to Influencing the Share of SDRs in Members' International Reserves

Some Executive Directors have noted that "... SDRs tend not to be held by the very group of countries whose need is cited as justification for an allocation ..." and have expressed the view that the persistent net use of SDRs, if repeated following an allocation, "... would constitute a permanent transfer of resources and would thus be contrary to the very purpose of the SDR." 1/ Some Directors have also expressed the view that such a persistent net use of SDRs, if accompanied by a transfer of resources, would impede necessary adjustment efforts in at least some of the countries using their SDR allocations. The sense has also been conveyed that some members' unwillingness to allocate SDRs is to some extent the manifestation of an unwillingness to hold SDRs. 2/ This memorandum examines these matters and reviews alternative ways in which an acceptable distribution of SDR holdings among participants may be achieved.

Section I discusses a number of general issues concerning the distribution of SDR holdings. Section II discusses two basic approaches to influencing the distribution of SDR holdings: the first focuses on regulating the level of SDRs held by participants and the second focuses on enhancing the characteristics of the SDR and making it more attractive for countries to hold. Under the first approach, SDR holdings could be regulated relative to either cumulative allocations or holdings of other reserve assets. Under the second approach, the attractiveness of the SDR could be enhanced by improving its usability and by increasing its rate of return relative to rates of return on other reserve assets. Section III presents a summary and concluding comments. An Appendix provides background on the reconstitution requirement.

I. Issues Concerning the Distribution of SDR Holdings

Following the reduction of the reconstitution requirement in 1979 and its abrogation in 1981, SDR holdings of the capital-importing developing countries as a percentage of their net cumulative allocations have declined in two distinct stages (Table 1 and Chart 1). The first pronounced decline occurred on the occasion of the payment of subscriptions pursuant to the increase in Fund quotas at the end of 1980. The second occurred during the period 1982-83 and was associated both with a relatively heavy use of reserves by these countries following the emergence of the debt crisis and with rising requirements to use SDRs in the payment of obligations to the Fund. Since 1983, despite further substantial increases in payments of SDRs to the Fund, the SDR holdings

1/ See "The Chairman's Summing Up at the Conclusion of the Discussion on the Allocation of SDRs - Consideration in Light of Recent Developments," Buff/86/62 (3/28/86).

2/ Ibid.

Table 1. Holdings of SDRs by All Participants and by Groups of Countries as Percent of Their Cumulative Allocations of SDRs and as Percent of Their Non-Gold Reserves, 1970-85 1/

(End-of-period data)

			Developing countries				
					Capital-importing		
	All participants 2/	Industrial countries	All developing countries	Capital-exporting	All capital-importing countries	With recent debt-servicing problems	Without recent debt-servicing problems
Holdings of SDRs as percent of cumulative allocations							
1970	91.5	105.2	55.8	4.8	56.9	72.8	34.7
1971	92.3	107.6	52.7	24.1	53.6	55.7	50.8
1972	93.3	106.0	60.5	68.0	60.2	56.2	65.6
1973	94.5	106.4	64.1	67.3	64.0	61.5	67.3
1974	95.1	106.6	65.4	79.6	64.9	67.3	61.8
1975	94.1	107.7	59.0	92.5	57.8	60.0	54.9
1976	92.9	107.4	55.6	108.4	53.8	53.6	54.0
1977	87.3	99.4	56.1	121.7	53.9	58.2	48.0
1978	87.1	95.3	65.9	166.0	62.5	64.9	59.2
1979	93.5	100.2	77.7	167.6	71.6	71.9	71.2
1980	67.9	74.7	53.2	133.0	46.0	44.4	48.1
1981	76.6	82.6	64.0	122.9	58.0	54.7	62.0
1982	82.8	97.6	52.2	186.8	38.4	20.8	59.7
1983	67.2	79.8	41.4	165.6	28.7	15.2	44.9
1984	76.8	92.5	44.4	185.2	30.0	15.1	47.9
1985	85.0	103.1	47.5	186.6	33.3	19.1	50.4
Holdings of SDRs as percent of non-gold reserves							
1970	5.9	6.7	3.1	--	3.6	5.7	1.7
1971	7.0	7.5	4.3	0.3	5.4	7.6	3.7
1972	8.2	8.9	5.0	0.9	6.0	7.2	5.1
1973	7.8	9.2	4.2	0.8	5.0	5.9	4.1
1974	6.3	9.1	2.5	0.3	3.9	4.4	3.4
1975	5.7	8.6	2.0	0.2	3.4	3.8	2.9
1976	4.9	7.8	1.5	0.2	2.5	2.8	2.2
1977	3.7	5.6	1.3	0.2	2.2	2.8	1.6
1978	3.5	4.5	1.7	0.4	2.3	3.0	1.7
1979	4.8	6.1	2.6	1.1	3.4	4.1	2.7
1980	3.8	4.8	2.1	1.3	2.6	3.1	2.2
1981	5.3	6.4	3.1	1.6	3.9	5.3	3.0
1982	5.8	7.6	2.5	2.3	2.7	3.0	2.6
1983	4.3	5.6	1.9	2.1	1.7	1.9	1.7
1984	4.4	6.0	1.7	2.5	1.4	1.2	1.6
1985	5.0	6.5	1.9	2.5	1.7	1.7	1.7

Source: International Monetary Fund, International Financial Statistics.

1/ Country groupings follow the definitions in the April 1986 World Economic Outlook. Countries with recent debt-servicing problems are those countries that incurred external payments arrears during the period 1983-85 or rescheduled their debts during that period.

2/ This category consists of all participants in the IMF's SDR Department. The part of cumulative allocations not held by the group of participants is held by the Fund (SDR 3.1 billion at the end of 1985) and by other holders (SDR 0.2 billion at the end of 1985).

Chart 1. SDR Holdings as Percent of Cumulative SDR Allocations for Selected Country Groups

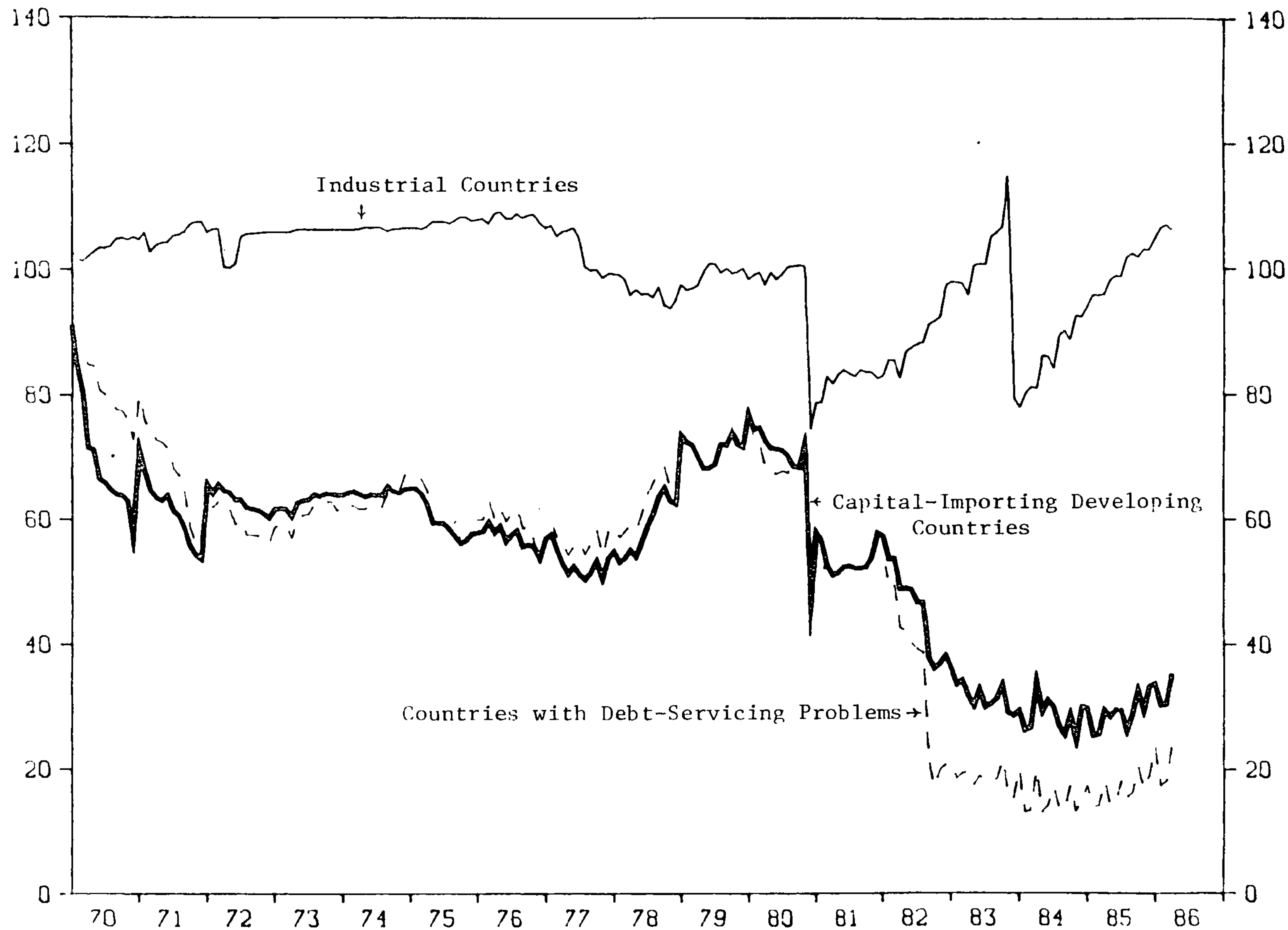
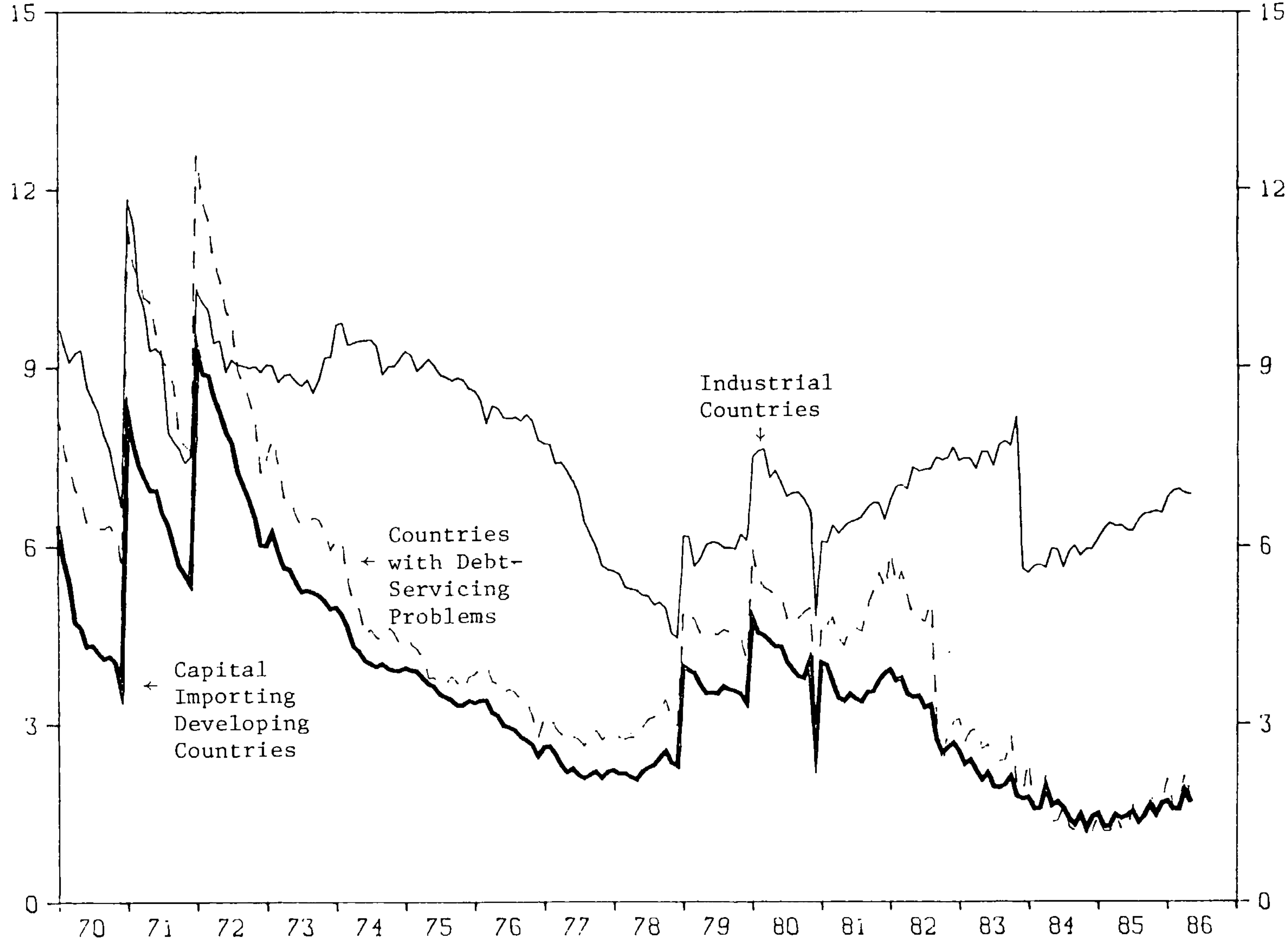


Chart 2. SDR Holdings as Percent of Non-Gold Reserves for Selected Country Groups



of the capital-importing developing countries, and of the subgroup of countries facing debt-servicing problems, have tended to stabilize as a proportion of net cumulative allocations--although at very low levels. As a proportion of non-gold reserves, the SDR holdings of the capital-importing developing countries rose during 1979-81 in association with SDR allocations during the third basic period; since the end of 1981, this ratio has declined substantially, but appears to have stabilized in 1984 and 1985 at a low level (Table 1 and Chart 2).

The reductions in the SDR holdings of some country groups to low levels have reflected a substantial and continuing increase in the percentage of all participants that have made prolonged net use of their cumulative allocations. As shown in Table 2, following the reduction of the reconstitution requirement in 1979 and its abrogation in 1981, the proportion of participants with SDR holdings averaging less than 30 percent of their cumulative allocations over five-year periods increased to 57 percent in 1985. This increase in the percentage of prolonged net users of SDRs has not, however, been associated with a rise in the proportion of participants with very high holdings of SDRs, e.g., in excess of their cumulative allocations. The asymmetry of a sharp rise in the percentage of participants with relatively low holdings without a compensating increase in the percentage of participants with relatively high holdings is partly to be explained by the fairly large rise in the SDR holdings of the Fund itself following the subscription payments made in connection with the Eighth Quota Review.

The reductions over the relatively long term in many countries' SDR holdings in relation to cumulative allocations and reserves have given rise to concerns that the SDR system, and allocations in particular, may involve the transfer of real resources and may undercut balance of payments adjustment. Two aspects of these issues have particular relevance: the relationship of resource transfers and adjustment efforts to SDR allocations, and the extent to which real resources obtained by the use of SDRs are subsidized. With regard to the first aspect, the effects of an SDR allocation on resource transfers and adjustment efforts depend on whether countries' reserves following an allocation exceed the amounts they desire. Desired reserves depend on many factors, including the marginal cost of acquiring them. It appears reasonable to assume that countries with considerable access to international capital markets will obtain the amounts of reserves they desire by supplementing their owned reserves with borrowings. For these countries, an allocation of SDRs would generally reduce their borrowings but not their overall reserve holdings, i.e., an SDR allocation would tend to result in a substitution of owned reserves for borrowed reserves.

For countries with limited access to international capital markets, however, the acquisition of reserves in response to an excess of desired over actual reserves, or in the growth of desired reserves over that of actual reserves through time, will tend to result in an outward transfer of real resources. One of the arguments in favor of SDR allocations is that, for such countries, allocations would lower the cost of acquiring

Table 2. Distribution of Participants by Ratio of SDR Holdings to Cumulative Allocations Over a Five-Year Averaging Period, 1975-85 1/ 2/

Holdings as percent of allocations	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
	Percentage of participants										
0 to 15	--	--	1	1	1	1	6	16	28	35	42
15 to 30	1	1	--	1	10	14	24	22	15	14	15
30 to 45	32	37	38	42	26	22	14	10	11	11	10
45 to 60	13	9	16	13	13	14	9	9	6	4	4
60 to 75	7	11	5	7	5	9	9	9	6	7	5
75 to 90	7	5	6	6	8	9	12	7	10	6	3
90 to 100	14	13	12	11	9	9	8	6	4	5	4
100 & above	26	24	22	20	27	23	17	20	20	18	18
Total	100	100	100	100	100	100	100	100	100	100	100

1/ Participants with net cumulative allocations of zero during any period are excluded for that period. The numbers for each year describe the distribution over the five-year period ending in that year. Column sums may not equal 100 because of rounding.

2/ Dashed line indicates the level of the reconstitution requirement.

reserves by reducing the need to pay out real resources to obtain them, thereby reducing or avoiding the associated degree of balance of payments restraint. By the same token, however, an allocation that leaves these countries with more reserves than they desire would induce an inward transfer of real resources associated with a running down of excess reserve holdings. In short, for countries with limited access to international capital markets, the failure to allocate SDRs in the face of growth in reserve demand, or to allocate sufficient SDRs in the face of a shortfall of reserves in relation to demand, would result in balance of payments adjustments leading to an outward transfer of real resources. Similarly, allocations to such countries in excess of the growth in reserve demand would have the opposite effect, leading to an inward real resource transfer.

Because SDRs are allocated to countries in proportion to the size of their quotas in the Fund, any rate of SDR allocation over time might well provide some countries with more than their desired increases in reserves and other countries with less than their desired increases. There might, therefore, be some resource transfers--and perhaps a considerable amount--as different countries sought to increase their total reserve holdings by more or less than the SDR allocations they received. Such resource transfers, however, could not be avoided by merely preventing a sustained net use of allocated SDRs. Allocated SDRs could indirectly finance real resource transfers or allow a relaxation of adjustment efforts if the receipt of SDRs led a country to use reserve assets other than SDRs to finance an increase in imports of goods and services. By the same token, an observed net use of SDRs does not necessarily imply a transfer of resources or a relaxation of adjustment efforts; such use could be for the purpose of repaying borrowed reserves or for exchanging SDRs for other reserve assets preferred by member countries. 1/ For these reasons, there is no simple relationship between SDR use and resource transfers or adjustment efforts.

Nevertheless, to the extent that the sustained net use of SDRs has permitted real resource transfers, there may be a cause for concern. In light of the desire to separate the provision of development aid from the provision of reserves, there could be concern about the extent to which resource transfers involve a gift or subsidy element. In this context the question becomes: to the extent that an SDR allocation does affect the pattern of resource transfers among participants, are the net users of SDRs subsidized by the net recipients? Under the present SDR arrangements, a sustained net use of SDRs involves a sustained payment of charges at a combined market interest rate that reflects the average of market interest rates on short-term instruments

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1/ The subscription payments in SDRs relating to the 1980 quota increase is an example of this kind of substitution of other reserve assets for SDRs.

denominated in the currencies contained in the SDR basket. 1/ Insofar as countries use SDRs to obtain current real resources, they are obligated to pay interest for as long as they sustain the net use of SDRs. 2/ Whether or not the combined effect of the transfer of resources and the payment of interest should be regarded as providing a subsidy to the net users of SDRs depends on the level of the SDR interest rate relative to those of other reserve assets. The present method of determining the rate of interest for the SDR would tend to insure that any subsidy would be relatively small or even nonexistent. 3/

The size of any subsidy on the net use of SDRs would be relevant for determining the extent to which economic incentives would have to be increased to induce countries to hold SDRs more willingly. Such a concept of a subsidy should be distinguished from the benefits that an SDR allocation would provide to countries that face quantity constraints or expensive terms in seeking to obtain credit on international capital markets. Virtually all countries hold some international reserves, so it can be inferred that, even for countries with limited or expensive access to international capital markets, the marginal benefits that reserves provide are commensurate with the high marginal cost of borrowing. These marginal benefits can be viewed as the interest rate earned on reserve holdings plus the implicit value of whatever insurance

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1/ The combined market interest rate is calculated as a weighted average of the yield on three-month U.S. Treasury bills, three-month interbank deposits in the Federal Republic of Germany, three-month interbank money against private paper in France, three-month U.K. Treasury bills, and the discount rate on two-month (private) bills, converted to a bond-equivalent yield, in Japan.

2/ In this regard, the stream of charges paid for the sustained net use of SDRs is analogous to the interest paid on short-term debt that is rolled over continuously, much like the outstanding short-term debts of public borrowers.

3/ During 1985, countries holding an SDR basket of currencies invested at three-month eurocurrency deposit rates could have earned interest at an annual rate that was 60 basis points higher than the interest rate on the SDR. Whether that represents an appropriate measure of the subsidy on the use of SDRs for such countries is arguable. To the extent that eurocurrency deposits are more risky than SDR holdings, it may be inappropriate to view the entire interest differential as a subsidy. By the same token, however, to the extent that restrictions on the use of the SDR, or other characteristics, would make the SDR less attractive than eurocurrency deposits even if their interest rates and risk characteristics were the same, the interest differential may tend to understate the subsidy.

benefits countries derive from being able to make use of reserves in times of need to avoid disrupting imports and absorption. 1/

The concern over any subsidies on the net use of SDRs arises from the "burdens" or costs that subsidies imply for the countries that effectively pay them, and from the effects that these burdens and subsidies might have on the smooth functioning of the SDR system. As will be discussed further below, such burdens have two aspects: one involving a unit cost of holding SDRs in excess of allocations, and the other relating to the quantity by which actual and desired holdings differ. Under the obligations associated with the designation mechanism, the sustained net use of SDRs by some countries may result in SDRs being acquired and held in excess of cumulative allocations by countries that may not desire them. 2/ Any burdens associated with holding excess SDRs, however, are currently less than they would be if the interest rate on SDRs had not been raised to the combined market rate. In addition, such burdens have been eased by the fact that countries without balance of payments need may now, within limits, reduce their SDR holdings through transactions by agreement with member countries or prescribed holders that need or wish to acquire SDRs.

Nevertheless, the burdens or perceived burdens of holding excess SDRs constitute one reason why it might be considered desirable to promote a more balanced distribution of SDR holdings. A second reason is related to the broader issue of the functioning of the international reserves system, which has an important influence on the functioning of the international trading system and the world economy in general. A smoothly functioning international reserves system provides major benefits to all countries. Accordingly, an unwillingness to hold SDRs may be undesirable for several reasons: it may impair the SDR's liquidity, hence its attractiveness, in both transactions with designations and by agreement; it may weaken the international reserves system by contributing to an unwillingness to allocate SDRs and thereby raising the cost of obtaining desired reserves; and it may limit the potential of the SDR for playing a constructive role as the international monetary system evolves and for becoming the principal reserve asset in the system.

1/ The fact that the implicit value of such insurance benefits may be high does not imply that the net use of SDRs is highly subsidized relative to the net use of the other reserves that virtually all countries hold, since each type of reserves provides the same insurance benefits. Nevertheless, the high implicit value of insurance benefits may be relevant to the issue of maintaining a volume of SDR allocations that is appropriate for meeting the demand for reserves of countries with limited access to international capital markets.

2/ Participants judged to be in strong balance of payments and gross reserve positions are obligated to accept SDRs and provide a freely usable currency when designated by the Fund (Article XIX, Sections 4 and 5). Their acceptance obligations are limited to the point beyond which their holdings of SDRs in excess of their net cumulative allocations are equal to twice their net cumulative allocations.

Any burdens associated with excess holdings of SDRs could be alleviated by promoting a more balanced distribution of SDR holdings through regulation or economic incentives, or perhaps through some combination of the two approaches. In considering alternative approaches, it is important to distinguish two different aspects of any such burden. First, if the SDR interest rate is less attractive to holders than the rates available on other reserve assets (after taking account of differences in a variety of attributes of the SDR and other reserve assets), then holding SDRs in excess of cumulative allocations can be viewed as involving a unit cost. Such a unit cost is difficult to quantify and might well be perceived differently by different countries, as might the counterpart unit subsidy received from the net use of SDRs. Second, if constraints in the system, such as a designation rule or a minimum holding requirement, cause SDRs to be held in different amounts than some participants desire (whether above or below cumulative allocations), those participants incur a separate burden (even if the unit cost they perceive is zero) associated with not attaining the desired compositions of their reserve portfolios.

In this context, a more balanced distribution of SDR holdings can be defined as a distribution that reduces or eliminates any burdens of holding SDRs, whether by reducing the unit cost, the quantity of holdings subject to the unit cost, or the discrepancy between the actual and desired composition of reserve portfolios. One approach to pursuing a more balanced distribution of SDR holdings, therefore, would be to reinstate a constraint on the level of SDR holdings relative to cumulative allocations, i.e., on the net use of SDRs, and hence on the quantity of holdings subject to a unit cost of holding SDRs. This concept of balance is the central focus of Schedule G, Section 1(a) defining the reconstitution requirement that operated prior to 1981.

A second approach to pursuing a more balanced or less burdensome distribution of SDR holdings would follow the provision contained in Schedule G, Section 1(b) in stressing "the desirability of pursuing over time a balanced relationship between ... holdings of special drawing rights and ... other reserve assets." Regulating SDR holdings in relation to reserves would seem less likely to generate departures from the SDR levels participants might wish to hold for portfolio preference reasons than regulating holdings in relation to allocations, and would to that extent tend to lessen the burden of departures from desired portfolios caused by regulations. Moreover, to the extent that this approach also tended to reduce the overall net use of SDRs, it would tend to reduce the quantity of SDRs subject to any unit cost of holding SDRs in excess of cumulative allocations.

A third approach would seek to reduce or eliminate any burden of holding excess SDRs by improving the characteristics of the SDR to reduce or eliminate any unit cost of holding SDRs. By not relying on regulation, or by relying less on regulation, this approach could also eliminate any additional burden that would result from requiring participants to hold unwanted SDRs, and could thus lead to greater balance between the actual and desired composition of reserve portfolios.

II. Approaches to Obtaining a More Balanced Distribution of SDR Holdings

The two approaches to obtaining a more balanced distribution of SDR holdings--through regulation and through incentives--are considered in more detail in this section. Although the two approaches could be combined, they are first discussed separately.

1. Regulations

As indicated above, Schedule G of the amended Articles of Agreement identifies two types of regulation that could be adopted as constraints on participants' SDR holdings. Section 1(a) specifies the reconstitution requirement that operated prior to 1981 as a required minimum average of SDR holdings relative to net cumulative allocations. Such a requirement can be translated into an equivalent constraint specifying the maximum permissible net use of SDRs as a proportion of cumulative allocations, where net use is measured as any shortfall of SDR holdings below cumulative SDR allocations.

By contrast, Section 1(b) suggests that a balance should be maintained between holdings of SDRs and other reserve assets, but does not specify the processes through which such balance could be maintained and monitored. One approach would require countries to maintain or exceed a minimum ratio of SDR holdings to total reserve holdings; in this case the drawing down of SDRs would be unconstrained until the minimum holdings ratio was reached, and thereafter the net use of SDRs could be no more than proportional to the use of total reserves on average. Thus, once the minimum ratio constraint became binding, it would be equivalent to a requirement that the net use of SDRs not exceed some fixed proportion of the net use of total reserves.

Given the correspondence between constraints on SDR holdings and constraints on the net use of SDRs, it is convenient to concentrate the discussion in this subsection on regulations that would constrain the net use of SDRs independently of any other considerations, and on those that would constrain the net use of SDRs relative to the use of other reserve assets. 1/ 2/ The two different types of regulation on the net use of SDRs can be compared with respect to several important considerations: (1) the amount of use that countries are permitted to make of their SDR allocations; (2) the implications of the net use of SDRs by some countries for the SDR holdings of other countries;

1/ The reframing of the discussion in terms of uses rather than holdings corresponds to the way the discussion was conducted at the time that the reconstitution requirement took shape; see the Appendix, subsection I.3.

2/ A third possibility that might be contemplated would be to regulate a country's use of SDRs according to quantitative indicators of whether the country would be financing a temporary or prolonged balance of payments deficit. It seems doubtful, however, that such an approach could be practical or effective.

and (3) the difficulties of conforming with and monitoring the regulations. It is convenient to focus in turn on the implications of each of these considerations for the choice between the two types of regulation.

With regard to the first issue, the reconstitution requirement that operated prior to 1981 defined the holding requirement as a minimum average holding over a period of time and thus gave each country the flexibility to choose between using a larger amount of SDRs for a shorter period or a smaller amount of SDRs for a longer period. A minimum average holding requirement over a period allows a country to make full use of its SDRs for a length of time that depends on the length of the averaging period.

A minimum average requirement on SDR holdings relative to allocations can have certain undesirable features, however, as was made evident by the difficulties and criticisms that arose during the operation of that type of reconstitution requirement. Some countries that made heavy net use of SDRs were obliged in the later part of the averaging periods to build their SDR holdings to levels much higher than their minimum average requirements, and in one case a participant was even obliged to acquire more than its cumulative allocation. This problem would not exist if the requirement to reconstitute could be met by restoring holdings to some required minimum level on a specific date or sequence of dates (including dates defined in terms of a length of time after any use beyond some threshold amount). However, such an approach would provide scope for "window-dressing" to circumvent the intent of the constraint as SDRs could be acquired to be held only on the specified dates. Window-dressing could be avoided by specifying that the required minimum level of holdings be maintained for a further period of time, but that would effectively impound holdings below the required minimum for that entire period of time. 1/ One variant of this approach that would give countries more flexibility would stipulate that the minimum level of holdings must be met on a certain proportion of the days in any specified holding period, without requiring that those days be consecutive. 2/

A different type of drawback associated with restrictions on net use in relation to cumulative allocations was the fact that a country might be obligated to reconstitute its SDRs regardless of its balance of payments situation, or might, by the same token, be unable to make further use of its SDRs in the short run regardless of its policies. This drawback could be addressed by shifting from a constraint on the

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1/ A maximum net use constraint that applied at every point in time would preclude ever using any SDR allocations in excess of the maximum amount and would thereby be tantamount to a cancellation.

2/ Such a suggestion has been made in another context by Mr. Sengupta. See "Proposals for Post-Allocation Adjustment in the Distribution of SDRs," SM/86/154 (6/27/86), Annex, pp. 36-39.

net use of SDRs in relation to allocations to a constraint on the net use of SDRs relative to the net use of total non-gold reserves. By design, the latter type of constraint would prevent the running down of SDR holdings while other types of reserves were being built up. Such regulations might require that SDRs be used at the same proportionate rate at which other types of reserves were used, or might even allow proportionately faster use of SDRs to enable a country to make full use of its SDRs before it exhausted its total reserves. Such a regulation might be specified in terms of the average net use of SDRs during a given period of time relative to the amount that the average level of non-gold reserves fell below some agreed benchmark level during the same period. 1/

Regulations on the net use of SDRs relative to the net use of total non-gold reserves would appear to have an advantage over regulations that constrained the net use of SDRs independently of a country's balance of payments situation. The advantage is that countries in extreme need could be permitted to make full use of their SDRs for longer periods of time, and by the same token, would be allowed to rebuild SDR holdings at a pace consistent with the rate at which they found it desirable to rebuild their total reserves following periods of extensive use. Defining the regulation as a constraint that must be satisfied on average over a period of time would avoid requiring countries to draw down both SDRs and other reserves together, transaction by transaction, and would also hold down the administrative costs of complying with and monitoring the regulations. In addition, such regulations would leave countries completely free to enter into voluntary transactions in SDRs, provided that over time any net use of SDRs was kept proportional to the net use of total reserves. However, since the demand for reserves would be expected to grow over time, such regulations would encounter complications unless SDR allocations kept pace with the demand for reserves.

The implications of the different types of regulation for the use that countries can make of their SDRs is only one of the relevant considerations in comparing such regulations. A second general issue is whether different regulations on the use of SDRs would have different advantages or disadvantages from the perspective of countries that might be designated to receive SDRs. In this regard, regulations on the net use of SDRs relative to the net use of total reserves would be similar to the current designation scheme, which tends to harmonize the excess holdings ratios (i.e., holdings in excess of cumulative allocations as fractions of gold plus foreign exchange reserves) of those countries judged to be "sufficiently strong" to be designated.

1/ It would also be possible to state the requirement as a constraint on the net use of SDRs relative to total reserves as of particular dates in time, such as the end of each month or some other calendar period. As indicated earlier, however, such a regulation would provide scope for "window-dressing" to circumvent the intent of the regulation by purchasing or borrowing SDRs to hold only on the specified dates.

Apart from this similarity, however, regulations on the use of SDRs relative to reserves would not appear to have any inherent advantages or disadvantages with respect to this consideration over regulations that simply constrained the use of SDRs relative to cumulative allocations. The relative attractiveness of different regulations to countries designated to receive SDRs would depend mainly on the extent of net use and designation under the different regulations, which would depend on how the regulations were "calibrated" as much as on the type of regulation per se.

A third issue is whether the two types of regulation would have different implications for the administrative difficulties and costs of compliance and monitoring. Regulation of the net use of SDRs relative to the net use of total non-gold reserves would require information both on SDR positions and on total non-gold reserve positions. To the extent that data on total reserve positions become available with a lag, this type of regulation might prove more difficult to operate than a regulation that simply constrained the use of SDRs relative to cumulative allocations. Additional difficulties could arise under a reserve-based regulation if some countries desired to keep their reserve data confidential, or if any countries resorted to practices of effectively holding reserves in forms that were not officially recorded as reserves.

In summary, these various considerations do not provide a full answer to the question of whether constraints on the net use of SDRs relative to the net use of total reserves would be preferable to the type of reconstitution requirement that applied prior to 1981. One possible advantage of a reserve-based regulation is that it could avoid the difficulties of having to reconstitute SDR holdings during or immediately following periods of balance of payments need; the rebuilding of SDR holdings could instead proceed at a pace consistent with the rate at which countries found it desirable to rebuild their total reserves. A disadvantage, however, is that the lags with which data on reserve holdings become available could make reserve-based regulation more difficult to comply with and monitor. Moreover, a general disadvantage of any of the regulatory approaches is that they would require participants to hold SDRs in amounts that might (and generally would) differ from the amounts they would want to hold in light of their particular economic situations. Nevertheless, to the extent that regulations reduced the prolonged net use of SDRs and generated support for a resumption of SDR allocations, this outcome might well be preferable for many countries to the present situation.

2. Economic incentives

The discussion of the SDR in the April 10, 1986 communique of the Interim Committee of the Board of Governors "... stressed the monetary character of the SDR, which should not be a means of transferring resources, and recommended that the Executive Board study possible improvements in the monetary characteristics of the SDR that would increase its attraction and usefulness as a component of monetary reserves." Improving the monetary characteristics of the SDR (including its liquidity) would be expected to increase the general willingness to hold this asset. The distribution of SDR holdings resulting from the preferences of individual holders for reserves of particular types in light of the SDR's characteristics would not, however, necessarily bear a very close relationship to either the distribution of their cumulative allocations or the distribution of their total holdings of reserves.

The demand for SDRs, aside from the influence of any regulatory requirements, depends on the nature of participants' reserve needs as well as on their assessments of the relative attractiveness of the SDR. Important considerations influencing the willingness to acquire and hold SDRs are the range and ease with which the reserve asset can be used. The major reserve currencies set the standards in this regard. The transaction costs of using these currencies are relatively low; arrangements for acquiring, holding, and using them are simple and transactions can be made rapidly; and there is a large range of financial instruments readily available in these currencies. Reserve assets denominated in these currencies, however, are subject to varying risks of impoundment or controls on the freedom with which they can be used. By comparison, the range of SDR-denominated assets is much narrower than the range of assets denominated in the major reserve currencies, the use of official SDRs is restricted and encumbered with regulatory and information requirements, and the liquidity of the SDR is limited for holders unable to use their SDRs with designation. 1/ On the other hand, the exchange-rate, political, and default risks associated with official SDRs are relatively low.

Broadening the range of the uses to which SDRs can be put could contribute in two ways to the willingness of participants to hold SDRs. New uses for the SDR could potentially increase its liquidity, in the sense of the ease with which a participant could adjust its holdings of SDRs to a desired level. New uses could also widen the range of activities for which the SDR might be used and in that way make it a more versatile asset. Expanding the uses of the SDR as a unit of account in pricing internationally traded goods and services and in denominating financial obligations (both within and outside the Fund) would increase the demand for financial instruments denominated in SDRs (both private and official) for covering exchange rate exposure and for making payments.

The uses of the official SDR could be broadened in a number of ways. A potentially important addition would be the more direct use of official SDRs for foreign exchange market intervention. This

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1/ See the separate report, "The Development of Voluntary Transfers of SDRs Among Participants and Prescribed Holders," SM/86/142 (6/18/86).

could, but would not necessarily, involve extending the range of holders of the official SDR to include commercial banks. This topic is the subject of a forthcoming staff paper. The Fund could broaden its own uses by purchasing SDRs (under Article V, Section 6(a)) in a variety of circumstances. Participants could be encouraged to repurchase in SDRs, Trust Fund repayments and disbursements and repayments under the Structural Adjustment Facility could be made in SDRs, or all Fund activities could be fully based on the SDR. 1/

The uses of the SDR among participants and prescribed holders (i.e., those uses not involving the Fund's holdings of SDRs) could also be broadened and simplified. Rather than enumerating each allowed use, the Fund could authorize any and all uses that are not specifically restricted. Operations (i.e., uses other than spot transactions exchanging SDRs for currency) could be freed from the requirement of using the Fund's official exchange rates. In addition, the instructions and reporting requirement associated with each use could be simplified. 2/

The Fund could more actively encourage the private use of the SDR, which might increase the total demand for SDR-denominated assets (private and official) and which might also facilitate certain uses of the official SDR (e.g., for exchange market intervention). 3/ However, in a recent Executive Board discussion of the role of the SDR, a number of Executive Directors were not convinced that the Fund should support the development of the private use of the SDR. 4/

In addition to being influenced by the relative usability of the SDR, the willingness to hold the SDR depends on its yield relative to the yields of other reserve assets. Since 1981, the SDR interest rate has been set at 100 percent of a weighted average of market interest rates on financial instruments that are denominated in the five currencies that have made up the SDR's valuation basket. The interest rates are those of prime financial instruments with three-month maturities for four of the five currencies and a two-month maturity for the Japanese yen. The yield on the SDR in terms of any currency unit reflects both the combined market interest rate on the SDR and any change in the value of the SDR in terms of the currency unit. The unification of the SDR's valuation and interest rate baskets means that its yield reflects the interrelationship of interest rates and exchange rates generated

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1/ J. J. Polak, "Thoughts on an International Monetary Fund Based Fully on the SDR," Pamphlet Series No. 28, 1979.

2/ See "Simplifications of Operations in SDRs," (SM/83/187, 8/15/83) and Sup. 1 (1/13/84) and "Establishment of Special Procedures for Operations to Set Aside SDRs to Secure the Performance of Obligations," (SM/83/188, 8/16/83).

3/ See "A Comparative Analysis of the Functioning of the SDR and the ECU," SM/86/20 (2/3/86).

4/ EBM/86/36 (2/26/86) and Buff Statement 86/42 (3/3/86).

in the market. Since August 1, 1983, the SDR interest rate has been set weekly.

The basket method of calculation is not necessarily optimal for the SDR system. The view taken in an earlier review of the SDR interest rate 1/ is that the optimal rate for the official SDR is, in principle, the interest rate that would be freely determined in a market for official SDRs. This SDR interest rate, relative to the rate of return on other reserve assets, would depend in part on the other characteristics of the SDR as compared with those of other reserve assets (liquidity, valuation, etc.) and on the volume of SDRs outstanding.

Accordingly, in assessing the appropriateness of the current level of the SDR interest rate it is necessary to consider all aspects of the relative attractiveness of the SDR as a reserve asset. In this regard, the SDR has some attributes that compare favorably with other reserve assets, suggesting that its interest rate could be somewhat lower, and others that compare unfavorably, suggesting that its interest rate would need to be somewhat higher than those of other reserve assets in order to remain competitive.

Among the attributes of the official SDR that might compare favorably with those of other reserve assets are its low default risk (compared, for example, with commercial bank deposits), its relatively stable value (basket valuation), its assured usability for countries with a balance of payments need, and its international origin and characteristics. It should be noted also that in "normal" periods with rising yield curves, the official SDR commands a higher yield than very short-term SDR-denominated deposits, 2/ even though the official SDR has a lower default risk and can be exchanged for currencies within a two-day period.

Among the present attributes of the SDR that might compare unfavorably with those of other reserve assets are its limited liquidity for prescribed holders and for participants having neither a balance of payments need nor obligations to the Fund, the limited number of possible holders (and ipso facto buyers and sellers of SDRs), and the limited range of uses that have been authorized by the Articles of Agreement or Executive Board decisions and the requirements associated with those uses (e.g., the need to characterize each use in terms of one of the forms authorized by the Fund, use of the Fund's official exchange rates, reporting requirements, etc.).

In the absence of a market in which the yield on the official SDR would be freely determined, it is difficult to judge what level of the

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1/ "The Level of the SDR Interest Rate," SM/83/244 (11/29/83), p. 2.

2/ This reflects the fact that the yield on the official SDR is based on the interest rates on three-month and two-month instruments.

interest rate would compensate on balance for both the relatively favorable and unfavorable attributes of the official SDR. Although SDR-denominated deposits that are potentially close substitutes for the official SDR in central banks' reserve portfolios are available at major commercial banks and generally pay interest rates higher than the rate on the official SDR, these deposits differ from the official SDR both in their degree of risk and in their usability. Nevertheless, while the market in private SDRs does not necessarily reveal an appropriate level for the interest rate on the official SDR, changes in interest rates on private SDRs might suggest appropriate changes in the interest rate for the official SDR.

While it would not be desirable for the official SDR to have a relatively unattractive yield, given its other characteristics, it would also not be desirable to improve its relative attractiveness beyond the point at which holders on average would be roughly indifferent between holding SDRs and other reserve assets. Raising the relative level of the SDR interest rate too high could make countries reluctant to use SDRs, and could thereby reduce the use of the SDR to finance payments imbalances. 1/

3. Combined approaches

In comparing approaches based on regulations with those involving economic incentives, it is important to note that while the interest rate on the SDR appears to be considerably less than the marginal cost of acquiring reserves for countries with limited access to international capital markets, it is not necessarily the case that the interest rate or other characteristics of the SDR would have to be enhanced significantly in order to discourage these countries from using SDRs relative to other reserve assets. The composition of reserves that countries wish to hold depends, in part, on the relative yields of alternative reserve assets and not on their yields in relation to borrowing costs. With the interest rate on the SDR already equal to a weighted average of market interest rates on alternative reserve assets, it is possible that some relatively modest enhancements of the characteristics of the SDR might significantly increase the willingness to hold SDRs relative to other reserve assets. Moreover, given the aggregate level of SDR allocations, the economic incentives approach could encourage a distribution of SDR holdings that would be more consistent with the preferences and situations of individual participants. 2/

1/ In its most recent review, the Executive Board concluded that the rate of interest on the official SDR remained appropriate. See "The Level of the SDR Interest Rate," SM/83/244 (11/29/83) and "The Fund's Net Income for FY 1986 and FY 1987 - Disposition of Net Income for FY 1986 and Determination of the Rate of Charge for FY 1987," EBS/86/116 (5/28/86), p. 20 and p. 24.

2/ Because individual holders differ in their preferences and circumstances, such an approach would, however, only coincidentally lead to a "harmonization" or balance of SDR holdings across participants in relation to allocations or to total reserves.

These potentially attractive features of the economic incentives approach may, however, be difficult to attain in the absence of a market for the official SDR. Without such a market, it may not be easy to judge how much adjustment in the characteristics of the SDR, including its yield, would be necessary to equilibrate the aggregate demand for official SDRs with the cumulative supply, given the conditions prevailing in markets for other reserve assets. In particular, an SDR yield below its "notional" equilibrium level could act as an incentive for some countries to make substantial net use of SDRs. This consideration raises the possibility that some regulation of the permissible net use of allocated SDRs could usefully be combined with enhanced incentives to hold SDRs. It should be recognized, however, that the combination of regulations and incentives should be designed to avoid a situation in which the SDR was used only infrequently in financing payments imbalances. It should also be recognized that regulations on the net use of SDRs would tend to reduce the attractiveness of holding SDRs, other things equal, and might thereby require that the economic incentives to hold SDRs be strengthened beyond the point that would otherwise balance the demand and supply. To the extent that regulation would reduce the likelihood of the net use of SDRs with designation, however, some countries might feel less need of strengthened economic incentives to hold SDRs.

III. Summary and Concluding Comments

The distribution of SDR holdings relative to cumulative allocations has continued to show a pattern of sustained net use by many countries. To an important extent, the net use of SDRs in recent years following the reduction and abolition of the reconstitution requirement has reflected extreme strains on members' external positions and reserve holdings in general. It has also been associated with rising payments of SDRs by indebted countries in the settlement of obligations to the Fund. Nonetheless, the net use of SDRs has been proportionately greater than the net use of other reserves for many countries. This has raised the issue of whether the present distribution of SDR holdings, which reflects heavy and prolonged use by some participants, should be a source of concern and, in particular, whether SDRs have been used to finance real resource transfers and to circumvent balance of payments adjustment.

In evaluating these concerns, it has been noted that merely preventing a sustained net use of allocated SDRs would not prevent SDR allocations from affecting resource transfers and adjustment efforts. It has also been noted that SDR allocations could affect resource transfers and adjustment efforts in either a desirable or an undesirable manner, regardless of the extent of any sustained net use of the allocated SDRs.

Despite these difficulties in assessing the implications of the net use of SDRs for the issues of resource transfers and adjustment efforts, it may be desirable to promote a more balanced distribution of SDR holdings for the purpose of reducing any remaining burdens or perceived burdens on countries designated to hold SDRs in excess of their cumulative allocations. A more balanced distribution could possibly reduce the unwillingness to allocate SDRs and help to remove a potential impediment to the development of the role of the SDR in the international monetary system. To the extent that unwillingness to hold and to allocate SDRs are both symptoms of burdens or perceived burdens of holding SDRs, the primary orientation of regulations or economic incentives to achieve a more balanced distribution of SDRs should be to address these burdens, and thereby to increase the incentives to hold SDRs rather than spend them.

The potential burden of holding SDRs has two aspects. First, if the SDR interest rate is less attractive than the rates available on other reserve assets (after taking account of the various attributes of SDRs and other reserves), then each unit of SDR holdings in excess of cumulative allocations involves a cost (which may well be perceived differently, however, by different holders). Second, if countries are constrained to hold SDRs in amounts that they do not desire (whether above or below their cumulative allocations), there may be an element of burden associated with not being able to attain the desired compositions of their reserve portfolios. Regulations on the net use of SDRs relative to cumulative allocations, reflecting the notion of a balanced distribution that is characterized in Schedule G, Section 1(a) of the Articles, would be designed to reduce the quantity of SDR holdings that are subject to the unit cost entailed by a relatively less attractive rate of return. So too would regulations on the net use of SDRs relative to the net use of other reserves, consistent with the notion of balance suggested in Schedule G, Section 1(b). By contrast, the economic incentives approach would seek to reduce the burden both by changing the characteristics of the SDR to reduce or eliminate any extent to which it is less attractive than other forms of reserves, and by relying less on regulation and thereby reducing discrepancies between the actual and desired shares of SDRs in members' international reserves.

The fact that the interest rate on the SDR (and on other reserve assets) is considerably less than the marginal cost of reserves to countries with limited access to international capital markets does not imply that economic incentives would have to be strengthened substantially to induce those countries to shift the composition of their reserves significantly toward SDRs. The composition of reserves that countries choose to hold depends, in part, on the relative yields of alternative reserve assets (not on their yields in relation to borrowing costs). Given that the interest rate on the SDR has already been raised to a weighted average of market interest rates on alternative reserve assets, it is possible that the characteristics of the SDR would not have to be enhanced considerably further before the economic incentives approach would be effective in discouraging countries from making prolonged net use of SDRs.

The consideration of approaches based on regulations and economic incentives makes clear the problems that arise in the absence of a market for the official SDR. With such a market, the yield on the official SDR (interest rate plus change in capital value) would gravitate to the level at which the demand for the official SDR would match cumulative allocations, given the conditions prevailing in the markets for other reserve assets. Without such a market, however, it may be difficult to judge the strength of the economic incentives required to equilibrate the aggregate demands for and supplies of reserves, including SDRs. This raises the possibility of combining economic incentives with regulations to prevent the excessive use of SDRs. In considering this possibility, it should be recognized that regulations on the net use of SDRs would tend to reduce the attractiveness of holding SDRs, other things equal, and might thereby require that the economic incentives to hold SDRs be strengthened beyond the point that would otherwise balance the demand and supply. To the extent that regulation would diminish the likelihood of the net use of SDRs with designation, however, some countries might feel less need of strengthened economic incentives to hold SDRs.

Background on the Reconstitution Requirement

I. Origin of the Reconstitution Requirement

This Appendix summarizes the arguments leading up to the original reconstitution requirement and to its subsequent abrogation.

1. Early discussions

The SDR scheme arose out of fears of a possible shortage of international liquidity in the mid-1960s and out of dissatisfaction with the established means of augmenting international liquidity. The reconstitution requirement reflected the desire to ensure that the new liquidity created by allocations of SDRs would not be used to finance prolonged balance of payments deficits or effect a permanent transfer of real resources from countries that accumulated SDRs to countries that made net use of them. 1/ Hence, a mechanism requiring countries to reverse some or all of their net use of SDRs was sought.

The evolution of thinking about how this objective could be achieved progressed in parallel with thinking about the nature and workings of other aspects of the new scheme. Different participants in this discussion had different perceptions of how to pursue this objective. Some wished to create a new reserve asset, on a par with gold and foreign exchange. Others wished any new scheme to be an extension of credit, along lines broadly similar to the extension of credit involved in drawings on the Fund. Hence, reserve units and drawing rights were put forward in 1966 and 1967 as alternative approaches to augmenting world liquidity. 2/ The February 1967 outline based on drawing rights contained a provision for reconstitution, whereas the companion outline based on reserve units did not. The former's provision for reconstitution was the same as the one that applied to gold tranche drawings.

As discussions proceeded, participants realized that approaches with similar economic impacts and similar rights and obligations could be set out either as a 'reserve unit' scheme or a 'drawing rights' scheme. The act or manner of creating the new asset was essentially an extension of credit. However, the nature of the instrument would

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1/ Margaret G. de Vries, The International Monetary Fund, 1966-71: The System Under Stress, Vol. 1, p. 108; see also Joseph Gold, SDRs - Character and Use, Pamphlet No. 13, p. 88.

2/ "Creation of Additional Reserves Through the International Monetary Fund (March 3, 1966)", pp. 3-7 of Margaret G. de Vries, The International Monetary Fund, 1966-71, Volume II, Documents, "Outline of an Illustrative Reserve Unit Scheme (February 23, 1967)" in de Vries, Fund, Vol. II, pp. 15-23, and "Outline of an Illustrative Scheme for a Special Reserve Facility Based on Drawing Rights in the Fund: (February 28, 1967)" in de Vries, Fund, Vol. II, pp. 24-29.

determine the extent to which it functioned like a reserve asset. The question then was whether, under either scheme, one would want to have some provision for repayment of drawings or reconstitution of holdings that had been drawn down. The principal arguments advanced on both sides of this issue are listed in the following subsection. 1/ 2/

2. Arguments concerning reconstitution

Proponents of a reconstitution requirement argued as follows:

a. Reconstitution would protect the liquidity, and hence the credibility of the scheme, by reducing or precluding the possibility that many countries would make large net use of SDRs on a sustained basis to acquire foreign exchange from creditor countries. Such prolonged use might exhaust the willingness of the creditors to supply currency, and thus bring the scheme to a halt.

b. Reconstitution would help to prevent an asset that was essentially fiduciary from being used to effect a permanent transfer of real resources. The new assets were intended to be held as reserve assets, to be used for financing temporary balance of payments deficits when needed, and subsequently to be restored.

c. Reconstitution might well contribute to the improvement of the adjustment process, or prevent the allocation of SDRs from weakening adjustment efforts, and thereby contribute to the stability of the system.

Opponents of a reconstitution requirement presented the following arguments:

a. Reconstitution would diminish the acceptability of the new asset compared with a more freely usable asset, implying less support for SDR allocations and less willingness to accept the asset in transfers. Hence, the SDR would be handicapped in playing the role envisaged for it. Moreover, there was no prima facie evidence that the scheme

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1/ Despite the objections of those preferring a 'credit' interpretation, most of the discussion was carried on in terms of 'assets.' Similarly, over the objections of the 'asset' school, the word 'credit' was used frequently. As part of the final compromise on the outline of the scheme, the 'drawing rights' nomenclature, with its connotation of credit, was used in naming the new entity. However, for ease of exposition and to capture better the flavor of the discussion, both 'asset' and 'credit' will be used where appropriate. The importance of nomenclature in arriving at the final outline is described in Joseph Gold, Special Drawing Rights, The Role of Language, Pamphlet No. 15, (1971).

2/ These arguments were most clearly set forth in a meeting of the Deputies of the Group of Ten in Paris in May 1967 (X/DEP/157, June 5, 1967, pp. 20-25).

needed such special protection in order to work. If, at some stage, the liquidity of the scheme appeared to be endangered, this problem could be tackled on an ad hoc basis.

b. The scheme would be lacking in symmetry if only persistent debtors, and not persistent creditors, were compelled to take corrective action--even if the latter were willing holders.

c. It would be preferable to rely on judicious use of interest rate differentials vis-a-vis other reserve assets, rather than a reconstitution requirement, to ensure the smooth working of the scheme and protect the liquidity of the SDR.

d. If conformity rather than freedom were the aim, outright harmonization of reserve policies would be preferable to the proposed reconstitution provision.

e. A reconstitution obligation that was attached to only one reserve asset would have little effect on the functioning of the adjustment process, while it would adversely affect the standing of the asset as a fully-fledged reserve. The relevant relationship was that between the adjustment process and the aggregate volume of unconditional reserve assets held by those countries that needed to adjust.

3. Reconstitution takes shape

At one stage the tentative outlines of the SDR scheme envisaged that reconstitution could be effected through the designation process. If a participant made large and sustained use of the units or drawing rights issued to it, the Fund, after making an appropriate representation to the participant, might decide that the participant would receive units or drawing rights in exchange for currency, even though it was not in a reasonably strong balance of payments and reserve position. 1/ Ministers concluded, however, that this approach was not sufficient and that a mathematical formulation of the reconstitution requirement was required. 2/ Two such formulations were considered; some regarded them as alternatives, while others considered that the scheme should have provisions of both types.

The first type of formulation involved a ceiling on the average net use of SDRs (as they had come to be known), which was not to exceed a fixed percentage of average allocations over a period. The second type of formulation reflected a principle of harmonization, whereby any use (in the sense of a reduction in holdings) of SDRs that was more than proportional to the use of total reserves over a period would have to be reconstituted.

1/ de Vries, Fund, Vol.II, pp. 32-33, 37.
2/ Communique of the Finance Ministers of the EEC, April 18, 1967, paragraph 7, and "Outline of a Facility Based on Drawing Rights in the Fund," circulated by the Secretary on June 28, 1967.

The Ministers of the Group of Ten agreed on an average net use principle in August 1967. It was set out in the Outline of the Scheme which the Executive Board presented to the Board of Governors for their approval at the Annual Meeting in Rio de Janeiro in September 1967. 1/ Average net use was not to exceed 70 percent of average net cumulative allocations over five-year periods. This outcome represented a compromise between those who wanted no reconstitution requirement and those who wanted a more stringent requirement, either in terms of complete repurchase of drawings or in terms of a combination of a tight ceiling on average net use and a harmonization with the use of other reserves. The reconstitution requirement--as embodied in Schedule G, Section 1(a) of the amended Articles of Agreement that became effective on July 28, 1969--stipulated that five years after the first allocation, and at the end of each subsequent calendar quarter, the average SDR holdings of each participant over the most recent five-year period must not be less than 30 percent of its average allocation over the same period. The harmonization principle survived in the expectation--as expressed in Schedule G, Section 1(b)--that participants would pay due regard to the desirability of pursuing over time a balanced relationship between their holdings of SDRs and other reserves.

4. Procedures for reconstitution

The channeling of SDRs in designation to countries with a need to reconstitute was one means of enforcing the reconstitution requirement envisaged in the Articles. Article XIX, Section 5(a)(ii) provided that participants shall be subject to designation in order to promote reconstitution and Section 5(a)(iii) required that, in designating participants, the Fund shall normally give priority to those that need to acquire SDRs for reconstitution over those to be designated on account of a sufficiently strong balance of payments and reserve position. 2/ The rules adopted in 1969 provided that when a participant's quarterly need to obtain SDRs exceeded ten percent of its net cumulative allocation, it would be subject to designation under the above provision. However, the application of this procedure to a country with low SDR holdings and low foreign exchange reserves would have entailed difficulties for that country in providing currency promptly when designated. Hence, the Executive Board decided in December 1971 that participants with a need to acquire SDRs in order to meet the reconstitution requirement could acquire the necessary SDRs from the General Resources Account, or from another participant with a balance of payment need to use SDRs. 3/ Acquisition of SDRs from the General Resources Account enabled countries to acquire SDRs at a time of their choosing rather than by being designated to receive them, possibly at a difficult juncture.

1/ de Vries, Fund, Vol. II, pp. 47-51.

2/ This Article was unchanged in substance by the Second Amendment, but it was renumbered. Before that Amendment it was Article XXV.

3/ Decision No. 3457-(71/121) G/S, December 3, 1971.

When it appeared that a participant would be subject to designation under Article XIX, Section 5(a)(ii) for a forthcoming quarter, the staff would communicate with the authorities of that participant to ascertain whether they wished to acquire the necessary SDRs voluntarily from the General Resources Account. In most cases they indicated an intention to acquire SDRs in this way and subsequently did so, and no designation under this provision took place.

II. Improvements in the Asset Qualities of the SDR - The Second Amendment and After

The Second Amendment of the Fund's Articles of Agreement, which entered into force on April 1, 1978, empowered the Fund to review the rules for reconstitution and to adopt, modify, or abrogate rules as a result of the review at any time. After the Second Amendment became effective, a number of measures related to the SDR came under consideration almost immediately. The goal of making the SDR the principal reserve asset had been incorporated into the Articles 1/ and the general sentiment seemed to be that, if the SDR were to play a more important role in the system, its relative attractiveness compared with reserve currencies would have to be improved. This objective was expressed in staff papers in terms of enhancing the attractiveness of the SDR and bringing its characteristics closer to those of reserve assets in the form of currencies. 2/ Against this background, the reconstitution requirement was an obvious target for those who wished to remove or reduce the impact of those features of the SDR scheme that made it less attractive or less usable than foreign exchange reserves.

The communique of the meeting of the Interim Committee of April 30, 1978, requested the Executive Board to review the rules for reconstitution under the amended Articles. 3/ In response, an aide memoire of the Managing Director dated August 1, 1978 proposed a package of measures concerning the characteristics and use of SDRs. The aide memoire included the following points: 4/

1. The increased attractiveness of the SDR resulting from proposed improvements should reduce the need for the reconstitution provisions, and there is fairly general agreement that the present requirement should be relaxed. 5/

2. Executive Directors were favorably disposed to three additional types of use of SDRs--for settlement of obligations, for loans, and as collateral.

1/ Article VII, Section 7; Article XXII.
2/ See, for example, "Special Drawing Rights - A Discussion Paper," SM/78/153 (6/9/78), p. 5.
3/ Annual Report, 1978, Appendix III, p. 139.
4/ EBM/78/131 (8/30/78).
5/ EBM/78/131 (8/30/78), Annex, p 27.

3. The SDR interest rate should be raised from 60 percent of the combined market interest rate (a weighted average yield of short-term money market rates) to 80 percent. 1/

The Executive Directors' report to the Interim Committee stated that the legal obligation of reconstitution had always been recognized as a characteristic not typical of other reserve assets. 2/ It indicated that the reconstitution rules should not be more severe than necessary nor retained beyond their period of useful service. The SDR was no longer unfamiliar and its yield was being raised. These and other changes could be expected to make participants generally more willing to hold SDRs, according to the report, and would thereby reduce the need to rely on obligatory reconstitution to prevent an undesirable distribution of holdings. Such considerations suggested that the reconstitution requirement could be relaxed, but it would be prudent to move gradually. The Executive Directors proposed, therefore, to reduce the reconstitution requirement from 30 percent to 15 percent.

This discussion in 1978, which took place in the light of more than eight years of experience with SDRs, focused on a number of interrelationships between aspects of the scheme that had not been stressed at its inception: notably, between allocations and the level of the SDR interest rate, and between the SDR interest rate and the reconstitution requirement. 3/ The Interim Committee's communique at its April 30, 1978 meeting stated that some members could support an increase in the SDR interest rate only on condition that an allocation of SDRs would be made. 4/ Presumably, countries that had made net use of SDRs wished to have the impact of a higher rate of SDR charges mitigated or offset by the availability of new liquidity. For countries that would eventually receive the newly allocated SDRs through designation, a higher interest rate on the SDR reduced the financial cost of receiving SDRs in exchange for currency. With a higher charge on the net use of SDRs, a reconstitution requirement that limited the extent of that net use was no longer as important a part of the scheme as it had been when the rate of charge was 1.5 percent per annum.

1/ From 1969 (when the SDR system was adopted) until mid-1974, the value of the SDR was linked to gold and its interest rate was set at 1-1/2 percent per year, about mid-way between prevailing market interest rates on U.S. dollar assets and the zero interest rate on gold. In mid-1974, the SDR interest rate was raised to 5 percent, subject to adjustment if the combined market interest rate moved outside the range of 9-11 percent. From July 1976 to December 1978, it was set quarterly at 60 percent of the combined market interest rate.

2/ See "Report of the Executive Directors to the Interim Committee on Special Drawing Rights," SM/78/215, Revision 4 (9/15/78), pp. 4-5.

3/ Participants receive interest on their SDR holdings and pay charges, at the same rate, on their SDR allocations. Hence net charges are payable on the difference between allocations and holdings.

4/ Annual Report 1978, Appendix III, p. 139.

The Managing Director's package of proposals was accepted by the Interim Committee. Subsequently, the quota increase was approved by the Board of Governors effective December 11, 1978, SDR allocations were resumed on January 1, 1979, and quota payments were made in December 1980. The required minimum average holding ratio was reduced to 15 percent, effective January 1, 1979.

III. Abrogation of the Reconstitution Requirement, April 1981

In 1979, the Program of Immediate Action of the Group of 24 expressed the widespread dissatisfaction of the developing countries with the working of the international monetary system. It made a number of suggestions, including the introduction of a 'link' between SDR allocations and development assistance whereby arrangements for the distribution of allocations would be revised to increase the proportion of SDR allocations that benefitted developing countries. It also proposed a regular annual allocation of SDRs. 1/ The Brandt Commission also called for a 'link' and for an increase in the role of the SDR in the international monetary system. 2/

In the Executive Board's discussion of these proposals, 3/ it became apparent that agreement would not be reached on either regular allocations or a 'link', and that progress was more likely to be made by moving further in the direction of making the SDR more attractive, specifically by raising the SDR interest rate to the full combined market rate and by abrogating the reconstitution requirement. For most participants in the discussion the two measures were closely associated. Hence, the Executive Board, in reporting on its discussions to the Interim Committee, indicated a widely-held view that improvements in the characteristics of the SDR would be of greater significance than the 'link' in determining the status of the SDR as a reserve asset and would have to be made if the role of the SDR were to be enhanced. 4/ Accordingly, the Interim Committee asked the Executive Board to give early attention to the question of adjusting the SDR interest rate to the full market rate and eliminating the remaining reconstitution requirement. 5/

In proposing the abrogation of the reconstitution requirement, the staff pointed out that since the time of the first SDR allocation,

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1/ Group of Twenty-Four, Outline of a Program of Action on International Monetary Reform (September 1979), Chapter IV.

2/ Independent Commission on International Development Issues, North - South: A Programme for Survival (Cambridge, MIT Press, 1980), pp. 209-210, 290.

3/ EBM/80/95 (6/20/80).

4/ "Report by the Executive Board to the Interim Committee," SM/80/215 (9/12/80), p. 3.

5/ Press Release No. 80/67, p. 5.

the range of transfers in which participants could engage had been extended. 1/ The use of SDRs by agreement no longer required a balance of payments need; this option was thus available to both surplus and deficit countries. It was also pointed out that no other asset was encumbered by a reconstitution requirement, which was a vestige of the original discussions and was out of place in the context of the effort to make the SDR the principal reserve asset of the international monetary system. Abrogation of the requirement would mean that the full amount of a participant's SDR holdings would always be available for permanent use, and a decision to use SDRs would no longer need to take into account the implications for meeting the minimum average holding requirement. The staff argued that the most effective safeguard against an undue concentration of SDRs among participants in strong external positions would be the enhanced yield and usability of the SDR. If the interest rate were raised to the combined market rate, there should be no incentive for SDRs to be used in preference to other reserve assets. With an enhanced willingness to hold SDRs, there would no longer be a need for a requirement that participants hold a minimum balance of SDRs.

Executive Directors generally agreed that a below-market interest rate and the reconstitution requirement reduced the attractiveness of the SDR vis-a-vis other reserve assets. The reconstitution requirement was therefore abrogated, effective April 30, 1981, and the SDR interest rate was increased to the level of the combined market rate, effective May 1, 1981. 2/

1/ "Special Drawing Rights Department - Abrogation of the Rules for Reconstitution," EBS/80/253 (11/24/80), pp. 2-4.

2/ Other measures were also taken to enhance the attractiveness of the SDR. In particular, between January 1, 1979 and May 1, 1981, the use of SDRs in transactions by agreement was fully freed of the requirement of a balance of payments need; additional uses among participants and prescribed holders were authorized (loans, swaps, settlement of financial obligations, etc.); the SDR interest rate and valuation baskets were unified; the number of holders was enlarged as a result of additional Fund members participating in the SDR Department and the prescription of other holders; and annual allocations were resumed.