FOR AGENDA

SM/86/302

December 17, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Concept of Long-Term Global Need for Reserve Supplementation in the Current Context

There is attached for consideration by the Executive Directors a paper on the concept of a long-term global need for reserve supplementation in the current context.

Mr. Isard (ext. 6640) is available to answer technical or factual questions relating to this paper prior to the Board discussion which has been scheduled for Monday, January 12, 1987.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

Concept of Long-Term Global Need for Reserve Supplementation in the Current Context

Prepared by the Research Department

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

Approved by R. R. Rhomberg

December 17, 1986

The continuing deliberations by the Executive Board on issues associated with SDR allocation have indicated a range of views on how the concept of a long-term global need for reserve supplementation should be interpreted in the context of the conditions under which the international monetary system is currently operating. The different views of the concept of a long-term global need reflect different interpretations of Article XVIII, Section 1(a) of the Fund's Articles of Agreement, which states:

> In all its decisions with respect to the allocation and cancellation of special drawing rights the Fund shall seek to meet the long-term global need, as and when it arises, to supplement existing reserve assets in such manner as will promote the attainment of its purposes and will avoid economic stagnation and deflation as well as excess demand and inflation in the world.

This sentence has focused attention both on the system's capacity to supply reserves and on whether the allocation or cancellation of SDRs would promote the attainment of the purposes of the Fund 1/ and would avoid economic stagnation and deflation as well as excess demand and inflation in the world.

1/ As set forth in Article I of the Articles of Agreement, the purposes of the International Monetary Fund are:

(i) To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.

(ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.

(iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.

(iv) To assist in the establishment of a multilateral system

To facilitate further consideration of the concept of a long-term global need by the Executive Board, Section I of this paper provides historical perspectives on how the concept emerged during the 1960s, when the First Amendment to the Fund's Articles of Agreement was drafted and adopted, and on how interpretation of the concept evolved during the 1970s in light of the changes that took place in the international monetary system. In 1984, a review of the legislative history of the concept of "global need" by the Legal Department clarified the concept under general circumstances, but did not focus on specific considerations that might indicate a global need, or a lack thereof, under current conditions. 1/

1/ (Cont'd from p. 1) of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

(v) To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.

(vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

1/ SM/84/148, "Allocations of SDRs - Legislative History of the Concept of 'Global Need' to Supplement Existing Reserves," June 27, 1984, which concluded (pp. 15-16):

The legislative history and application in practice of Article XVIII, Section 1(a) of the Fund's Articles supports the following propositions:

1. The requirement of a "global" need to supplement existing reserves through the allocation of SDRs before an allocation can be decided upon means that the Fund must be satisfied that the world economy as a whole has a need for reserve supplementation. If this need exists, an allocation of SDRs could be made even if the need could or would be met in other ways.

2. The determination of the needs of the world economy must necessarily involve consideration of the adequacy of the reserves of individual countries. However, for the purpose of this determination, the significance of an actual or projected inadequacy of the reserves of an individual country or group of countries depends on the impact of this inadequacy on the performance of the world economy and the functioning of the international monetary system.

3. Consequently, the fact that many individual countries or groups of countries need to increase their reserves does not necessarily mean that a "global" need for a supplement exists, in the sense of Article XVIII, Section 1(a). Conversely, it is not necessary under the concept to establish that all or nearly all countries need to increase their reserves.

Section II addresses the concept of a long-term global need for reserve supplementation in current circumstances. A prominent feature of the current environment is that some countries can borrow large quantities of reserves at relatively low net costs while many other countries either have no access to international capital markets or confront difficult and uncertain terms and conditions when seeking to gain or retain access to those markets. The paper considers two points of view from which this feature of the current environment might be taken to indicate a long-term global need for reserve supplementation. The first point of view is based on arguments that a system that relies heavily on borrowing to satisfy the long-term growth in the global demand for reserves is likely to be less stable than a system that creates owned reserves to satisfy the growth in the global demand. The second point of view is based on arguments that for many countries the difficulties and uncertainties of access to international capital markets could be a long-term phenomenon, that such a long-term phenomenon would counteract the objectives of the Fund, and that reserve supplementation could shorten the duration of the phenomenon or otherwise reduce the extent to which the objectives of the Fund were counteracted.

Section III provides some concluding remarks.

I. Historical Perspectives

1. Developments during the 1960s

The creation of the SDR--through authority provided in July 1969, when the First Amendment to the Fund's Articles of Agreement entered into force, and through the resolution adopted in October 1969 to begin allocating SDRs at the start of 1970--marked the end of a decade of growing concern about the ability of the Bretton Woods system to generate an adequate supply of international reserves while also sustaining confidence in the gold convertibility of the U.S. dollar, the principal reserve currency. During the period from 1963 through 1967, the Fund and the Deputies of the Group of Ten (G-10) had conducted a series of studies on the functioning of the international monetary system, the need for reserves, and the design of a facility for creating reserve assets. 1/ By the end of July 1967, the G-10 Deputies had agreed on an outline of a plan for creating special drawing rights, which was then considered and modified by their finance ministers and central bank governors, approved by the Executive Board of the Fund, and released by the Fund in mid-September as an "Outline of a Facility Based on Special

---

1/ Discussions of these studies can be found in: Margaret Garritsen de Vries, The International Monetary Fund 1966-71: The System Under Stress, Volumes I and II, International Monetary Fund, Washington, D.C., 1976; SM/84/148, op. cit.; and SM/85/340, "Implications of Changes in the International Monetary System for the Role of the SDR," December 27, 1985.

Drawing Rights in the Fund" (henceforth, the Outline). 1/ At its Annual Meeting in Rio de Janeiro late in September, the Board of Governors of the Fund adopted a resolution to proceed with establishing an SDR facility based on the Outline and with making associated improvements in the rules and practices of the Fund, and to propose amendments to the Articles of Agreement on these matters. At the time, many features of the SDR plan remained to be drafted; in particular, the Outline did not include an explicit statement of the principles on which decisions to allocate SDRs were to be based.

Those principles, however, had been taking shape in the various studies and discussions leading to the Outline. The first explicit written reference to the concept of "global need" occurred in a report of the G-10 Deputies annexed to a Ministerial statement issued on August 10, 1964. 2/ By the end of 1966, a broad consensus had been reached that:

> Deliberate reserve creation, when decided upon, should be neither geared nor directed to the financing of balance of payments deficits of individual countries, but should take place on the basis of a collective judgment of the reserve needs of the world as a whole. 3/

Furthermore, during the subsequent consideration of amendments to the Articles of Agreement by the G-10 Deputies and the Executive Directors of the Fund, it was agreed that reference should be made to a "long-term" global need, on the grounds that this would convey the point that attention should be focused on long-term trends, and on structural rather than on cyclical developments. 4/ The final language that was included in the First Amendment to the Articles of Agreement, which entered into force in July 1969, is the language that still remains in Article XVIII, Section 1(a), as reproduced on the first page of this paper. 5/

In September 1969 the Managing Director transmitted to the Board of Governors a report containing his proposal for the first allocation of SDRs. 6/ At the time, Article XXIV, Section 1(b) provided that:

1/ See de Vries, ibid., Vol. I, pp. 155-59, and Vol. II. The Outline is reproduced in Vol. II, pp. 47-56.

2/ See SM/84/148, op. cit., p. 2.

3/ Communique of the G-10 Ministers issued at the end of their meeting on July 25-26, 1966 in the Hague, as cited in SM/84/148, op. cit., p. 4, and de Vries, op. cit., Vol. I, pp. 95-98.

4/ SM/84/148, op. cit., pp. 5-6.

5/ Although Section 1(a) had reached the form in which it now exists in Article XVIII, during the period between the First and Second Amendments it appeared in Article XXIV.

6/ This report is reproduced in de Vries, op. cit., Vol. II, pp. 251-65.

> The first decision to allocate special drawing rights shall take into account, as special considerations, a collective judgment that there is a global need to supplement reserves, and the attainment of a better balance of payments equilibrium, as well as the likelihood of a better working of the adjustment process in the future.

Following an introductory section, the Managing Director's report indicated that the growth of reserves had "flattened markedly" over the previous five years and expressed concern about an increasing reliance on borrowed reserves. 1/ The report then addressed the basic criteria of reserve adequacy from the perspective that "the long-term development in the need for global reserves ... may be defined as that amount and rate of growth of reserves which is most conducive to the attainment of the objectives described in [Article XVIII, Section 1(a)]." 2/ Here it should be noted that the criteria did not all point in the same direction, and that the main indications of reserve inadequacy were taken to be an increased reliance on restrictions on international transactions and an increased recourse to financial assistance for meeting payments deficits and sustaining reserves. Thus, the report stated:

> After about 1964, the signals supplied by the basic criteria of reserve adequacy became conflicting. Judged by the criterion of world demand conditions alone the period from 1965 to the present could scarcely be considered one of reserve inadequacy. World output and international trade expanded rapidly in these years; domestic prices rose rather fast, though international prices were stable; and demand pressures intensified, particularly in North America.
>
> The same holds true to a lesser extent of the criterion of exchange stability. While the exchange rate devaluations which occurred during these years were possibly speeded up by the tightening of the reserve situation, they cannot be said either to have been undertaken prematurely or to have been excessive in amount, though it might have been otherwise had there not been widespread resort to international credit and the associated generation of reserves.
>
> The main indications of reserve inadequacy in these years lie in the increased reliance on restrictions on international transactions and the increased recourse to international financial

---

1/ In particular, it noted (p. 253):

> Since about 1964, there has been a change in the situation: growth of reserves flattened markedly, the ratio of reserves to trade declined more rapidly, the transfer of reserves from deficit to surplus countries ceased to act as a force tending to equalize reserve ratios, and there was increasing resort to international credit as a means of relieving the tightness of reserves.

2/ Ibid., p. 253.

> assistance, bilateral and multilateral, for the purpose of meeting payments deficits and sustaining reserves. Liberalization of trade has continued but its momentum has slackened. Temporary balance of payments restrictions have been imposed on trade and tourism in several major countries. Aid-tying and national preference in the granting of government contracts have been maintained or intensified in many countries. Above all, measures to restrict, attract, or occasionally repel capital flows have been applied or intensified for payments reasons in many countries, large and small. At the same time, there has been a substantially increased use of Fund resources and of other forms of balance of payments assistance, provided notably by the spreading network of swap arrangements and other types of credit arrangements between monetary authorities. These developments, while partly attributable to the persistence of payments disequilibria that could and should be corrected, have almost certainly been exacerbated by a growing shortage of, and increasing desire to obtain, reserves. 1/

The report went on to consider the relationship between reserves and the adjustment process, arguing that:

> In present circumstances ... it appears unlikely that reserve creation would have any significant effect in increasing the imbalances of those countries which in the past have had the biggest deficits. The United States and the United Kingdom are under such strong pressure to correct their deficits that any relief of this pressure afforded by a general expansion of reserves is likely to be negligible ....
>
> In these circumstances, the supplementation of reserves would be most unlikely, on balance, to exercise any adverse effect upon the adjustment process, and indeed if nothing were done to supplement reserves the stabilization efforts now being made by deficit countries might well be frustrated by the defensive measures of others. 2/

The report was submitted to the Board of Governors, together with a draft allocation Resolution, which was adopted at the 1969 Annual Meetings in October. The adoption of the Resolution set in motion an SDR allocation equivalent to approximately $9.5 billion over a three-year period, beginning on January 1, 1970.

2. Developments during the 1970s

During the 1970s, a number of developments occurred in the international monetary system that reflected or contributed to changes in the demand for and supply of international reserves, thereby influencing

---

1/ Ibid., p. 254-55.
2/ Ibid., p. 256.

perceptions of the global need for reserve supplementation. 1/ In 1969 the United States had experienced a $3 billion surplus in its balance of payments on an official settlements basis, but in 1970 its official settlements balance swung to an unprecedented deficit of nearly $10 billion. Although this development during 1970 primarily reflected a large build-up of liabilities to foreign official monetary institutions, it was also associated with a decline of $2.5 billion in the official reserve assets of the United States to a level of $14.5 billion at year-end, the lowest they had been in the post-war period, and some $10 billion less than the cumulated stocks of U.S. liabilities to foreign official agencies. 2/ The decline in U.S. official reserve assets continued during the first two quarters of 1971, and while actual conversions of foreign claims on the United States into gold could, for a time, be limited by moral suasion, in August 1971 the U.S. authorities acted to terminate the convertibility of the dollar into gold.

A second, and related, development was the breakdown of the Bretton Woods system of fixed exchange rates. By March 1973, the major industrial countries were allowing their currencies to float, although for much of the subsequent period some of the European countries maintained the exchange rates between their currencies within fixed bands, and all of the major industrial countries at times encountered circumstances in which they attempted to manage the exchange values of their currencies through intervention in foreign exchange markets.

A third major development was the expansion and integration of international credit markets, which not only helped to catalyze the first two developments, but also made private credit more available to official borrowers, thereby altering the mechanisms through which countries could expand their official reserve holdings. And as a fourth significant development in the international monetary system the 1970s brought an increase in the importance of currencies other than the U.S. dollar in official reserves, with a concomitant decline in the share of dollar-denominated assets in total foreign exchange holdings.

These developments, associated as they were with extremely rapid growth in the volume of international liquidity during the 1970-72 period and the first quarter of 1973, 3/ limited any support for SDR

1/ See SM/85/340, op. cit., for a recent review of these developments.

2/ See de Vries, op. cit., Vol. I, pp. 489-90.

3/ Members' reserves, after rising by about SDR 6 billion in 1967-69, increased about SDR 15 billion in 1970, SDR 30 billion in 1971, SDR 23 billion in 1972, and SDR 18 billion in the first quarter of 1973. See the "Report by the Managing Director to the Board of Governors and to the Executive Directors," June 29, 1977, as reproduced in Margaret Garritsen de Vries, The International Monetary Fund 1972-1978: Cooperation on Trial, International Monetary Fund, Washington, D.C., 1985, Vol. III, p. 274.

allocations during the years that followed the end of the first basic period. The possibility of an SDR allocation did not even receive formal consideration by the Executive Board between 1973 and 1977. 1/ During that period, however, the role of the SDR was actively debated as part of the discussions on international monetary reform. Proposals for establishing a link between SDR allocations and development assistance were rejected, while proposals to enhance the attractiveness of the SDR and make it "the principal reserve asset in the international monetary system" were incorporated into the Second Amendment of the Articles of Agreement, which entered into force in April 1978.

Early in 1977, with the third basic period due to begin the following year, serious consideration of the case for an SDR allocation resumed. 2/ Support for an allocation remained insufficient at the time of the Interim Committee meeting in April 1978, but began to build over the next half year. In August the Managing Director circulated to Executive Directors a confidential Aide Memoire outlining a package of related measures that included allocations of SDR 4-6 billion a year over a three-year period, along with a general quota increase, of which 25 percent would be payable in SDRs. At its meeting in September, the Interim Committee reached a consensus on allocations of SDR 4 billion a year in 1979, 1980, and 1981. The Managing Director's formal proposal for an allocation was adopted by the Board of Governors in December.

It should be emphasized that the consensus on SDR allocation was conditional on a general quota increase, and that some Executive Directors may have supported the allocation without fully supporting the language adopted in the Managing Director's proposal. It may also be noted that, as a general indication of the sense in which a long-term global need was perceived to exist at the time, the Managing Director's proposal did not refer to any concerns about, or inadequacies in, the overall level of reserves that then existed, but rather emphasized that countries could be expected to increase their reserves in coming years. The proposal then justified an SDR allocation in terms of both the difficulties that arise when reserves are accumulated through borrowing and the objective of making the SDR the principal reserve asset of the international monetary system. Specifically, the Managing Director stated:

> The proposal to allocate special drawing rights is made in accordance with my conclusion that, as required by Article XVIII, Section 1(a), there is at present "a long-term global need ... to supplement existing reserve assets." The basis for this conclusion is set forth below.

1/ Ibid.

2/ For more extensive discussions of the 1977-78 period see: SM/84/148, op. cit., pp. 9-15; and de Vries (1985), op. cit., Vol. II, pp. 876-83.

With greater exchange rate flexibility, countries might have been expected to make do with much smaller reserves. Moreover, important changes have taken place in world financial markets in the last decade, and most countries can obtain reserves by making use of international money and capital markets.

Experience shows, however, that countries want to increase their reserves as the level of their international transactions rises, and such increases can be expected to continue in the coming years. While it is true that most countries have a means for satisfying their need for reserves when international capital markets are as free as they are today, the decision to allocate special drawing rights does not depend on a finding that the long-term global need cannot be met except by allocation. A characteristic of a system in which countries add to their gross reserves as their international indebtedness increases is that they are faced with the need for periodic refinancing. This difficulty does not arise when additions to net reserves are made through allocation of special drawing rights.

Another consideration is the objective of making the special drawing right the principal reserve asset of the international monetary system, as set out in Article VIII, Section 7 and Article XXII. Exclusive reliance on the accumulation of reserve currencies to provide the needed reserve increases would hardly be compatible with that objective. Although the role of the special drawing right does not depend on purely quantitative considerations, the amount of special drawing rights in existence is nonetheless relevant. The volume of special drawing rights has not increased since the beginning of 1972, and thus the share of this component in international liquidity has been progressively reduced. When allocation of special drawing rights for 1970-72 was decided upon at the end of 1969, it was thought that thereafter special drawing rights might well account for the bulk of reserve increases. In the event, holdings of reserve currencies have increased much faster than expected, and the actual share of holdings of special drawing rights in reserves excluding gold has declined from about 10 per cent at the beginning of 1972 to about 4 per cent at present. In the absence of allocation, the special drawing right would continue its rapid decline as a proportion of reserves.

In view of these considerations, I have concluded that, in accordance with the Articles, a decision should be taken to resume allocation of special drawing rights. 1/

1/ "Proposal by the Managing Director of the International Monetary Fund," October 25, 1978, as reproduced in de Vries (1985), op. cit., Vol. III, pp. 275-76.

3. Contrasts between the first and second activations of the SDR facility

The historical developments can be put into perspective by contrasting the perceptions and motivations that prevailed at the times of the first and second activations of the SDR facility. At the time of the first activation, not only was there a general perception that the world economy was confronting a "dollar shortage" or "liquidity problem," but there was also a generally accepted analytic framework for inferring how reserve supplementation could play a role in improving the functioning of the international monetary system and the performance of the world economy. The analytic framework presumed that countries other than reserve-currency countries augmented their reserves mainly by earning balance of payments surpluses, that an adequate expansion of global reserves relied heavily on the balance of payments position of the United States (the principal reserve-currency country), and that the U.S. balance of payments position was influenced by the economic policies and performances of both the United States and other countries. From that analytic perspective, it was generally perceived that:

> Whether or not there is a "need" for increases in reserves depends on the expected consequences of such increases and on whether the consequences are judged on balance to be desirable or undesirable in the light of such generally accepted objectives as those set forth in Article I of the IMF Articles of Agreement. In the main, reserve changes exercise their effects through the incentives which they provide to governments and monetary authorities to change their policies in various ways. 1/

In that context, it is not difficult to appreciate why the First Amendment to the Fund's Articles had characterized the principles that were to govern activation of the SDR facility in terms of the concept of a long-term global need. The fact that judgments as to whether reserve supplementation would have desirable consequences were to be based on "long-term" considerations reflected partly the difficulties of assessing the character and implications of any short-run fluctuations in balance of payments positions and reserve stocks, and partly the view that reserve increases could be expected to exercise their full effects on economic policies and performances only after a considerable time lag. 2/ The fact that decisions were to be based on international judgments about the "global" liquidity situation and the likely effects of reserve supplementation on the performance of the "global" economy is

---

1/ See "The Need for Reserves: An Exploratory Paper," prepared by the Fund staff in January 1966, as reproduced in International Reserves: Needs and Availability, International Monetary Fund, Washington, D.C., 1970, p. 370. See also the discussion in the Fund's Annual Report for 1964, pp. 26-29.

2/ See "The Need for Reserves: An Exploratory Paper," ibid., p. 374.

hardly surprising, given the nature and purposes of the Fund. It was recognized, nevertheless, that:

> The precise relationship of these global needs to the needs of individual countries is a matter of some debate. On the one hand, it is clear that the aggregate level of reserves should not be influenced disproportionately by the reserve needs of particular countries, nor can the over-all needs of the world be arrived at by adding up the amounts countries "would like" to have as reserves, or even the amounts that, taken individually, they may, in some sense, be deemed to need. On the other hand, the world is made up of countries, and global needs for reserves must, in the last resort, be determined with respect to the welfare of these countries considered individually. 1/

And the fact that decisions about reserve supplementation were to be based on judgments of "need" apparently reflected the desire to distinguish between simply supplying the amount of reserves that countries "demanded" or "would like" and supplying the amount of reserves that was judged to be most appropriate for attaining the purposes of the Fund and avoiding economic stagnation and deflation as well as excess demand and inflation in the world.

By the time of the second activation of the SDR facility, however, the functioning of the global economy had changed considerably, and there no longer existed a generally accepted conceptual framework for analyzing the effects of reserve supplementation on the performance of the world economy. Nevertheless, concerns had emerged about the stability of a reserve system based predominantly on borrowed reserves. For reasons related to those concerns, moreover, the Second Amendment had established the objective of making the SDR the principal reserve asset of the international monetary system. In this regard, it is noteworthy that even though the discussion of proposals to make the SDR the primary reserve asset had begun during the early 1970s, 2/ the breakdown of the Bretton Woods system did not diminish the importance that was attached to that objective. As described in the 1979 Annual Report of the Fund:

> This goal is viewed as a long-term means of reducing the asymmetries and instabilities inherent in a system whose main reserve assets are individual national currencies. 3/

Thus, the changes in the international monetary system had shifted the nature of concerns about long-term global reserve needs from a focus predominantly on the quantity of reserves to a focus that gave greater emphasis to the quality of reserves.

1/ Ibid., p. 372.
2/ See de Vries (1985), op. cit., Vol. I, pp. 131 and 178.
3/ Annual Report 1979, International Monetary Fund, p. 55.

In this context, the second activation of the SDR facility, which was justified in terms of both the difficulties that arise when reserves are accumulated through borrowing and the objective of making the SDR the principal reserve asset of the international monetary system, was seen as an action that contributed to the quality of reserves not only by substituting owned reserves for borrowed reserves, but also by substituting SDRs for increases in official foreign exchange holdings. 1/ Within a few years following the second activation, however, the issue of substituting SDRs for official foreign exchange holdings was no longer a central topic in discussions of international monetary reform, partly because exchange market developments had weakened desires to substitute away from official dollar-denominated foreign exchange holdings, and partly because of the growing concern of the international community with problems of adjustment rather than problems of liquidity creation.

II. Long-Term Global Need for Reserve Supplementation Under Current Conditions

In many respects, the conditions under which the international monetary system is currently operating are much the same as they were at the end of the 1970s, when the SDR facility was last activated. Several important changes have occurred, however: the expansion and integration of international credit markets has continued; the international debt crisis has made it more difficult for many developing countries to obtain access to private capital markets; and the balance of macroeconomic pressures in the world has shifted as conditions of excess demand and inflation have been restrained considerably in many industrial countries while conditions of economic stagnation and deflation have taken hold in some developing countries.

In light of the fact that the changes that have occurred in the international monetary system during the 1980s have primarily been changes in the degree of capital market integration and in the intensity and balance of economic strains, it may not be surprising that the range of interpretations of the concept of a long-term global need for reserve supplementation under current conditions remains similar to the range of views that were expressed a decade ago. 2/ In describing the different interpretations and the perspectives from which they arise under current conditions, given the language of Article XVIII, Section 1(a), it is convenient to focus first on the system's capacity to supply reserves (Subsection 1), and to consider then the implications of SDR allocation for the objectives of the Fund (Subsection 2).

1/ Ibid., p. 56.

2/ For discussions of the views expressed a decade ago, see de Vries (1985), op. cit., Vol. II, pp. 878-80.

1. The system's capacity to supply reserves

As indicated earlier, the creation of the SDR in the late 1960s emerged from a consensus that the international monetary system lacked the capacity to generate adequate growth in the supply of international reserves without undermining confidence about the gold-convertibility of the U.S. dollar, the principal reserve currency. During the 1970s, however, the role of the SDR was affected by a number of developments in the international monetary system, including the abolishment of gold convertibility, the advent of greater exchange rate flexibility, the expansion of private international financial markets as an important source of borrowed reserves, and the use of multiple reserve currencies. These developments were associated with changes in both the demand for reserves and the capacity of the international monetary system to supply reserves.

In considering the capacity of the system to supply reserves under current conditions, distinctions have been drawn between reserves acquired by borrowing, which must be repaid or periodically renewed, and owned reserves, which include both the reserves that countries earn by generating balance of payments surpluses and the reserves that are acquired through SDR allocations. Distinctions have also been drawn between different groups of countries to which the system is called upon to supply reserves. It is generally acknowledged, moreover, that the system's capacity to supply reserves must be analyzed with reference to the terms and conditions under which reserves are supplied, and that a prominent feature of the current environment is that some countries can borrow large quantities of reserves at relatively low net cost, and can be confident of their continuing access to international capital markets, while many other countries either have no access to private capital markets or confront difficult and uncertain terms and conditions when seeking to gain or retain access to those markets.

There are two points of view from which this feature of the current environment might be taken to indicate a long-term global need for reserve supplementation. The first point of view is based on arguments that a system that relies heavily on borrowing to satisfy the long-term growth in the global demand for reserves is likely to be less stable than a system that creates owned reserves to satisfy the growth in global demand. The second point of view is based on arguments that for many countries the difficulties and uncertainties of access to international capital markets could be a long-term phenomenon, that such a long-term phenomenon would counteract the objectives of the Fund, and that reserve supplementation could shorten the duration of the phenomenon or otherwise reduce the extent to which the objectives of the Fund were counteracted. These two lines of argument will be considered in turn.

Arguments that a long-term global need for reserve supplementation might be inferred from the potential instabilities of a system that relies heavily on borrowed reserves have been discussed in a paper

considered by the Executive Board early in 1986. 1/ These potential instabilities can arise to the extent that a predominance of borrowed reserves can make the reserve system more sensitive to disturbances in financial markets or to abrupt changes in perceptions (or misperceptions) of countries' creditworthiness. Thus, from the perspective of substituting owned for borrowed reserves, as well as from the perspective of providing an alternative to holdings of individual national reserve currencies, SDR allocation has been seen as a mechanism for contributing to international monetary stability by changing the composition and improving the "quality" of reserves. Indeed, this was the stated purpose for the second activation of the SDR facility.

This concern to provide for adequate long-term growth in the supply of owned reserves is reflected in the readiness, in principle, to make the SDR available as a safety net when the supply of international liquidity is threatened by adverse circumstances. In this regard, the 1985 Report of the G-10 Deputies indicated that:

> ... the Deputies, noting the SDR's owned-reserve nature, believe that the instrument may still have a useful role to play in meeting the long-term global need for supplementing reserves in a system largely based on borrowed reserves. In this context, the Deputies have considered various ways of making the SDR available as a safety net for future contingencies, including the possibility of private markets being unable to respond adequately to a legitimate long-term global need for international liquidity. They have not agreed, however, that any of these approaches would be desirable or appropriate at this stage. 2/

A separate line of argument is that a long-term global need for reserve supplementation might be inferred from the adverse and uncertain terms and conditions that confront many countries seeking to gain or retain access to international capital markets. Such arguments are based, first, on the contention that the difficulties and vagaries of access to international capital markets may be a long-term phenomenon for many countries and, second, on the contention that reserve supplementation could reduce the extent to which such a phenomenon impeded the objectives of the Fund.

In considering the first of these contentions, it is useful to recall two different points of view that have been expressed about the process of restoring access to credit markets. One view is that limited access to financial markets points mainly to problems relating to the

---

1/ SM/86/17, "The Potential Contribution of the SDR to Economic Stability," January 29, 1986.

2/ "The Report of the G-10 Deputies on the Functioning of the International Monetary System," EBD/85/154, Supplement 1, June 21, 1985, para. 72.

adjustment efforts of the individual countries seeking to borrow. Thus, the 1985 Report of the G-10 Deputies states:

> Countries can obtain reserves from financial markets provided they maintain their creditworthiness, which is mainly a function of their own domestic policies and performance. 1/

By contrast, the second perspective is that creditworthiness--once it has been lost--cannot be quickly restored through adjustments in policies and performance. Thus, the 1985 Report of the Deputies of the Group of Twenty-Four (G-24) states:

> It is often held that access to commercial credit would depend on "creditworthiness," which in turn is dependent upon adjustment. But despite vigorous adjustment policies pursued by developing countries leading to a sizable improvement in their current account position, "creditworthiness" was not restored; nor was there a reversal of the decline in bank lending. 2/

These perspectives have focused attention on developing a deeper understanding of how long it takes to restore creditworthiness and how the process can be accelerated. In this context, the view has been advanced that the restoration of creditworthiness and spontaneous new lending may require a combination of adjustment and provision of additional resources on a scale that is sufficient to eliminate discrepencies between the contractual values and the market valuation of outstanding debts. It is true that data on market valuations of debt are fragmented and must be interpreted cautiously, given the relatively low frequency with which outstanding debts appear to be traded on secondary markets and the limited numbers of participants in those markets. Nevertheless, the data suggest that the discrepancies between market and contractual values of outstanding debts are currently quite large for many countries.

The relevance of these discrepancies in the analysis of creditworthiness is based on the assumption that the market's valuation of outstanding debt is approximately equal to the present value of the stream of payments that market participants expect the debtor countries to be able and willing to make on their outstanding obligations. From that point of view, a debtor country can raise the market's valuation of its outstanding debt by undertaking sound and substantial adjustment measures. Yet, for a country bearing an initial overhang of debt that is large relative to its initial capacity to generate a repayments

---

1/ "Report of the G-10 Deputies on the Functioning of the International Monetary System," EBD/85/154, Supplement 1, June 21, 1985, para. 60.

2/ "Report of the Deputies of the Group of Twenty-Four on the Functioning and Improvement of the International Monetary System - Transmittal to the Interim Committee," EBD/85/228, August 30, 1985, para. 94.

stream, even sound and substantial adjustment actions may leave the market's valuation of its debt considerably below the contractual value. Accordingly, without external commitments of some kind on a sufficient scale to raise considerably the present value of the stream of payments that market participants expect the debtor country to be able and willing to make on its outstanding obligations, substantial adjustment actions by the debtor country may be required over a prolonged period to close the gap between the market's valuation and the contractual value of the debt. Until that gap is closed, however, the incentive for lenders acting individually to extend additional credit to the country on a voluntary basis is likely to remain weak.

To the extent that this analysis is valid, the prospect that the restoration of creditworthiness could require prolonged reliance on some forms of import compression and payments restrictions might be viewed to imply a long-term global need for reserve supplementation. Nevertheless, the contention that the restoration of creditworthiness could be a long-term process for many countries does not imply that the international monetary system lacks the capacity to supply the additional reserves that countries collectively demand over time, since it is possible, in principle, for countries with limited access to credit markets to augment their reserves over time through balance of payments surpluses, while other countries run balance of payments deficits and augment their reserves through borrowing. 1/

2. The implications of SDR allocation for the objectives of the Fund under current conditions

According to the principles established by Article XVIII, Section 1(a), an assessment of the long-term global need for reserve supplementation must focus not only on the system's capacity to supply the reserves and the growth in reserves that countries demand, but also on whether meeting that demand through reserve supplementation would promote the attainment of the purposes of the Fund and avoid economic stagnation and deflation as well as excess demand and inflation in the world. In considering the system's capacity to supply reserves, the previous subsection has focused on two aspects of the current environment that might be taken to indicate a long-term global need for reserve supplementation. This subsection now considers more specifically how

---

1/ To the extent that countries with limited access to credit markets do not in practice succeed, however, in earning reserves through balance of payments surpluses, a situation is created in which SDR allocations become substitutable, in a sense, for reserve creation through extensions of credit by the Fund and other financial institutions. To the extent, moreover, that the latter extensions of credit are perceived to meet a global need, one question that arises is whether an operational distinction can be drawn between meeting a long-term need and meeting a succession of shorter-term requirements.

reserve supplementation, in the context of those two aspects of the current environment, could be perceived to meet a long-term global need.

The first of the two aspects is the fact that the reserve system currently relies heavily on borrowing to satisfy the long-term growth in the demand for reserves. In that context, it has been argued that by providing injections of owned reserves, and thus reducing the degree to which the international monetary system depends on borrowed reserves, SDR allocation can make the reserve system less sensitive to disturbances in financial markets or to abrupt changes in perceptions of countries' creditworthiness, thereby promoting stability and orderly adjustment, consistent with the purposes of the Fund. Indeed, the difficulties that can potentially arise when reserves are accumulated through borrowing, together with the view that exclusive reliance on the accumulation of reserve currencies would "hardly be compatible with" the objective of making the SDR the principal reserve asset in the system, were the two considerations that were taken to justify the activation of the SDR facility in the third basic period. 1/ Some Executive Directors have nevertheless questioned whether SDR allocation by itself is sufficient for making the SDR the principal reserve asset in the international monetary system. In particular, it has been suggested that progress toward that objective may also require enhanced economic incentives or regulation to prevent participating countries from maintaining low holdings of SDRs relative to their cumulative allocations and their total reserve holdings. 2/

The second aspect of the current environment that might be taken to indicate a long-term global need for reserve supplementation is the fact that many countries confront adverse and uncertain terms and conditions in seeking access to international capital markets. It has already been suggested that the alleviation of these difficulties and vagaries could be a long-term process that might require prolonged reliance on some forms of import compression and payments restrictions. In that context, SDR allocation could promote the elimination of restrictions by the many countries facing prolonged difficulties when seeking access to international credit markets and, more generally, could reduce the reliance of these countries on measures to compress imports and thereby restrain economic activity and development. By doing so, moreover, SDR allocations could have indirect benefits for most, if not all, other countries as well, and in that sense could be judged to meet a long-term global need.

1/ "Proposal by the Managing Director...," as reproduced in de Vries (1985), op. cit., Vol. III, p. 276.

2/ The latter issue was the subject of a paper discussed by the Board last August: SM/86/169, "Consideration of Alternative Approaches to Influencing the Share of SDRs in Members' International Reserves," July 9, 1986. Further discussion of this issue has been tentatively planned for the Board's agenda during 1987.

III. Concluding Remarks

As background for considering the concept of a long-term global need for reserve supplementation under current conditions, Section I of this paper has provided historical perspectives on how the concept emerged during the 1960s, as it was embodied in the First Amendment to the Fund's Articles of Agreement and applied when the SDR facility was first activated, and on how that concept was adapted, when the SDR facility was next activated, to the considerably changed international monetary system as it was functioning at the end of the 1970s. At the time of the first activation of the SDR facility, the Managing Director's report emphasized that reserve growth had "flattened markedly" over the past five years and expressed concern about an increasing reliance on borrowed reserves; it further noted that the signals supplied by the basic criteria of reserve adequacy were conflicting, and that the main indications of reserve inadequacy at the time were an increased reliance on restrictions on international transactions and an increased recourse to international financial assistance for the purposes of meeting payments deficits and sustaining reserves. 1/ At the time of the second activation of the SDR facility, which was associated with the quota increase under the Seventh General Review of Quotas, the Managing Director's proposal did not refer to any concerns about, or inadequacies in, the overall level of reserves that then existed, but noted, rather, that countries could be expected to increase their reserves in coming years, and justified the case for an SDR allocation in terms of both the difficulties that arise when reserves are accumulated through borrowing and the objective of making the SDR the principal reserve asset of the international monetary system. 2/ The emphasis had thus shifted from concern about the quantity of reserves under the Bretton Woods system of fixed par values to concern about the quality of reserves during a period of greater instability in exchange rates and in the international monetary system.

In a fundamental sense, the different motivations for the first and second activations of the SDR facility reflected the changes that took place in the international monetary system during the 1970s, including the abolishment of gold convertibility, the advent of greater exchange rate flexibility, and the expansion of private international financial markets as an important source of borrowed reserves. When the SDR mechanism was being conceived during the 1960s, prior to those changes in the international monetary system, it was widely perceived that deficiencies in the functioning of the world economy could be associated to an important extent with "liquidity problems," which could in turn be addressed by introducing a mechanism for supplementing the quantity of reserves over the long run.

1/ Recall the excerpts from that report in Section I.1.
2/ Recall the excerpts from that proposal in Section I.2.

By contrast, in the current context, it is not so widely perceived that deficiencies in the performance of the world economy are related in a major way to inadequacies in the reserve creation mechanism per se, although it is clearly recognized that the performance of the world economy depends crucially on the broader functioning of the international liquidity system and its influence on the adjustment process. Nevertheless, certain aspects of the functioning of the reserve creation mechanism in the current context have given rise to arguments that reserve supplementation could improve the performance of the world economy, consistent with the purposes of the Fund, and could thereby meet a long-term global need.

Section II has discussed two types of arguments that might be considered to indicate a long-term global need for reserve supplementation under current conditions. The first contends that a system that relies heavily on borrowing to satisfy the long-term growth in the global demand for reserves is likely to be less stable than a system that creates owned reserves to satisfy the growth in that demand. The second contends that the difficulties and uncertainties that many countries confront in seeking access to international credit markets could be a long-term phenomenon, and that reserve supplementation in that context could meet a long-term global need by improving the performance of the world economy and facilitating the objectives of the Fund. The latter assessment, however, gives rise to a broader set of issues based on the general perception that progress toward improving the functioning of the international monetary system and establishing more desirable macroeconomic conditions in the world hinges critically on the willingness and ability of both the industrial countries and the developing countries to adopt appropriate policy stances. Thus, the effects of SDR allocation on countries' policies are of crucial importance in the assessment of the long-term global need for reserve supplementation.