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To: Members of the Executive Board
From: The Acting Secretary
Subject: Review of the Level of the Fund's SDR Holdings

Attached for consideration by the Executive Directors is a paper on the review of the level of the Fund's SDR holdings. A draft decision appears on page 7.

This subject has been scheduled for discussion on Friday, April 25, 1986.

Mr. Coats (ext. 8249) is available to answer technical or factual questions relating to this paper, prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

Review of the Level of the Fund's SDR Holdings

Prepared by the Treasurer's Department

(In consultation with the Legal Department)

Approved by W. O. Habermeier

March 31, 1986

1. Introduction

The Executive Board has annually reviewed the policy on sales of SDRs through the operational budgets since 1981. ^{1/} During the course of the reviews held in February 1984 and March 1985, which followed implementation of the increase in quotas pursuant to the Eighth General Review, it was agreed that the Fund would aim at reducing the level of its SDR holdings from about SDR 7 billion at end-1983 to about SDR 2.5 billion by May 31, 1986 and that the Fund would review the question again prior to April 30, 1986. ^{2/}

This memorandum reviews the level of the Fund's SDR holdings and discusses the factors that might be taken into account by the Executive Board in considering of the appropriate level of the Fund's SDR holdings over the next year. In light of these considerations and the circumstances explained below, it is proposed that the Fund aim to reduce its holdings of SDRs from the level of about SDR 2.4 billion which is expected to be attained by end-May 1986 to about SDR 1 billion by end-May 1987. The amount of SDRs proposed for sale by the Fund under the quarterly operational budgets during the year would be determined in light of this aim.

^{1/} The relevant memoranda were "Review of the Policy on Sales of SDRs and Currencies through the Fund's Operational Budgets" (SM/81/37, February 13, 1981); "Review of Policy on Sales of SDRs and Currencies in the General Resources Account" (SM/82/46, March 1, 1982; Correction 1, April 22, 1982; and Supplement 1, May 3, 1982); "Review of the Sales of SDRs and Proposal on the Level of the Fund's SDR Holdings" (SM/83/63, April 18, 1983); and "Review of the Level of the Fund's SDR Holdings" (SM/84/24, January 19, 1984 and SM/85/81, March 7, 1985). An earlier memorandum dealing with this issue was "The Role of SDRs in the General Resources Account" (SM/78/284, November 29, 1978).

^{2/} Executive Board Decision No. 7941-(85/50) G/S adopted March 29, 1985.

2. General background

The General Resources Account receives and disburses SDRs in a variety of ways. Some of these receipts and disbursements are made at the initiative of the Fund; some are at the initiative of members. ^{1/} As a result, the Fund is not in a position to control precisely the level of its SDR holdings. The Board has decided to review the level of the Fund's holdings of SDRs from time to time and determine the approximate range within which the Fund will aim to maintain its SDR holdings. ^{2/} The main way in which the Fund is able to regulate the level of its SDR holdings on a continuing basis is by determining the amounts of SDRs to be sold in purchases under the operational budgets. The principal purpose of the periodic reviews of the level of SDR holdings is to assure that the amount of SDRs to be sold in purchases under each operational budget is not to be decided on an ad hoc basis, but responds to a longer-term view on an appropriate level of the Fund's SDR holdings.

In reviews held prior to the last general increase in quotas, it was decided that the Fund's SDR holdings should be reduced to approximately SDR 1.5 billion by the end of 1983. This level was reached in November 1983, following which quota payments led to a build-up of the Fund's SDR holdings to about SDR 7 billion by end-1983. In the review held in March 1985, the Executive Board decided that holdings should be reduced from the level of SDR 4 billion that was expected by end-May 1985 to approximately SDR 2.5 billion by end-May 1986. The Fund's holdings of SDRs at end-May 1985 were actually SDR 4.4 billion, somewhat above the target, as a result of delays in the completion of a number of purchases. Inflows and outflows of SDRs in the period since

^{1/} As regards inflows of SDRs to the General Resources Account, a member is required to pay charges in SDRs, while repurchases may be made in SDRs if a member wishes and the Fund is obliged to accept the SDRs. Members are required to pay 25 percent of payments for quota increases in SDRs, unless the Fund decides otherwise. The Fund also receives interest on its SDR holdings in SDRs. As regards outflows, members are not obliged to accept SDRs in any transactions or operation except replenishment and only then up to a member's acceptance limit. However, the Fund offers SDRs to members as an alternative to currencies in many of the payments it makes to members. Members accept SDRs willingly in purchases, as they are able to convert the SDRs so acquired into currency in a transaction with designation if they wish and receive the same value as if currency were received directly. Significant amounts are accepted in remuneration payments; and SDRs have been accepted in repayment of loans and in payment of interest on Fund borrowing, and are sold by the Fund against the currencies of other members to countries needing them to pay charges.

^{2/} Executive Board Decision No. 6275-(79/158) G/S, adopted September 14, 1979.

then to end-February 1986 are shown in the table below. Inflows, mainly charges, repurchases and interest on the Fund's SDR holdings, amounted to about SDR 3.6 billion. These were more than offset by outflows totaling about SDR 5.1 billion, in the form of sales to members making purchases, payments of remuneration and other operational transfers by the Fund, and sales to members needing to acquire SDRs for the payment of charges. As a result, the Fund's SDR holdings have been reduced overall by about SDR 1.5 billion, to about SDR 2.9 billion as of end-February 1986. In the light of inflows and outflows of SDRs expected during the period March-May 1986, including transfers agreed by the Executive Board under the operational budget, it is projected that the Fund's SDR holdings will amount to about SDR 2.4 billion by end-May 1986. ^{1/}

3. Considerations bearing on the future level of the Fund's SDR holdings

In earlier reviews, the following factors have been considered in determining the target range of the Fund's holdings of SDRs: (a) the Fund's holdings of SDRs in relation to total allocations of SDRs; (b) the Fund's liquidity; (c) the Fund's operational need to hold SDRs; and (d) the Fund's income.

a. A general consideration is the relation between the Fund's SDR holdings and the total of SDR allocations. In the past, most Executive Directors have felt that it was in general preferable for SDRs to be held in members' reserves rather than in the Fund. Fund holdings at the level of about SDR 2.4 billion expected at the end of May 1986 would represent 11.2 percent of total allocations of SDR 21.4 billion. An appropriate level for the Fund's SDR holdings in proportion to total allocations of SDRs is largely a matter of judgement. The Fund's holdings should not represent an unduly large proportion of total allocations, and the Fund should not aim to hold a higher proportion of total SDRs than may be justified in light of its liquidity, operational needs, and net income.

b. SDRs held by the Fund are highly liquid assets because they can be readily used to finance members' purchases and to replenish its holdings of needed currencies. As a large proportion of SDRs transferred by the Fund to members making purchases is exchanged for currencies through the designation system, these transfers are subject to the capacity of members in "sufficiently strong" balance of payments and reserve positions to absorb SDRs within their acceptance limits.

^{1/} As agreed at EBM/86/47 (March 19, 1986), the operational budget for March-May 1986 provides for somewhat larger transfers of SDRs in order to help accelerate the harmonization of members' reserve tranche positions in the Fund in relation to their gold and foreign exchange holdings (see EBS/86/50, March 4, 1986).

Receipts and Transfers of SDRs by the General Resources Account--
Actual and Projected Flows from June 1985 to May 1987

(In millions of SDRS)

	Actual June 1985- Feb. 1986	Anticipated March - May, 1986	Projected June 1986- May 1987
Fund's SDR holdings at beginning of period	4,425	2,870	2,400
A. <u>Inflows of SDRs</u>	(+) 3,617	(+) 750	(+) 4,500
(i) Charges net of refunds	2,541	370	2,650
(ii) Repurchases	860	325	1,700
(iii) Interest & Assessments	215	55	150
(iv) Quota payments	1	--	--
B. <u>Outflows of SDRs</u>	(-) 2,445	(-) 520	(-) 2,000
(i) Remuneration	1,122	370	1,400
(ii) Acquisitions for charges	1,323	150	600
C. <u>Use of SDRs in purchases and payments to lenders</u>	(-) 2,727	(-) 700	(-) 3,900 <u>1/</u>
Fund's SDR holdings at end of period	2,870	2,400	1,000

1/ The amount of SDR 3.9 billion represents transfers in purchases and payments to lenders that would be necessary in the light of the present estimate of other inflows and outflows of SDRs in order for the Fund's holdings to be reduced to about SDR 1 billion by May 31, 1987.

This scope is normally large. 1/ The Fund can also, subject to the SDR acceptance limit of the member concerned, replenish its holdings of a needed currency by requiring the member concerned to sell its currency to the Fund against SDRs. The adequacy of the Fund's liquid assets, of which SDR holdings are a portion, must be seen also in relation to the size of its liquid liabilities. The Fund's liquid liabilities totaled SDR 41.1 billion at end-January 1986, of which reserve tranche positions amounted to SDR 26.5 billion and loan claims SDR 14.6 billion. The Fund's total holdings of usable ordinary resources (unadjusted) amounted to SDR 38.8 billion at end-January 1986, including SDR 35.9 billion of usable currencies. 2/ The relatively high level of usable currencies tends to reduce the need to hold SDRs for liquidity purposes, because the potential need to replenish a member's currency is likely to be less. However, the usability of the Fund's SDR holdings is not subject to the uncertainties that exist for currencies.

c. As regards operational requirements, the Fund needs working balances to be able to provide SDRs to members that need them to meet obligations payable in SDRs. These obligations are (i) charges on the use of Fund resources and (ii) quarterly payments of net charges and the annual payment of assessment in the SDR Department. In addition, the Fund offers to pay remuneration in SDRs, and adequate holdings should be maintained for this purpose. Although charges payable to the Fund will remain high in the period ahead, SDRs needed by members for paying charges may also be acquired from others in transactions by agreement. Transactions by agreement have increased substantially in recent years, and the possibility of such transactions may reduce demands on the Fund to make SDRs available to members for paying charges. The magnitudes and timing of prospective inflows and outflows are such that, in the view of the staff, the operational needs of the Fund to hold SDRs in the period ahead could be adequately covered by working balances on the order of SDR 1 billion.

d. As long as the SDR interest rate is higher than the rate of remuneration, a higher (lower) level of SDR holdings results in a somewhat higher (lower) level of net income to the Fund. As a result of increases in the remuneration coefficient in relation to the SDR interest rate, the financial effects of a reduction in the Fund's SDR holdings on its income and expenses have diminished. A reduction of the

1/ At the end of February 1986, for example, the obligations of members judged "sufficiently strong" to accept SDRs within their acceptance limits were in excess of SDR 25 billion, compared with the Fund's SDR holdings of about SDR 3 billion.

2/ See EBS/86/55, "The Fund's Liquidity and Financing Needs" (March 5, 1986). Italy has since been excluded from the list of members considered sufficiently strong and as a result, usable ordinary resources declined by about SDR 2 billion.

Fund's holdings of SDRs from the level of SDR 2.4 billion anticipated at the end of May 1986 to approximately SDR 1 billion at the end of May 1987 would imply an average reduction in the Fund's holdings of about SDR 0.5 billion during financial year 1987 from the level of SDR 2.4 billion at end-May 1986. On the basis of the present SDR interest rate, for example, and taking into account the remuneration coefficient that would be projected under Rule I-10 for May 1986 on the basis of the present SDR interest rate (i.e., 97 percent of the SDR interest rate), this would imply a reduction in the Fund's net income for the financial year 1987 by about SDR 1 million, with an effect of about one half of one hundredth of one percentage point of the rate of charge (0.005 percentage point) and its effect may therefore disappear in the rounding. 1/

4. Proposal on the future level of the Fund's SDR holdings

As a result of reviews held in the early 1980s, it was decided by the Executive Board to reduce the level of the Fund's SDR holdings to about SDR 1.5 billion at end-1983, a level that was attained just prior to the large increase in holdings at year-end associated with quota payments. In the review held in March 1985, the question was raised whether the Fund should again aim to reduce its holdings to the same level by early 1987, i.e., at a rate similar to that resulting from earlier reviews. The Board's decision to reduce the level of holdings to about SDR 2.5 billion by end-May 1986 was consistent with a pace of reduction that would, if continued, achieve this result and which implied the maintenance of transfers of SDRs at approximately one-half of the total of projected transfers by the Fund, including transfers to lenders in loan repayments and interest payments.

Projected inflows of SDRs remain at relatively high levels and, as discussed above, the staff does not consider that the Fund's foreseeable operational requirements would call for the maintenance of working balances in excess of about SDR 1 billion. To reduce the level of holdings to about SDR 1 billion by end-May 1987 would require that transfers of SDRs be about one half of total transfers, including transfers to lenders in loan repayments and interest payments, projected for the four coming quarters. 2/ While a more extensive use of

1/ The SDR interest rate in the week beginning March 24, 1986 was 6.76 percent per annum. Based on a remuneration coefficient of 97 percent, the rate of remuneration would be 6.56 percent and the differential 0.20 percentage point.

2/ Taking into account likely net inflows as shown in the table above, a reduction in the Fund's SDR holdings to about SDR 1 billion over the period June 1986 - May 1987 would imply total transfers of SDRs in purchases and payments to lenders under the four operational budgets of about SDR 4 billion. This would represent about one half of total transfers of currencies and SDRs for the same period, projected

SDRs would speed up somewhat further the harmonization of members' reserve tranche positions in the Fund in relation to their gold and foreign exchange reserves, the staff feels it is not desirable to aim to lower the SDR holdings of the Fund below the approximate amount judged prudent for working balances, keeping in mind also the effects, although extremely small, of lowering SDR holdings on the income of the Fund. In view of the objective mentioned above of temporarily speeding the harmonization of members' reserve tranche positions in the Fund, some emphasis would be given to the use of SDRs during the first two operational budgets of financial year 1987 (i.e., covering the period June to November 1986) in order to somewhat reduce the use of currencies in transfers in this period. Accordingly, it is proposed that the Fund's SDR holdings be reduced to a level of approximately SDR 1 billion by end-May 1987 and that, prior to April 30, 1987, a further review be conducted to determine whether further change in the target for the Fund's SDR holdings is warranted.

5. Recommended decision

In the light of the above, and in accordance with Executive Board Decision No. 6275-(79/158) G/S, it is proposed that the Executive Board adopt the following decision:

In determining the amounts of SDRs to be transferred in purchases under the operational budgets, the Fund will be guided by the aim of reducing the Fund's SDR holdings to a level of approximately SDR 1 billion by May 31, 1987. Prior to April 30, 1987, the Fund will again review the level of its SDR holdings.

2/ (Cont'd from p. 6) at SDR 8 billion, consisting of about SDR 3 billion in operational transfers to lenders in the operational budgets and, consistent with the latest assessment of the Fund's liquidity (EBS/86/55), about SDR 5 billion in purchases of the Fund's ordinary resources, including possible encashments of reserve tranche positions.