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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/18

3:00 p.m., January 31, 1986

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	N. Toé, Temporary
	D. C. Templeman, Temporary
	H. G. Schneider
	T. Alhaimus
	M. Sugita
G. Grosche	
Huang F.	
J. E. Ismael	Jaafar A.
A. Kafka	
T. P. Lankester	M. Foot
H. Lundstrom	
M. Massé	
	A. Abdallah
	P. E. Archibong, Temporary
F. L. Nebbia	
Y. A. Nimatallah	J. E. Suraisry
P. Pérez	
J. J. Polak	S. de Forges
	A. V. Romuáldez
G. Salehkhou	O. Kabbaj
A. K. Sengupta	A. S. Jayawardena
S. Zecchini	N. Coumbis

L. Van Houtven, Secretary
B. J. Owen, Assistant

Also Present

European Department: A. Fidjestol. External Relations Department: P. J. Bradley, M. Goldstein. Legal Department: J. G. Evans, Jr., Deputy General Counsel; S. A. Silard. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director; D. Folkerts-Landau, P. Isard, D. J. Mathieson. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; T. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer; W. L. Coats, Jr., E. Decarli. Advisors to Executive Directors: W.-R. Bengs, J. Hospedales, G. Nguyen, A. Ouanes, P. Pêterfalvy, I. Puro, A. Vasudevan, K. Yao. Assistants to Executive Directors: J. R. N. Almeida, A. Bertuch-Samuels, F. Di Mauro, J. J. Dreizzen, G. Ercel, R. Fox, S. Geadah, V. Govindarajan, S. King, H. Kobayashi, S. Kolb, A. H. Mustafa, J. Reddy, J. E. Rodríguez, M. Sarenac, B. Tamami, H. van der Burg, B. D. White, Yang W.

1. ROLE OF SDR - IMPLICATIONS OF CHANGES IN INTERNATIONAL MONETARY SYSTEM

The Executive Directors resumed from the previous meeting their discussion of a staff paper on the implications of changes in the international monetary system for the role of the SDR (SM/85/340, 12/27/85).

Mr. Grosche said that basically he could go along with the historical presentation in the staff paper. But while the staff had done well in presenting the divergent views on the roles that the SDR could play in the present system, some of those views needed to be spelled out more clearly, as he would attempt to indicate.

His only remark on the historical presentation in Section I concerned the assertion by the staff on page 9 that "the main provision with respect to allocation of SDRs in the amendment of the Articles of Agreement establishing the SDR specifies that 'the Fund shall seek to meet the long-term global need'...," Mr. Grosche continued. To his knowledge, the first amendment to the Articles of Agreement contained only one legal provision with respect to the allocation of SDRs and not several as the staff seemed to suggest.

On the central issue of how the SDR's role in the current international monetary system was perceived, Mr. Grosche noted that the staff paper rightly pointed out that the structural changes in the 1970s had deeply affected that perception. Obviously, the role of the SDR as an asset to strengthen confidence in the convertibility of the dollar into gold had lost its relevance after the suspension of that convertibility. The question was the extent to which the traditional role of the SDR in relieving a reserve shortage was still relevant under current conditions. That question could be expanded to cover an inquiry into the potential of the SDR for other purposes such as enhancing the stability of the international monetary system; increasing control over international liquidity; and reducing the asymmetries perceived to be associated with the process through which reserves were being supplied.

The function of the SDR as a reserve supplement basically continued to be relevant, Mr. Grosche considered. However, as the report of the G-10 Deputies had noted, the expansion of international credit markets had become an important source of reserves. While it was true that those markets had not functioned in a fully satisfactory way in supplying reserves, it had to be acknowledged that they had generally been quite flexible and efficient in providing liquidity to countries demonstrating their creditworthiness or undertaking adequate adjustment efforts. Indeed, most countries that pursued adequate economic policies were able to meet their demand for reserves either by generating surpluses on the balance of payments or by borrowing on international credit markets. The few countries whose access was severely restricted, despite appropriate economic policies, did not establish a global need for additional liquidity through an SDR allocation; other ways would have to be found to assist them.

Yet there was a legitimate need for owned reserves that had to be satisfied either by balance of payments surpluses or SDR allocations, Mr. Grosche remarked. If none of the reserve currency countries had a balance of payments deficit, the case for new allocations could be made easily. In such a situation, the wish to acquire owned reserves could be realized only through what he would call an overadjustment by non-reserve currency countries, a policy stance which obviously should be avoided. Given the current pattern of balance of payments deficits, however, that situation seemed to be far off.

He had some problems with the view mentioned by the staff on page 13 of SM/85/340 that additional SDRs might be needed in order to alleviate the burden of refinancing borrowed reserves at highly fluctuating interest rates, Mr. Grosche said. Holding a higher share of nonborrowed reserves could reduce such costs, but the desire for cost reduction did not seem to be sufficient to establish a long-term global need to supplement reserves through an SDR allocation. He also doubted whether an allocation would reduce costs in those cases where--once again--the additional SDRs would be spent without the intention of an early reconstitution. In that respect, he had noted the point made by Mr. Polak.

He had difficulty accepting the view that additional SDRs could help to reduce asymmetries that were perceived to be associated with the process of supplying reserves in the existing system, Mr. Grosche went on. Such asymmetries, which reflected the differences between countries undergoing adjustment and those neglecting the need to adjust, could be considered as beneficial in promoting adjustment, at least for a large number of countries. The report of the Group of Twenty-Four asserted in that context that "despite vigorous adjustment policies pursued by developing countries...creditworthiness was not restored." However, it should not be forgotten that the progress made by some countries in the external sector had not been matched by internal adjustment. Although a single reserve currency country might be able to delay adjustment to a certain extent--but not indefinitely--that was not true of other reserve currency countries. The latter were as vulnerable to external perceptions as nonreserve currency countries--probably even more so--and they therefore had to adjust promptly in order to safeguard the value of their currencies.

It would be more appropriate to reflect in greater depth on the issue of the SDR's contribution to the stability of the international monetary system when the relevant staff paper (SM/86/17, 1/29/86) was discussed, Mr. Grosche considered. However, referring briefly to certain remarks on pages 19-20 of SM/85/340, he noted first that he saw no convincing reason to assume that regular allocations of SDRs would prevent excessive borrowings on international financial markets. Rather, he tended to share the doubts of others that the instabilities associated with excessive borrowing might be even greater. Second, the idea of using the SDR as a safety net had to be seen in the context of the SDR fulfilling its principal role in meeting the long-term global need for reserve supplementation. Finally, with respect to the role that the SDR might play in controlling global international liquidity, he recalled the view expressed in the G-10 report that "the preponderance of market-supplied international liquidity has reduced the scope for influencing the process of reserve creation directly." Nevertheless, he believed that that aspect of the SDR in particular needed to be explored further.

In concluding, Mr. Grosche said that his skepticism about the immediate need and the scope for enlarging the role of the SDR was not meant to sound negative. His authorities fully subscribed to the conclusion of the G-10 report that the SDR might still have a useful role in meeting the long-term global need for reserves in a system largely based on borrowed resources. He agreed particularly with the last sentence of the staff paper, stating that the SDR system could have a role in facilitating some control over international liquidity.

Mr. Massé said that he wished to raise three points that were of some relevance to the current work on the role of the SDR. As demonstrated in the staff report, concerns about the adequacy of global liquidity had continued to exist in a world of floating exchange rates just as they had in the fixed rate system. The nature of that concern had of course changed considerably. Instead of focusing upon the available stock of gold and reserve currencies, it was necessary to concentrate, among other things, on the implications of increased reliance upon commercial credit markets to supply reserves. The growth of international capital markets over the past 15 years had permitted creditworthy countries quickly to supplement their foreign exchange reserves. As the staff had stated, no country was permanently barred from access to borrowed reserves. A country's creditworthiness was largely a function of the kind of economic policies it had adopted over time. Nevertheless, concern about the overall stability of the world monetary system could arise when there was a shift in the perceived creditworthiness of a number of countries. Even if countries adjusted their external accounts, their credit rating was not likely to be restored over night. In the meantime, global economic performance, as well as their own, would be below potential. Countries that entered credit markets in order to rebuild their reserves might also face problems associated with the recurring need to refinance or roll over their borrowed reserves. Those problems might include changes in the maturity of their loans and changes in the premium or spread over the base interest rate. Thus, even if access was not curtailed, that access might come at a signi icant and increasing price.

His second point concerned the speculative forces that continued to affect exchange markets and levels of liquidity, Mr. Massé continued. Under the pre-August 1971 exchange system, the threat of speculation ha centered on the price of gold and its potential impact on the stock of gold reserves. The question at present was rather different but the speculative nature of foreign exchange markets, made manifest through rapid and sizable fluctuations in exchange rates, was no less real.

Third, reserve switching in a multicurrency reserve system in r to changing expectations could have a destabilizing effect on the s as a whole, Mr. Massé observed.

In light of those considerations, Mr. Massé said that it was clear that developments in the international monetary system had modified but not eliminated the rationale for the SDR. All the countries that had elected him believed that the SDR still had a valuable contribution to make to the stability of the international monetary system. Within the Fund itself, the SDR was serving a useful role as a unit of account, a role that should be continued. However, views were divided in his constituency on whether part of the SDR's role should be to reduce asymmetries in the system; therefore, he did not wish to give too much weight to that function for the time being.

The staff had noted the difficulty of determining at any particular moment whether there was a global need for reserve creation, Mr. Massé said. That difficulty was due in large measure to the availability of commercial sources of liquidity. The lack of agreement on a global need for reserves had prevented any SDR allocation in recent years. Nevertheless, the G-10 report raised the prospect of using the SDR as a safety net in future contingencies, including the possibility of private markets being unable to respond adequately to a legitimate long-term global need for international liquidity. There was considerable merit in that safety net role, and he would have further comments to make on it during the Board's later discussion.

Finally, Mr. Massé remarked, the question of moving from an SDR as a stable accounting unit to an SDR-based fund was more problematic because it depended as much on developments in private markets and other inter- itional financial institutions as it did on the Fund's own operations. ie staff paper comparing the SDR and the European Currency Unit (ECU) ould address one aspect of that question, but he wondered whether further alysis beyond the papers already under preparation might not also be ranted.

Mr. Sugita said that his authorities were in agreement with the staff is of the shortcomings of the gold exchange standard and of the role ed for the SDR at the time of its creation. They could also support ysis of the subsequent changes in the structure of the interna- netary system although they disagreed on the assessment of the ce of such changes for the role of the SDR.

uld clearly be no disagreement with the staff that the role confidence in the convertibility of the U.S. dollar into been considered essential when the SDR had been created, relevant with the suspension of convertibility in 1971, ued. With respect to the alleviation of reserve short- that the gold exchange standard had imposed an inherent upply of reserves. The supply of gold had been limited ing gold production, and foreign exchange could be U.S. balance of payments deficits on an official the end of the 1960s, the need to supplement exist- both evident and impending. The subsequent changes in the international monetary system, particularly the development of international capital markets, had fundamentally altered the mechanism for supplying reserves and had substantially eased the previously existing constraints on the supply side. Over the past few years, the total reserves of all countries had increased, for the most part in accordance with the evolution of world trade. Those developments had shown the resilience of the present mechanism for supplying reserves in response to changes in demand.

While conceding that the quantitative constraints on the supply of reserves had been eased, the staff had argued that easing the terms on which reserves were provided could become a new objective of the SDR, Mr. Sugita observed. Specifically, the staff had asserted that an SDR allocation would improve the quality of reserves by increasing the relative share of owned reserves. His authorities had some reservations in that respect. While the SDR had been created as a reserve asset, it was not sufficiently liquid to be usable as a means of intervention or of payment. The need to convert the SDR into freely usable currencies, either through designation or transactions by agreement, took a few days at least. In that sense, although SDRs were said to be a type of owned reserve, they did not possess the normal qualities of owned reserves. From the viewpoint of a user, on the other hand, the SDR resembled a credit line on very easy terms. By transferring SDRs, a country could borrow foreign exchange at a relatively low interest rate for an indefinite period and without any conditionality, provided that it was judged to have a balance of payments need at the time of the transfer. In addition, the balance of payments need test was not very strict and was conducted only after the transfer of SDRs had taken place. Under the circumstances, an allocation of SDRs might well lead to undermining the discipline of the sound economic policies followed by the recipient countries, especially if it took place when there was no global reserve shortage.

Furthermore, the SDR had not been used very actively in many developing countries as a reserve asset, as had been intended, Mr. Sugita observed. Non-oil developing countries currently held only about one fourth of cumulative allocations. There had been a large once-and-for-all transfer of SDRs from those developing countries to some developed countries with strong external positions. In a sense, the SDR had been used virtually as a means of transferring resources from developed to developing countries. At the same time, countries accumulating large amounts of SDRs through designation were concerned about the liquidity of the SDR.

In the view of his authorities, it was highly unlikely that a global reserve shortage would emerge in the foreseeable future, except for the possibility of contingencies, Mr. Sugita stated. Therefore, if an SDR allocation was aimed simply at increasing the share of owned reserves and paid inadequate attention to the amount of existing reserves, it might well lead to excess liquidity and a resurgence of inflation. Under the circumstances, the role of the SDR in alleviating global reserve shortages had lost its fundamental significance in the present system.

Looking ahead, the international capital market would continue to play an important role in supplying reserves, Mr. Sugita considered. An adequate and stable supply of reserves through that channel would require, among other things, efforts to improve the creditworthiness of the borrowing countries and further liberalization of capital markets by the lending countries. It should be noted that Japan had taken a number of positive steps toward the internationalization of the yen and the further liberalization of capital markets.

As for the mitigation of asymmetries in reserve creation, the staff paper had argued that asymmetries continued to exist between creditworthy countries able to borrow in the market and those countries that could not borrow, Mr. Sugita noted. Surely, that was a rather liberal use of the word "asymmetry." In his view, the two types of country that could not borrow included countries that as a result of recent debt problems had lost creditworthiness and the least developed countries. The former needed conditional liquidity accompanied by structural adjustment policies in a medium-term and long-term perspective, to which the Baker debt initiative would make an important contribution. The latter were in need of concessional financing rather than a new allocation of SDRs.

For those reasons, Mr. Sugita considered that the three roles envisaged for the SDR at the time of its inception had either been eliminated or had lost significance. His authorities believed that the role remaining for the SDR in the current system was to provide 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 reserves. However, given some of the SDR's basic problems, which he had already mentioned, his authorities considered that the SDR's role as a safety net should also be interpreted in a rather limited manner.

Mr. Romuáldez remarked that he saw the purpose of the present debate as being to establish the framework and to set out the issues for the ensuing discussion on the potential contribution of the SDR to economic stability. It seemed to him that the framework would have to revolve around a common understanding of the nature of the international reserve system. For his part, the essential points were, first, as a result of the access that governments--and their nationals--had gained to international capital markets, countries had acquired the potential to finance a deficit on the current account of their balance of payments by issuing their own liabilities, albeit usually denominated in one of the currently more numerous reserve currencies. Thus, countries were no longer necessarily constrained in their balance of payments policies by the foreign exchange reserves accumulated as a result of previous current account surpluses, as had largely been the case when the SDR was created. Second, international capital markets had become the principal source of international reserves. Accordingly, the supply of reserve currencies was less narrowly constrained than when the balance of payments positions of reserve currency countries had been the primary determinant of the growth of world reserves. Central to the smooth functioning of the current system were the capacity and willingness of international capital markets to create cross-border credit and the terms of that credit, all of which were greatly influenced by the policy stance of reserve currency countries. Third, under the existing system of international reserve creation, the supply of reserves was much more elastic but not necessarily always more accommodating than it had been previously. The rate and distribution of the supply of reserves were currently being dictated largely by the market and by its not always accurate or evenhanded assessment of countries' creditworthiness and by the general state of sentiment in the market.

Those points should be relatively uncontroversial, Mr. Romuáldez remarked. The issues to be taken up were in his view first, the extent to which an SDR-type mechanism could regulate international liquidity at a time when capital markets were so unconstrained; that scope seemed to be limited. Second, was it necessary, desirable, or possible to constrain capital markets in order to enable the SDR mechanism to play a role closer to that originally envisaged for it--including the objective of making the SDR the principal reserve asset in the system--or were there in fact emergent constraints on capital markets that called for the SDR mechanism to play its originally envisaged role? Alternatively, should the SDR mechanism be adapted to the circumstances, and possibly become a swing supplier of reserves, or a supplementary source of reserves when capital markets were judged to be behaving in an unduly constricted manner--including the terms on which reserves were supplied--and vice versa. If so, was an SDR-type mechanism, which did not discriminate among countries according to their creditworthiness or their balance of payments needs, well suited for such a role compared with, say, the facilities available in the General Department complemented by a more effective and symmetrical surveillance than had been carried out hitherto.

That list of issues was derived from the basic premise that the underlying role of the SDR should remain centrally concerned with the smooth functioning of the international monetary system, Mr. Romuáldez stated. There were those, including some in his constituency, who envisaged a wider role for the SDR, incorporating an aid or development link. There were also those for whom the future role of the SDR lay more as a unit of account and a currency in which to denominate international transactions. The potential for a useful contribution by the SDR in the latter area had become much greater in the existing multicurrency floating exchange rate environment. The staff paper had not gone very far into the possible role of the Fund--and the SDR--as a central monetary institution, a possible role that might be worth further consideration, as a long-term objective.

In conclusion, Mr. Romuáldez noted that all those issues would no doubt be examined more closely in the subsequent meeting of the role of the SDR in promoting economic stability. He looked forward to that discussion with interest and with no small measure of urgency about the need to reach conclusions.

Mr. Lundstrom said that his chair had no major problems with the staff paper. He was also prepared to subscribe to most of the remarks made by Mr. Polak at the previous meeting. Therefore, he would limit his remarks to accentuating a few points related mainly to the staff paper.

The current historiography presented the gradually declining role of the SDR as being an unavoidable result of exogenous developments, Mr. Lundstrom remarked. That presentation tended to ignore another explanation--namely, the fact that member countries had adopted a passive attitude and had been unable to agree on measures to strengthen the position and attractiveness of the SDR. His authorities were of the opinion that the SDR should maintain a role in supplementing reserve creation. It would be desirable to keep in the future an instrument to create reserves through carefully considered international decisions. The improvement in the quality of reserves was an important rationale for SDR allocations, even if there was no reason to fear that the creation of liquidity by other means would become insufficient.

The problem of asymmetries was currently a matter of the liquidity position of countries with and countries without access to international capital markets, Mr. Lundstrom noted. Certain countries could raise considerable amounts of liquidity through borrowing whereas others could strengthen their reserves only by generating payments surpluses. In that not altogether satisfactory situation, SDR allocations of the traditional type might have a certain although restricted role to play. Through such allocations, it was also possible to influence the relative proportions of owned and borrowed reserves. The current far-reaching dependence on borrowed reserves had inherent risks--for example, from the point of view of stability, although the contribution of SDR allocations in that respect could be only marginal.

The criteria for SDR allocations presented obvious problems in that connection, Mr. Lundstrom said. Presumably, the Board would have another opportunity to return to the issue. He observed only that the present criteria would have to be re-examined so that they could be made less ambiguous and more operational. The existing guidelines could be interpreted in so many different ways that decisions had de facto been blocked. The argument that SDR allocations would negatively affect some countries' adjustment efforts, or constitute a soft option, was invalid, particularly when account was taken of the rather limited allocations that could be expected.

It should be kept in mind during the ongoing discussion of the SDR issue, which had been precipitated partly at the instigation of the Group of Ten and the Group of Twenty-Four, that opinions within the Group of Ten were divided, Mr. Lundstrom noted. The opinions of the G-10 countries that took a negative view of the SDR, and that happened to be the largest countries, were easily overemphasized, as was partly true of the staff assessment on pages 17-18 of SM/85/340. Consequently, the differences of opinion between the G-10 and G-24 countries tended to be exaggerated, impeding unnecessarily the narrowing of views.

In sum, although the role of the SDR undoubtedly had changed, there were still good grounds for maintaining and developing the SDR system, Mr. Lundstrom considered. The continued discussions should concentrate on efforts to find concrete means to strengthen the role and attractiveness of the SDR, including the issue of the revolving nature of the SDR and of the criteria for its allocation. Of course, solutions that could be broadly supported would have to be sought.

Mr. Alhaimus noted that the staff analysis supported on balance the view of his chair that the SDR continued to be useful and that in current international financial conditions it was perhaps more useful than it had been previously. The principal role envisaged for the SDR had been to supplement reserves by helping to alleviate existing or expected shortages of international liquidity. He agreed with the staff that that role for the SDR continued to be relevant but that it had to be seen in a different light. The development of freer international capital markets had made it difficult to determine the existence of a reserve shortage in the sense of the demand for reserves exceeding the available supply at some particular price. Creditworthy countries could satisfy their demand for reserves at all times; thus, a global need for reserve supplementation to bring demand and supply into equilibrium seemed unlikely. However, such a view ignored the impact of various market imperfections and the problems faced by countries perceived as being noncreditworthy. More important, it ignored the importance of the terms on which reserves were supplied. The level of reserves that equated the demand for and supply of reserves was adequate only in a narrow technical sense but not necessarily in the optimal sense of being the level of reserves most conducive to international economic prosperity. In that latter sense of optimality, equality of the demand for and supply of reserves did not preclude deliberate reserve creation that could improve the terms on which reserves were supplied or the manner in which they were distributed.

Another role that had originally been envisaged for the SDR was to reduce the asymmetries associated with the mechanism for supplying reserves, Mr. Alhaimus continued. As acknowledged by the staff, that role had not been diminished by the structural changes affecting the international monetary system; rather, it had been both widened and deepened. However, the assertion by the staff on page 17 of its paper that the relevant asymmetry of the system no longer lay in the difference between reserve centers and other countries was misleading. Clearly, that asymmetry, although reduced under the multiple currency reserve system, had not been completely eliminated. First, the demand for reserves by reserve centers was relatively less than that of other countries to the extent that the former could count on the acceptability of their own currencies by nonresidents when the need arose to finance external deficits. The reduced need to hold reserves reduced the costs associated with holding reserves. Second, reserve centers could borrow to finance external deficits or could augment their reserves by issuing liabilities denominated in their own currencies while other equally creditworthy countries, including some industrial countries, could borrow in international capital markets by issuing liabilities denominated usually in the currency of a reserve center. Under those circumstances, the difference in the cost of borrowing in favor of reserve centers was similar, say, to the difference between the U.S. treasury bill rate and the Eurodollar rate.

As for the asymmetry associated with creditworthiness, the staff had emphasized that it lay in the distinction between countries that could acquire reserves by borrowing and those that could not, Mr. Alhaimus noted. The cost to creditworthy countries of increasing their reserves was the relatively small difference between the rate at which reserves were borrowed and the rate at which they were invested. The similar cost incurred by countries without access to the international credit market was the high real cost associated with the need to generate external payments surpluses. Other aspects of that asymmetry were related to certain country characteristics which, other things being equal, could affect the demand for reserves and the creditworthiness of countries having such characteristics. Those characteristics included the degree of openness, the size, and the stage of development of the economy. He would be interested in knowing the staff's reaction to the proposition that, other things being equal, the more open, the smaller in size, and the less developed an economy, the greater a country's need for reserves and the more its creditworthiness was at risk.

Besides reserve supplementation and the reduction of asymmetries, the second amendment of the Articles of Agreement had envisaged that the SDR would play the role of the principal reserve asset of the international monetary system, Mr. Alhaimus recalled. The staff had referred to that aspect at the end of its paper in relation to the control of international liquidity; he looked forward to the discussion of that issue at a later date, although he would be interested in the staff's comment on how the relevance of the envisaged role for the SDR had been affected by the structural changes in the international monetary system and the current multiple currency reserve system.

Mr. Zecchini noted that the staff paper in front of the Board clearly spelled out the functions originally assigned to the SDR as well as the major developments in the international monetary system that had affected those functions in the past decade. At the beginning, the SDR had been thought of as a useful means of supplementing the supply of international reserves during a period in which the supply was seen to be insufficient. At the same time, the SDR had been considered as a reserve instrument capable of becoming, within an unspecified time span, the most utilized and the most important one.

He would not recall the historical developments, which had been usefully and concisely reviewed in the staff paper, except to comment on a few aspects that were still open for discussion, Mr. Zecchini continued. First, on the question of the asymmetry of the supply of international reserves, the staff paper had stressed, correctly and effectively, that a problem of asymmetry still existed in the current reserve system, to which all countries had contributed. The countries involved had simply changed somewhat over time. The asymmetry existed at present not only between countries issuing reserve currencies and other countries but also between countries that were able to borrow the means of financing their balance of payments deficit and others whose ability to do so had been impaired. Some might argue that the danger of losing creditworthiness provided a discipline for borrowing countries analogous to that enforced by the old rule of currency convertibility. But surely, discipline expressed by financial markets' attitudes--their bandwagon behavior or vagaries--was not an appropriate substitute for the past system. Actual market behavior was far from the ideal model of rationality that the staunch advocates of laissez faire took as an assumption.

Just as in 1969, the adjustment mechanism in the current international monetary system was unbalanced, Mr. Zecchini observed. There was an unsatisfactory relationship between the cost and availability of reserves and the adjustment process for different countries. In 1969, in the dollar standard system, the problem had been the too strong dependence on the evolution of the U.S. basic balance of payments for the supply of world reserves. At present, the problem was related to the fact that countries with insufficient ability to attain access to international capital markets were too dependent on and vulnerable to the monetary, fiscal, and banking policies of major currency countries. Moreover, the cost and availability of external reserves was not sufficiently correlated with a country's adjustment effort. In that respect, as in 1969, there remained a major role for the SDR. The currency composition of the SDR basket could certainly help to solve the new asymmetry problem because it was more stable by definition in terms of return and value compared to its component currencies and because of the nature of a currency unit administered under the control of the international community. Later, he would outline the way to accomplish that role. Of course, the need for a ceiling on the creation of SDRs must be recognized so as to maintain a certain degree of pressure on deficit countries for external adjustment.

On the definitional problem of how to evaluate the presumptive global need for reserves, there was both an old and a new issue, Mr. Zecchini remarked. The former concerned the evaluation of the optimum amount of reserves in the system. The latter was related to highly developed capital markets in which market creditworthiness had a crucial role in allowing countries to obtain supplementary international liquidity. In 1969, agreement had been reached on the criteria for testing the existence of a global need for reserves. In subsequent years, the perspective had changed somewhat. A global need as usually interpreted had not emerged very often. Yet the development of large capital markets had created an opportunity to overcome the lack in the supply of owned reserves.

Those developments had given rise to great instability in the supply of owned reserves, together with episodes of severe curtailment of lending, Mr. Zecchini added. In fact, the market's appreciation of a country's creditworthiness--sometimes partial and ill-founded--had become crucial. As a consequence of that process of privatization in the supply of reserves, countries with financing needs had been engaged in an unprecedented way in an effort to preserve or regain creditworthiness. Those efforts had not always been successful, for the reasons that had been discussed recently by the Executive Board in connection with conditionality (EBM/86/11, EBM/86/12, and EBM/86/13, 1/27/86). At the same time, those unprecedented efforts might have contributed to a deflationary bias in the world economy. There was very little doubt that borrowed reserves were a very imperfect, if not poor, substitute for owned reserves in countries' optimal reserve portfolios as well as from the point of view of the stability of the international monetary system.

It was precisely for that reason that positive considerations should be given to a process of controlling the expansion and stabilization of the creation and the use of SDRs, Mr. Zecchini went on. The process of deciding on new SDR allocations had to be freed from inappropriate considerations concerning monetary control over the short term. SDRs should be injected into the system gradually but continuously in accordance with a criterion that would ensure a stable increase over time. The aim should be gradually to raise the share of SDRs in the portfolios of monetary authorities over the longer term without impairing the attainment of appropriate macroeconomic discipline in the short term. That process of creating additional SDRs could also be viewed in the context of the Fund's financing of the adjustment process. For example, a certain amount of SDRs could be created when the Fund financed an adjustment program. He would mention two of several possible advantages: first, the creation would be subject to an assessment of the debtor countries' adjustment effort; and second, given the characteristics of the SDR, the cost for the country could be lower than that of market financing.

To those who had argued that the major function left for the SDR was to provide a safety net for the present multiple currency and market-dominated reserve system, Mr. Zecchini recalled that apart from the considerations he had already mentioned, the larger and more unstable the system, the larger and stronger the safety net should be. Otherwise, the net would give way under the pressure of a hard monetary landing or a financial crisis and would not be worth putting in place; its existence could even be dangerous if it conveyed the illusion to the market of being an effective net. Therefore, from that standpoint as well, a reinforcement of the SDR's share in reserve portfolios was needed.

The question of the development of the SDR as a unit of account and private market instrument was closely related to the issue of improving its characteristics for the purpose of enhancing its attractiveness, Mr. Zecchini considered. That was also true of monetary authorities, who should be given an incentive in that way to demand, hold, and exchange SDRs on a larger scale than in the past.

The private use of SDRs had not been considered in the staff paper, Mr. Zecchini noted, although recent developments in the international monetary system seemed to suggest an important additional role for the SDR in capital markets. In its private version, the SDR was already widely used to denominate bank current accounts and deposits, Eurobonds, syndicated loans, and certificates of deposit. A study on the private

SDR, "An Assessment of its Risk and Return," published in the March 1984 issue of IMF Staff Papers, showed that the SDR component of portfolios denominated in different currencies performed well. To quote from the conclusion of that study, for the sample period considered (1977-82), the standard deviation of the total return on the SDR was less than all other standard deviations on the return on the five component currencies, and the SDR had an above average total return during the period studied with respect to the same five component currencies. Moreover, during the most recent period, the evidence in terms of the comparative return was even more strongly in favor of SDR investments. In addition, a recent study of the Bank of Italy showed that the compounded return in dollar terms of money market instruments denominated in SDRs was better than that on the ECU, yen, and deutsche mark, being second to the dollar only in the period of particular dollar strength in 1981-85.

Given that international financial developments were likely to continue to be characterized by considerable fluctuations in interest rates and exchange rates, Mr. Zecchini remarked, the positive qualities of the existing reliable unit of account, which was potentially attractive because of its record of stability, inferior risk, and above average yield should be fostered. Greater use of the private SDR could not only be useful in providing the market with a more stable and reliable instrument but could be seen as an important step toward improving the liquidity of the official SDR. If public authorities had the possibility of depositing SDR assets with private financial institutions--for instance, along the lines suggested by Peter Kenen or in other technical proposals--use of the SDR among official holders would increase. Various limitations on the use of the SDR would have to be eliminated, and the way in which the SDR circulated would have to be improved to enable the instrument to offer advantages to the holder rather than being a burden. In that respect, he considered parallel development of the official SDR and the private SDR to be crucial.

Mr. Nimatallah remarked that use of the SDR as a means of payment did, of course, require its exchange into a convertible currency. However, it was only a matter of one additional step compared with the direct use of a currency to purchase goods and services. As for the difference between those countries in need of conditional credit and others in need of concessional credit, it seemed to him that it was also a question of the need of some countries for additional capital. A parallel could be drawn with a new business venture that needed capital, part of which it obtained in exchange for shares. Countries also needed to start afresh, especially as, unlike businesses, they could not cease to operate. Therefore, countries sometimes needed to find new capital, either from an unconditional source--which could be the SDR in exchange for another currency--or by borrowing it, if the country had access to the market.

The Treasurer noted that although SDRs could not be used to settle private obligations or for intervention in the exchange market, they could be used to settle official obligations under a decision adopted for that purpose. For example, SDRs were used by governments or other official holders of SDRs to make payments of interest or principal on loans between each other. The volume of such transactions was small but there was no reason why it should not grow if the SDR were more often used as a unit of account among central banks and other official holders of SDRs in their financial relationships outside the Fund. As for the use of SDRs to settle private obligations, a considerable number of suggestions had been made for a more radical departure from existing procedures; the possibilities could be explored if there was a general will to do so.

It took three days to convert official SDRs into currency within the designation process, the Treasurer commented, but with the cooperation of members, only two days would be needed. By comparison, it could take two days for a central bank to liquidate its holdings of treasury bills in foreign currency in exchange for cash.

As for the use of SDRs with designation, participants had to represent in good faith that they had a balance of payments need to use SDRs, the Treasurer stated. In essence, the participants represented that the SDR was not used to change the currency composition of reserves. For some countries, such a representation of balance of payments need was an obstacle because they did not wish to claim a balance of payments need even if its existence was evident. Such a declaration of balance of payments need could be seen as detrimental to confidence in countries' ability to manage their foreign exchange position, and some countries had hesitated to use the SDRs they held in their reserves, whereas other countries had made regular use of SDRs whenever they had a balance of payments deficit. He had been encouraged recently by the use of SDRs through the designation process by a major Fund member, which had thereby been able to obtain considerable amounts of currency in exchange within three days. A technique had been developed over the years to enable members to sell SDRs in substantially larger amounts than were sold with designation, and within two days. Although there might not always be a buyer, the volume of those transactions had been sufficiently large that a modicum of SDRs could be sold almost every day, without the seller having to invoke the balance of payments need, to another party willing to buy them voluntarily.

Finally, the Treasurer observed that possibilities existed under the Articles of Agreement to make the SDR even more usable and liquid. In his view, considerable scope remained for improving the acceptability and the reserve characteristics of the SDR. The staff had made several suggestions in that respect a few years previously, but those suggestions had been put on one side pending consideration of the future role of the SDR.

Mr. Sengupta made the following statement:

> We welcome this opportunity to begin our deliberations on the future role of the SDR in the international monetary system, as desired by the Interim Committee. Clearly, as indicated by this chair on previous occasions when we considered the question of an allocation of SDRs, the central issue is not whether the

SDR has a role in the international monetary system. It is worth noting that the Interim Committee in its communiqué of October 1985 has clearly stated that "the SDR constitutes an integral part of the structure of the Fund." The question now is how effectively the SDR plays that role in the future and what steps we need to take to make it more useful to the international community.

The staff paper provides a useful backdrop to our deliberations on this subject. Understandably, it has not examined in detail the merits and demerits of the proposals relating to the future role of the SDR and international liquidity policy. We will have an opportunity to discuss some of these issues at length toward the end of February. The points I am raising today are mainly to help the staff to prepare for that discussion, which should lead to some agreement on the future role of the SDR, as suggested by Mr. Polak.

I am quite impressed with the structuring of the staff paper which enables us to look at the developments in the international monetary system during the turbulent period of the past 15 years or so. In a nutshell, these are the suspension of convertiblity of the U.S. dollar to gold; the breakdown, as a result, of the system of fixed exchange rates and the move toward greater exchange rate flexibility; the substantial expansion and integration of international capital markets; and the growth in the importance of currencies other than the U.S. dollar in official reserves.

I agree with the staff that these changes have had a significant impact on the international monetary system as a whole and also on the mechanism through which international liquidity is provided in the system. They tended to weaken the constraints that par values placed on the pursuit of policies by individual countries. But at the same time they also weakened the element of international cooperation that was in-built in the system and left it to react to uncoordinated or less coordinated actions of individual countries, especially the reserve currency countries. I also agree with the staff view that creditworthy countries can borrow from the commercial markets to settle their deficits for a period of time without undertaking adjustment measures. But this is particularly true of large industrial countries, which not only have a greater economic power to attract such flows but also are the major participants in the international capital markets. For developing countries, however, the options are very limited. Financing helps them to adjust, not to avoid adjustment.

Let me therefore outline what we see as the impact on developing countries of the changes in the international monetary system during the past 15 years or so since the SDR was activated.

The developments no doubt made liquidity available to some of the developing countries during this period at a high cost but on the whole did not enable the system to function satisfactorily to satisfy the liquidity needs of developing countries in an orderly and appropriate manner.

First, the changeover to a flexible exchange rate system did not bring about any perceptible decline in the world demand for reserves; second, the experience with the floating exchange rate system has not been satisfactory, especially due to large, and at times, violent swings; this, together with large payments disequilibria and high interest rates, contributed to countries' holding substantial reserves to protect themselves against uncertainties; third, larger reserves were needed also, especially by developing countries, to insulate themselves against frequent exogenous "shocks"; and fourth, adequate reserves were needed by some countries to prove their "creditworthiness" and to gain access to international markets.

This takes us to the question of creditworthiness. Arguments have been advanced that the shortage of liquidity faced by countries, especially by developing countries, is primarily an indication of a lack of creditworthiness and is not related to a general shortage of liquidity. In this context, it is worth noting the experience of the bankers who operate in the capital markets. I am quoting from Country Risk, a book by Euromoney published in 1984, on how a country's "creditworthiness" is determined by the banking community.

> Events of the last decade have demonstrated that, just as the stock market, the international financial market can in the short term be disastrously wrong in its collective evaluation of country risk.
>
> Recent research has shown that loan syndicates each have a hard core of 10-20 banks that usually syndicate together; that there are less than a dozen such families on the Euromarket and that very often a family specializes in a particular geographical area. This means that there are not thousands of banks facing thousands of potential borrowers in 160-odd countries, but relatively few syndication families of banks facing a few dozen clients in a dozen or so countries.
>
> Competition on the Euromarket is thus not near perfect as previously thought; it is oligopolistic. Risk evaluation as reflected in the spread is not necessarily an unbiased market consensus; it can be tainted by the prejudices and twisted by the errors of a few lead managers of the families competing in a particular area.

This, I hope you will appreciate, fairly sums up the nature of market-determined creditworthiness. Again, as noted by the Group of Twenty-Four, recent experience also indicates that the adoption of proper policies by developing countries would not necessarily restore creditworthiness. I quote from the G-24 report:

> ...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. Reserves have to be built up first to earn 'creditworthiness' and, for obtaining such a position, developing countries will have to either generate current account surpluses or depend upon other nonmarket sources. Improvements in the operation of capital markets, whether through risk evaluation by banks or by increased deregulation, will not automatically improve the liquidity position of developing countries.

Then the G-24 report goes on to say:

> It is necessary to recognize that movements of exchange rates, inflation rates and growth of output and trade that affect the balance of payments of these countries are themselves subject to the influence of the domestic policies pursued by major industrial countries. These policies have not been internationally consistent and coordinated and have therefore not promoted international adjustment.

It is therefore necessary to study in detail the actual manner in which markets behave and provide liquidity to countries, before jumping to the conclusion that once countries adopt appropriate policies, markets would always provide them with the necessary liquidity.

It is for these reasons that the Group of Twenty-Four has suggested that the Fund should continue to have the power to influence the liquidity needs of the world economy through a more efficient SDR creation and distribution than at present. We need to concentrate on the aspect of efficiency in SDR creation, and make the SDR more attractive.

We should also ponder the question of the distribution of reserves. On this subject, I would like to quote from the Board's Annual Report for 1966, the time when there was a great debate on the need for supplying international liquidity through the creation of an international reserve asset. And the arguments made then remain valid.

> The economic significance both of reserve stocks and of reserve growth depends on their distribution among countries. If the distribution of the stock is very uneven in relation to need, as it was at the end of World War II, even a relatively high level of global reserves may be insufficient to serve the world's needs. In general, any improvement in the distribution of reserves is likely to have much the same effect on the world economy as an increase in total reserves. Thus the reduction over the postwar period in the reserves of the United States, and to some extent in those of certain other countries with initially high reserves, has increased the ability of the stock of reserves to meet global needs. The effect of any deliberate increase in global reserves will similarly depend in part on its initial distribution by country. The greater the proportion of the initial distribution of reserves that accrues to countries that are likely to utilize them quickly, the greater the initial impact on the world economy.

The subject of reserve distribution brings me to the important concept of the link which developing countries have raised several times in the past. When we are attempting a thoroughgoing review of the role of the SDR, it will be necessary for us to examine this aspect in detail once again. Mr. Polak is right that with the rising cost of the SDR, the old argument for a link related to its seigniorage compared with that on reserve assets, is no longer that compelling. But still there are other arguments, especially those related to the distribution of liquidity commensurate with reserve needs, which should be examined. It is unfortunate that Mr. Polak thought that this might be a possible disincentive for SDR allocation. To us, it should be the reverse--especially because we believe this can be used as an effective instrument of an international effort to help developing countries in the process of adjustment. After all, development assistance has been accepted by everybody as a desired international objective. The Report of the Committee of Twenty, whose deliberations I am afraid did not incorporate all the arguments in favor of the "link" or consider all the various possibilities, however, placed its emphasis on the right point:

> A link would contribute to the smooth functioning of the adjustment process, since, by enabling developing countries to run larger current account deficits, it would tend to relieve the tensions involved in the pursuit by developed countries of the current account surpluses that many of them prefer.

But even if the element of long-term resource transfer involved in the "link" proposal does not find general acceptance, there is a case for distributing international liquidity appropriately in order to meet the reserve requirements of developing countries. This is justifiable purely on grounds of improving the efficiency of the system, as you will note from the above quotation from the IMF Annual Report for 1966. There are different ways in which the distribution of SDRs could be made more efficient. At present, SDRs are allocated to each country on the basis of its quota, and this distribution does not take into account the needs of individual countries. Some of the earlier proposals made by Mr. de Groote and Mr. de Maulde were aimed at correcting this situation. Nevertheless, when their proposals were discussed, we stated that the allocations should be unconditional, as required under the Articles, and that we cannot support any conditional use of SDRs. Therefore, methods should be found which retain the SDR's unconditional character, yet enable the Fund to change the distribution mechanism in such a way as to take into account particular needs of the world economy at the time of the allocation.

The immediate example is the present debt situation in many market borrower countries and the untenable reserve situation in most African and Asian economies which need an immediate substantial allocation. Several ways could be thought of in order to achieve an efficient redistribution of allocated SDRs and I would like to suggest an alternative to Mr. de Groote's and Mr. de Maulde's proposals that retains the nonconditional as well as the reserve asset character of the SDR but distributes the asset more appropriately. For example, the SDRs allocated to countries that do not need them at the time of allocation, such as the industrial countries, could be reallocated to the needy developing countries. These developing countries should be allowed to retain the transferred additional SDRs permanently as an overdraft facility but use these SDRs, only if necessary, and for a limited period of maybe three years or so--to be fixed with reference to the world conditions or cycles of balance of payments adjustment--after which they would be required to pay back the additional SDRs used by them. So long as these SDRs are not used but are kept as reserves, no interest would be paid on them. When the additional SDRs were used, the interest paid on them could accrue to the countries that originally provided the reallocated SDRs. The repayment would be like the rebuilding of SDR holdings but not exactly in the same manner as that of the old reconstitution method. It would be more like unconditional lending for three years or so, if countries use the SDRs for meeting their reserve needs; otherwise, they would be held just as reserves in the form of an overdraft facility. A scheme along these lines could have several positive features.

First, it will ensure that for a given overall allocation, the needs of the more needy members are better met through the redistribution mechanism; second, it enables countries, especially those with serious debt problems, both low-income and major debtors, to augment their reserves immediately and enables them to undertake the adjustment measures needed for viability with greater flexibility and confidence; third, it will ensure that, for the sake of reducing an immediate balance of payments gap, countries do not undertake measures that restrict growth, such as a drastic reduction in imports and cuts in investment; fourth, because the additional SDRs are available only for a limited period of time, it encourages the country concerned to put in place quickly viable policies to achieve the needed adjustment within that period; fifth, it enables the Fund to play its role usefully as a provider of international liquidity for the purposes of stability of the international economy and in line with the provisions of the Articles of Agreement on SDR allocation; and sixth, it improves the role of the SDR and makes it a more useful tool for the promotion of international economic stability and growth.

To sum up, in addition to the points raised by Mr. Polak in his excellent presentation this morning, the staff and we in the Board could reflect on some of the following areas which I have covered a little earlier.

First, it appears necessary to examine the statement that countries become creditworthy by following prudent adjustment policies and to study how free market forces have responded to the needs of the countries which have undertaken strenuous adjustment measures in the past few years. What are all the perceptions that a banker has in mind in determining whether a country is creditworthy or not? Some deeper analysis in this area would be useful.

Second, the G-10 report also indicates that developing countries which, despite adjustment efforts, lack sufficient access to capital markets, should be provided with official finance. When we discuss this aspect of the role of the SDR in the provision of international liquidity, it would be necessary to examine the mechanism suggested by the Group of Ten to generate such official finance to determine whether it would be flexible and able to meet the liquidity needs of all such countries in an unconditional way.

Third, it is necessary also to examine how far the proposal of the Group of Twenty-Four relating to the link has relevance, especially in relation to the developing countries.

> Fourth, we should also look into schemes on the lines of the examples I have outlined above that would have the necessary flexibility to meet the liquidity needs of countries in a difficult situation but at the same time set a time frame within which they undertook voluntary adjustment. A scheme of that type could meet some of the important concerns, not only of those who are opposing an SDR allocation at this moment, but also those of the developing countries which do not wish to give up the unconditional character of SDRs, as that would be against the Articles of Agreement.

Mr. Huang said that as the consensus between the views of his chair and those of the Group of Twenty-Four was well known, he would concentrate his remarks on a few topics on which further emphasis might be needed.

Focusing first on the potential role of the SDR in the evolving reserve system, Mr. Huang commented that it was evident that the international monetary system had undergone fundamental changes in the years since the creation of the SDR. Among those changes, the dramatic development of international capital markets had exerted the greatest impact on the evolution of the reserve system. In contradiction with the objective set forth in the second amendment of the Articles of Agreement of making the SDR the principal reserve asset, it had been argued that international capital markets had become the most flexible and efficient way to provide international liquidity, thereby significantly reducing the role of the SDR.

Almost all industrial countries had entered the international capital markets, and they were understandably satisfied with the present reserve system, which enabled them to obtain reserves easily by borrowing in those markets whenever necessary, Mr. Huang continued. However, some developing countries found their ability to acquire reserves constrained by limits on their access to international capital markets. The illiquidity of those countries had deprived them of the option of phasing adjustment over an adequate period of time. The number of adjustment programs with high conditionality that had been imposed on them had resulted in undesirably severe austerity. The disturbing debt situation was one of the best illustrations of the weakness of a reserve system that relied on the functioning of international capital markets. Some might argue that the limited access of developing countries to those markets was the result of inappropriate policies that had led to the loss of their creditworthiness. In that view, prompt adjustment was the best way to gain access, an argument that in his view was superficial; the need for adjustment did not dispose of the problem of reserve shortage. As a matter of fact, in spite of vigorous adjustment efforts by some developing countries, the banking community had frequently ignored the necessity to reassess their creditworthiness. Moreover, creditworthy countries could augment their reserves by borrowing in the market without having to undertake specific adjustment measures. Such unchecked borrowing led to delays in taking the necessary steps to correct the underlying imbalances that had led to the borrowing. With the market meeting the demand for liquidity without constraints, the imbalances in the economy exerted no immediate pressure for adjustment until they had reached a point at which harsh measures had to be taken. Conceivably, the delay in signalling the need for adjustment was a systemic weakness of the present reserve system.

Furthermore, a characteristic feature of financial markets had been overreaction in the form of both speculative forces and an unpredictable psychology, Mr. Huang remarked. Such an overreaction inevitably led to volatile changes in the supply of reserves, with excessive expansion being followed by sudden contraction. That volatility had been highlighted by the overlending of the banking community to Latin American countries in the 1970s and early 1980s and the abrupt suspension of commercial financing after the 1982 debt crisis. The irony of borrowed reserves being withdrawn when they were most needed was another glaring drawback of the international capital markets.

There was great potential for enhancing the role of the SDR to counter those aforementioned shortcomings of international capital markets in managing international liquidity, Mr. Huang considered. SDR allocations would help less creditworthy countries to build up their reserves over time without having to run current account surpluses and without international banks having to increase their involuntary lending. SDR allocations would enable debtor nations to phase adjustment more efficiently and to spread out spending over time. A larger share of SDRs in international reserves would also help to bring the reserve-generating process under international control, thereby overcoming the volatility of the process. In that way, the SDR could become a safety net for the world economy. Moreover, the SDR could provide a more stable unit of account than any individual national currency so that arbitrary variations in the real value of international assets and liabilities could be minimized. Sufficient SDR allocations could also provide countries with a greater capacity to intervene on a meaningful scale on the exchange markets, and alleviate the conflict between the control of monetary aggregates and the management of exchange rates.

Therefore, despite the enormous changes in the international monetary system, the long-term objective of making the SDR the principal reserve asset remained valid, Mr. Huang considered. The view that it would be inflationary to expand the share of SDRs in international reserves was based on an analogy with monetary theory: just as an increase in the money supply prompted increased spending, which bid up prices, so would an increase in reserve holdings permit the financing of increased payments deficits, the latter typically induced by a relaxation of anti-inflationary policies. However, monetary theory also argued that monetary expansion did not necessarily lead to inflation if it financed real growth, an argument that was highly relevant to the case for SDR creation. The SDR had been invented in order to provide the world with an instrument to expand reserves in line with real growth. Provided that the resulting growth in reserves was no greater than the increase in the demand for reserves that resulted from the growth in the volume of trade, SDR allocations were not inflationary. The limits defined by the growth of trade and the legitimate demand for reserve replenishment gave little reason to fear that SDR allocations would be inflationary.

As to whether SDR allocations should be regarded as simply another way of extending loans to developing countries--loans of indefinite duration and without conditionality--it was most likely that the major reserve currency countries would be designated to receive SDRs and to supply reserve currency in exchange, if there was a new round of SDR allocations, Mr. Huang observed. If the yield on the SDR was below the market interest rate, the transaction would be unprofitable to reserve currency countries. Under those circumstances, they would consider that they were providing credit to countries using SDRs, overwhelmingly the developing countries. In his opinion, that was a shortsighted view. The interests of the major industrial countries in the operation of the international monetary system were not confined to the ability to make tiny profits in SDR transactions. The industrial countries would derive greater benefit from a stable international monetary environment, brought about by the enhanced functioning of the SDR, than would the developing countries. A substantial depreciation of the dollar was under way and the risk that a collapse of confidence might produce a new round of overshooting in the downward direction, igniting severe inflationary pressures, could not yet be dismissed. The United States also had an important national interest in a further allocation of SDRs because it would gain more freedom to maneuver in the exchange market than its present reserves offered. Of course, it was obvious that defusing the debt problem was closely related to the health of the U.S. banking system. Because the solution to that problem required debtor countries to rebuild their reserves, the question was whether that could best be done by means of an increase in imports by the United States and an even further cutback in U.S. exports. Surely, it would be preferable to provide reserves in a neutral way--namely, in the way permitted under the SDR scheme.

In short, Mr. Huang concluded that both the developing and the industrial countries would benefit from an enhanced role for the SDR. The enormous changes in the international monetary system had by no means reduced the significance of the SDR. On the contrary, those changes invited further exploration of the great potential of the SDR in the international monetary system and in promoting the growth and stability of the world economy.

Mr. Toé observed that the staff had provided useful background on the circumstances leading to the creation of the SDR, and in particular on the evolution of the international monetary system and the role of the SDR over the years. As he was in broad agreement with the staff's conclusions, he would confine his remarks to points of emphasis.

The move to a flexible exchange rate system, together with the emergence of a multiple reserve currency system and the changes in international credit markets, had opened up the possibility of new roles for the SDR, Mr. Toé considered. The great volatility in the exchange rates of the major reserve currencies that characterized the present system, with all its adverse effects at the national and international levels, certainly warranted the search for, and the promotion of, a reserve asset that could help to cushion those swings, thereby stimulating the development of international trade and smooth adjustment in developing countries. Promoting the SDR as the principal reserve asset in the system could serve that purpose successfully. In that connection, the new SDR valuation that had become effective on January 1, 1986 could be expected to have a stabilizing effect on the world economy, the weights of the five reserve currencies in the valuation basket having been altered to ensure a closer relationship between the behavior of the SDR and the evolution of underlying economic conditions in the five major industrial countries. The attractiveness of the SDR had been enhanced over the past few years. But it was cause for regret that the unwillingness of the major industrial members of the Fund had prevented the resumption of SDR allocations. Although it had been argued by some that expanding the relative share of the SDR in countries' total reserve holdings did not, per se, warrant allocations of the asset, it was nonetheless hard to understand how the objective of making it the principal reserve asset could be realized unless the quantitative aspect were correctly addressed.

As to the role of the SDR in supplementing reserves, Mr. Toé continued, the argument had been made that given the possibility of creating reserves through the international credit mechanism to meet the demand for reserves, no such supplementation would ever be needed. On various occasions, the Group of Twenty-Four had stressed the inadequacy, uncertainty, and unevenness of such a source of reserve creation and distribution. In the 1978 Annual Report of the Executive Board, Directors had cautioned against the possible drawbacks of relying on international credit markets when they had stated: "While the international capital markets have played an important role in channeling funds from surplus to deficit countries, reliance on this mechanism for providing balance of payments financing and reserves is not without its drawbacks." One such drawback could be an abrupt decline in the availability of funds, and it was commonly admitted that since the onset of the debt crisis in 1981-82, there had been a sharp decline in lending through the international markets, partly because of the unwillingness of commercial banks to lend. That decline had been more pronounced with respect to developing countries, new loans to those countries having fallen from $75 billion in 1982 to only $41 billion in 1984. Preliminary indications suggested that new lending to the developing countries had almost ceased during the first half of 1985. Moreover, the Fund's financial assistance to member countries had been scaled down since 1983.

On more than one occasion, Mr. Toé noted, the Managing Director had referred to the decrease in bank lending to developing countries, most recently in his address to the Bretton Woods Committee on January 22, 1986. Efforts currently being made by Secretary Baker to stimulate the resumption of bank lending to developing countries bore witness to the failure of the present mechanism of reserve creation. The Fund was entrusted by the Articles of Agreement with the task of exercising surveillance over international liquidity and of creating SDRs to supplement the existing stock of reserve assets. If the SDR became the principal reserve asset of the system, as laid down in Article XXII, the Fund, through the creation and cancellation of the asset, would be in a better position to control international liquidity. The Fund should move in a more resolute fashion to assume its responsibility instead of letting the decisions of private creditors alone govern the creation of reserves.

The SDR's role in reducing asymmetries in the system was more relevant than it had ever been, given the increasing importance of borrowed reserves, Mr. Toé stated. Countries that had access to international credit markets bore the cost of refinancing the reserves they acquired; those that did not have such access had to run payments surpluses. So far, developing countries had generated such current account surpluses through deflationary policies that inhibited their economic growth. Either way, the burden fell on nonreserve currency countries, for the most part, the developing countries. The cost of refinancing borrowed reserves, often short term, and the hardship of generating current account surpluses at the expense of economic growth could be alleviated through unconditional allocations of SDRs.

The structural changes that had occurred in the international monetary system were in his view far from having altered the need to strengthen the SDR and make it the principal reserve asset in the system, Mr. Toé concluded. The SDR had a critical role to play in the existing system. He looked forward to the staff's elaboration on that issue in the broader context of the current program of study on the SDR and the forthcoming paper on allocation of SDRs - consideration in light of recent developments.

Mr. de Forges remarked that as Mr. Polak had mentioned, it was difficult to separate into two parts the discussion of the SDR issue. The evolution of the role of the SDR since its inception was interesting from an historical point of view, but to be useful it had to be evaluated from a forward-looking perspective. The SDR's contribution to the stability of the international monetary system was obviously central to the issue although it would be taken up somewhat later. However, while he regretted the breakdown of the discussion, he had tried to limit his intervention to the content of the staff paper before the Board. Certainly, the staff had made an important contribution by providing a good résumé of the events marking the short life of the SDR. He concurred in particular with the historical presentation and the analysis of the SDR's role. The structural changes in the course of the 1970s and early 1980s had greatly modified perceptions of the functioning of the international monetary system, the exchange system, and the provision of international liquidity. The views of the French Government on those issues were well known, having been developed in various forums. He would simply recall the position of his authorities on the possibility of a new allocation of SDRs.

More generally, his authorities remained convinced that to totally abandon the task of allocating liquidity among countries to capital markets was not a satisfactory solution, Mr. de Forges continued. Some countries had limited or no access to markets, according to market criteria, with the exception of specific countries that benefitted from the commercial bank credit catalyzed by the intervention of the Fund in the framework of debt rescheduling. For a large number of indebted countries, the near privation of direct refinancing was a destabilizing factor. The alternative of carrying out the entire adjustment process by generating larger than necessary surpluses on current account was not realistic in the medium term for those countries which, because they had to finance their development, were faced inevitably with a structural deficit on current account.

As noted in the report of the Group of Ten Deputies, the SDR was not intended to replace the market, Mr. de Forges commented. Nevertheless, SDR allocations could speed up the renewal of bank commitments and ease the adjustment process by reducing borrowing requirements and by increasing the volume of owned reserves. At the same time, the terms and conditions on which those reserves were obtained would become more appropriate for a number of developing countries that were currently in difficulties. From that point of view, the SDR could play a useful role in the solution of the debt problem, a consideration that could be integrated into the current initiative aimed at mobilizing complementary resources for indebted countries. The same role could be played, under different conditions, in respect of poor countries having no access to international markets: the SDR could be a determining factor in building up reserves, supplementing other sources of concessional financing--for instance, from the Special Disbursement Account and the International Development Association.

A resumption of SDR allocations would also generally reduce the relative share of borrowed reserves, thereby making reserve holdings less vulnerable to fluctuations in financial markets, Mr. de Forges said. That argument had been one of the major justifications for the last allocation in 1978, which had taken place at a time when access to financial markets had been widened significantly.

The Executive Board would have an opportunity within one month to return to the issue, and more particularly to the idea of the SDR as a safety net for the international monetary system, Mr. de Forges noted. The system continued to labor under unmitigated uncertainties, uncertainties that could even increase suddenly--for instance, if the situation of oil producing countries worsened. For the purpose of that forthcoming discussion, he looked forward to the paper requested by Mr. de Maulde during the previous discussion of the question of the allocation of SDRs on the relationship of world reserves to the total balance of payments position of the United States, a request that the Chairman had accepted in his summing up.

Mr. Dallara said that he welcomed the initial opportunity to consider issues relating to the role of the SDR in the international monetary system. It was appropriate to focus at the present meeting on the implications of changes in the system for the SDR because any attempt to evaluate the present or future role of the SDR must first begin with an understanding of the extent to which, and the way in which, the international monetary system and the world economy had changed since the inception of the SDR in 1969. Only with a clear and, he hoped, common view of those changes could informed judgments begin to be made about the appropriate present and future role of the asset.

The staff paper cited three reasons for the decision to create the SDR, Mr. Dallara observed. First, the basic rationale incorporated in the Articles of Agreement was the SDR's role as a supplemental source of liquidity that could be issued independently of existing reserve assets--essentially gold and dollars. Second, the SDR had been viewed as contributing, albeit rather modestly, to the maintenance of dollar convertibility into other reserve assets, and thus to strengthening confidence somewhat in the par value/gold-based monetary system. Third, the staff paper suggested that another reason for creating the SDR had been to address perceived asymmetries in the Bretton Woods system, particularly the presumed net benefits accruing to the reserve center. Although he recognized that that had been a consideration in the minds of many in the discussions leading up to the creation of the SDR, he had difficulty with the suggestion that a very important justification for the original creation of the asset had been to enhance or to restore some concept of fairness to the international monetary system.

The alleged asymmetries in the gold exchange standard were not all that clear, Mr. Dallara added. First, the fact that the United States was performing--and continued to perform--the function of a reserve currency country reflected primarily the size, strength, and openness of the U.S. economy; the clear need for the system to have a source of liquidity that did not rely exclusively on gold; and the willingness of the United States to assume the responsibilities associated with that role. Second, the benefits to the United States of the reserve currency role of the dollar under the Bretton Woods system--and there clearly had been some--had been accompanied by costs, primarily associated with the circumscribed ability of the United States to change the dollar exchange rate and to pursue a relatively independent economic policy to achieve domestic economic objectives and balance of payments adjustment. Third, despite the so-called privileges attributed to the reserve currency role of the dollar under the Bretton Woods system, it was worth noting that no other country had actively sought to assume that role, an attitude that seemed to continue to prevail. Probably no other currency could have played that role, at least through the late 1950s, but it had been necessary to encourage other countries to do so since that time. It could also be argued that the Bretton Woods asymmetries permitted surplus countries the exorbitant privilege of maintaining undervalued currencies and avoiding their full international responsibilities as potential reserve currency countries.

Some observers had suggested that the critical problem for the Bretton Woods par value/convertibility system had been the absence of sufficient adjustment incentives and appropriate adjustment techniques, rather than inadequate liquidity, Mr. Dallara said. Whether or not the creation of the SDR had been the right response, its role had to be assessed in light of the changes that had occurred in the system. The adoption of more flexible exchange rate arrangements and the integration of international capital markets had had the most significant consequences for the SDR. It was true that flexible exchange rates had not reduced the demand for reserves to the extent originally expected, although that seemed to have more to do with the attitude of authorities to rate movements than with any inherent qualities of the system. It was also worth recalling that the present system was the result of economic forces and conscious political decisions made by governments in the 1970s. Those developments, as the staff paper had noted, had provided countries with more autonomy in pursuit of some of their economic objectives than had been possible under the Bretton Woods system as it had evolved.

It was necessary to be cautious in comparing the existing system with an idealized rather than the actual Bretton Woods system as it had functioned, Mr. Dallara said. For instance, pressures to avoid needed adjustment or adjustment in the most efficient economic manner had been just as strong under the Bretton Woods system as they were at present. He recalled the frequent recourse to controls during the 1960s that had been undertaken to minimize the impact of divergent economic performance on capital flows and associated frequently with avoiding more fundamental adjustment, as was often the case at present. At the same time, the existing system did exercise some discipline on member countries although the staff paper seemed to suggest that such discipline was almost totally lacking. The adoption of more flexible exchange rates clearly had altered the form and timing--and perhaps the extent--of the adjustment pressures, or discipline, but had not totally eliminated them.

Clearly, the growth and integration of international capital markets had exercised the greatest impact on the role of the SDR, Mr. Dallara went on. The staff paper had noted correctly that the present system generally enabled creditworthy countries to meet their reserve needs without difficulty; those countries were thus not in need of a supplementary source of liquidity. However, the amount of liquidity that might sometimes be provided was a cause for some concern; some of the excesses in international lending in the early 1980s had been related to inadequacies in economic policies of both developing and industrial countries. However, he had serious reservations about the extent to which SDRs could serve to offset the effects of those policies. Consequently, he had doubts about the staff suggestion that the SDR's role as a supplementary source of reserves should be assessed in light of the assumed objective of "easing the terms" on which reserves were supplied to the world economy.

One argument appeared to be that the role of the SDR as a supplemental source of reserves was to reduce the costs of obtaining owned reserves, Mr. Dallara remarked. That was an important issue, but the arguments were not persuasive. Moreover, experience suggested that the greater risk to the system had been excessive liquidity and the costs associated with inflation. In those circumstances, his concern was that the official creation of owned reserves could add to, rather than substitute for, other reserve sources. He noted that some had argued that the stability of the system might have been improved by a conditional SDR; he had also noted that others had categorically rejected any conditionality for the SDR.

He also had reservations about the argument that the SDR would contribute to the stability of the system by reducing reliance on borrowed reserves, which needed to be refinanced, Mr. Dallara said. A system largely based on private markets obviously had some imperfections. But the need to refinance and/or repay borrowed reserves could be viewed as providing a useful discipline on economic policies, thereby representing at least in part a stabilizing force for the system. Moreover, SDR allocations did not necessarily reduce total borrowing in the system, but simply shifted the need to borrow from countries with reduced access to capital markets to those that were more creditworthy, since net holders of SDRs had to finance the acquisition of reserves.

Apparently the staff believed that a multicurrency reserve asset system was inherently unstable, Mr. Dallara noted. The issue of instability, which was dealt with only briefly in the staff paper, merited closer scrutiny although he was not convinced that the present system was any more unstable than one characterized by a larger amount of SDRs. The issue might rather be whether stability would not be enhanced by a multi-reserve currency system that was based no longer on the dollar alone but on several currencies.

The rationale for the SDR based on the need to reduce alleged asymmetries in the system between members with access to capital markets and those without it was a very strange concept, Mr. Dallara remarked. It was one thing to argue about supposed asymmetries in the old system; it was another to convey the mistaken idea that differences in access to credit markets constituted an asymmetry. He could not support such a concept, which hinted at the SDR as a means of resource transfer and had been surprised at the degree of emphasis given to it. Unless the assessment of the SDR's role took place within the context of the agreed objective of strengthening the system generally, the discussions in the weeks ahead would be difficult. Strong views on the use of the SDR for the transfer of resources would put a consensus out of reach.

In conclusion, Mr. Dallara said that the staff had rightly pointed out that improvements in the functioning of the international monetary system would require sound economic policies, greater convergence in economic performance, and more compatible economic policies on the part of all member countries. The future of the SDR would depend critically on whether and how it could contribute to those processes. Furthermore, the way in which member countries' economic policies interacted was likely to be strongly influenced by the existence of an international economic environment in which international capital markets would continue to grow, and the use of diversified multiple currency reserves would expand. As the staff paper on conditionality had pointed out, linkages in the monetary system should be considered carefully. Common assumptions and understandings were needed about the openness of capital markets and the multiple currency system. Without broad agreement on the basic characteristics of the liquidity system, the role of the SDR could not be evaluated. In that connection, his authorities considered that the role of the SDR as a unit of account could be given more attention.

Mr. Ismael stated that he was in full agreement with the staff analysis and its conclusion that the SDR was still relevant in spite of the changes that had taken place in the international monetary system since the 1960s. He recalled that the staff paper under discussion had had its origin in the assertion in the Executive Board that under the present day multicurrency reserve system, the need for reserves could easily be satisfied by external borrowing; therefore, the SDR no longer had a role to play in the international monetary system. The staff had disproved that assertion: the SDR still had an important role to play.

As the international monetary system had evolved into a multicurrency reserve system, Mr. Ismael noted, many of the reserve currency countries had gained freedom to manage their domestic policies, which were no longer constrained by balance of payments considerations because those countries were able to issue domestic currency liabilities to settle their external obligations. The same privilege was not available to other countries, leading to what the staff had called asymmetries. There was thus a strong case not only for keeping SDRs but for increasing their share in total reserves in order to reduce the existing asymmetries. Indeed, some countries had even suggested that the asymmetries should be reversed by linking the creation of international liquidity to development assistance, a position that he understood.

It had sometimes been argued, quite erroneously in his view, that the demand for reserves could be satisfied easily through existing sources of reserve creation, Mr. Ismael remarked. The scale of import compression in many developing countries and the consequent decline in the growth rates of those countries provided ample evidence of reserve shortages. He also agreed with the staff that SDR allocations could bring about considerable improvements in the terms on which reserves were supplied. The supply of reserves by commercial banks was generally unstable, the maturities were short, and the costs high, primarily because a large proportion of global savings was pre-empted by some reserve currency countries to finance large fiscal deficits.

Another major objective of SDR allocations in the present international monetary system would be to impart stability to the system by ensuring stability in the supply of international liquidity, Mr. Ismael added. The banking system was withdrawing from a number of countries, to the concern of the international community. Indeed, the central element of the Baker debt strategy was to stabilize the supply of international liquidity to a certain group of countries. However, there were doubts about many aspects of the Baker strategy, including its limited application to countries facing reserve shortages. In present circumstances, a more global approach based on the SDR as the principal source of reserves would more effectively meet the reserve needs of member countries. To counteract the instability in the flow of reserves that had affected the stability of the international monetary system, the SDR should be made the principal reserve asset in the system, in accordance with the provisions of the Articles of Agreement.

Finally, Mr. Ismael noted in passing that when it had first been decided to allocate SDRs, the proposal had been supported in order to provide greater confidence in the ability of the U.S. Government to ensure the convertibility of the dollar. While that rationale was no longer relevant, the staff had pointed to numerous other considerations suggesting not only that the SDR should play an important role in strengthening the international monetary system, but that that role could be fulfilled only by allocations on a scale that would increase the share of SDRs in global reserves.

Mr. Kafka noted that the evolution of the international monetary system had not rendered the SDR obsolete. That evolution had equalized countries' access to reserves or relieved countries from the need for such access, but only as between the traditional reserve centers of the postwar world and countries perceived by the banks--rightly or wrongly--as creditworthy, essentially, but not only, the industrial countries. Since the debt crisis, some of the largest nonindustrial countries had been excluded from the magic circle and other countries had never been part of it; nor had the cost of acquiring reserves been equalized. Both those considerations were relevant because the global need to supplement reserve assets was multifaceted and not simply a quantitative concept. Reliance on the self-interest of banks clearly did not ensure a perfectly functioning mechanism of reserve supply through bank lending. The resulting one-sided distribution had global consequences, which could be mitigated by allocation. Thus, the very absence of systemic reasons against an allocation in his opinion justified such an allocation.

As for the opposition in certain quarters to an allocation, however modest, Mr. Polak had rightly reiterated that the threat of inflation was not a valid reason, Mr. Kafka noted. More explicitly, any likely allocation could not contribute to inflation, either materially or by giving false signals, to more than a trivial extent. For the same reasons, the limited impact of allocations of the size suggested--especially for countries in deficit or in debt, including the United States--would hardly dissuade them from efforts at adjustment. Moreover, as discussed already in the Executive Board on previous occasions, consideration could be given to re-establishing rules for reconstitution in order further to assuage fears on that account.

The more serious defects of the SDR as an international reserve asset were related to its apparent inability to be used in market intervention and the prohibition on SDR holdings by private parties, Mr. Kafka remarked.

Nevertheless, and without rescinding that prohibition, it would be possible to provide for the use of SDRs in intervention, either on the lines of a proposal made over ten years previously by Mr. Sangster of the United Kingdom, or in other possible ways.

Some of the universal advantages to be derived from a higher proportion of SDRs in global reserves--SDRs that were neither borrowed nor acquired at heavy cost by countries already lacking the resources to finance the investment needed desperately for growth and the creation of employment--had been outlined in the staff paper, Mr. Kafka observed. SDRs would impart stability to the volume of reserve assets, unless there was an international consensus on changing that volume.

Mr. Foot considered that the current role of the SDR had to be seen in terms of ensuring the adequacy of international liquidity and of ameliorating any asymmetries that might exist in the reserve creation system. His chair remained unconvinced that a global shortage of international liquidity had been proved. The growth of international capital markets had enabled countries, in a way that had not been possible in the past, to increase gross reserves by borrowing. Those in the magic circle had borrowed on a major scale. Some countries had not been able to borrow, either because of inadequate adjustment efforts or because of the contagion effect in a given region. The Baker initiative would have a major role to play in encouraging flows that would avoid such problems for countries that had taken the appropriate actions.

As for the possibility of asymmetries in the system of multireserve currency countries, Mr. Foot said that two factors should be underscored. First, as the staff and Mr. Dallara had pointed out, relatively few countries had been willing to accept the responsibility of a reserve center in the decades between the 1950s and 1970s. Second, the SDR was not an instrument of development finance. His authorities saw the issues of international liquidity and development assistance as being separate and needing to be dealt with individually.

The role of the SDR needed to be evaluated in light of present rather than past circumstances, Mr. Foot stated. The SDR might have a valuable role to play in improving the quality of reserves, owing to its owned nature, and in providing a safety net in the event that world liquidity became insufficient at some future time. While the owned nature of the SDR would protect countries from the swings in confidence on private capital markets that made those markets an unreliable source of financing at times, he noted that many developing countries generally spent their SDR allocations rather than holding them in their reserves.

The illiquidity of the SDR made it unattractive to hold by the recipients, Mr. Foot added. Therefore, he looked forward to the forthcoming discussion of possible measures to increase the attractiveness of the SDR as a reserve asset in comparison with the success of the European

Currency Unit (ECU). Of course, his remarks should not be taken as an endorsement in advance of the adoption of similar features for the SDR but as an indication of the scope for further discussions.

Mr. Archibong associated himself with some of the views expressed by Mr. Polak, particularly those relating to the key issue of SDR allocation. The obvious conclusion that emerged from the staff paper as well as from the writings of independent observers was that the changes in the international monetary system had reinforced rather than diminished the important role intended for the SDR. The problem of international liquidity--its adequacy, composition, distribution, and the need for greater stability and predictability in its provision--had remained major concerns that the emergence of the present multicurrency reserve system had not helped to alleviate.

A basic objective that the SDR had been intended to serve was the supplementation of existing reserves, both quantitatively and qualitatively, Mr. Archibong recalled. The shift from the gold exchange standard to a multicurrency reserve system had not resolved the problem of liquidity shortage. Most developing countries continued to suffer from inadequate reserves, as reflected in the volume of their imports and hence their economic growth and the expansion of their trade. The view that the development of international capital markets and the emergence of commercial bank credit as a source of reserves had eliminated the need for a deliberate act of reserve creation was in his view an invalid generalization. While capital markets and commercial bank credit had provided an important source of reserve supplementation to a limited number of middle-income countries, the majority of developing countries, and in particular the low-income countries, had had little access to those sources. For the majority of countries, the main source of acquiring reserves was still through the generation of payments surpluses. However, with the secular weakening of international demand for and the prices of commodities, worsening terms of trade, mounting debt service obligations, and the decline in the domestic production of exports, the ability of those countries to acquire reserves continued to be eroded.

Even for middle-income countries that might have been able to borrow on international financial markets, such a source of borrowing had proved temporary, volatile, and highly expensive, Mr. Archibong commented. Commercial bank credit to developing countries had expanded rapidly in the 1970s but had dried up at an even faster rate following the 1980 debt crisis. That was clear evidence of the unreliability of commercial bank credit, which was subject to the uncoordinated decisions of private creditors. Moreover, the buildup of external debt and the mounting debt service burden of borrowing countries that had threatened the smooth functioning of the international monetary system in recent years were other indicators of the unsustainability of commercial credit as a reliable source of reserve supplementation over the long term. Therefore, it was easy to conclude that the changes in the international monetary system had in fact reinforced the role of the SDR in relieving reserve shortage and improving the terms and conditions of reserve provision.

The reserve supplementation function of the SDR had also been intended to improve the quality of existing reserve assets and the mechanism for their provision, Mr. Archibong recalled. There was no doubt that a principal objective at the inception of the SDR system had been to provide an internationally accepted means of increasing liquidity by discretionary, concerted international action rather than by the happenstance of a single country's deficit. With the introduction of the existing multicurrency reserve system, that function of the SDR had assumed an additional dimension. Besides protecting the provision of international reserves from undesirable influences of changes in domestic policies of reserve center countries, the SDR system would also help to insulate the reserve provision mechanism from the adverse effects of divergences in industrial countries' national policies, avoiding problems as a result of currency misalignment and reducing uncertainties generated by the volatility of exchange rates. Therefore, the stabilizing function of the SDR had become more important as a result of structural changes in the international monetary system. The SDR was more needed than ever for its increased stability and predictability and to ensure a more orderly provision of international reserves.

As for the role of the SDR in reducing asymmetries resulting from the reserve provision system, Mr. Archibong said that he fully shared the staff conclusion that such a role "has not been diminished by structural changes since the first allocation. Indeed, that role could be said to have been both widened and deepened." The asymmetries were not limited to the distribution of benefits and costs of reserve creation but also existed in the distribution of the costs of adjustment. The reserve center countries enjoyed considerable seigniorage on the creation of new reserve assets; they could acquire real resources through the mere expansion of their liabilities whereas the ability of other countries--developing countries in particular--to acquire reserves was limited to the size of the surpluses they could generate. The resulting inequities were inherent in the present system of reserve creation and could be tackled only by subjecting the act of reserve creation to the will of the entire international community.

As noted by the staff, those asymmetries had been further complicated by the emergence of international financial markets as a source of reserves for creditworthy countries, Mr. Archibong said. The majority of developing countries with no access to financial markets had suffered further inequities in their ability to acquire reserves. They had also ended up bearing the brunt of adjustment of the system imposed on them. Those gross inequities indicated that the role of the SDR in addressing asymmetries was of greater significance than when the asset had first been envisaged.

His final point was related to the function of the SDR in promoting economic development in low-income countries, Mr. Archibong added. The importance of the availability of international liquidity for low-income countries went beyond facilitating international commercial transactions. Those countries relied heavily on imported inputs and capital goods in the development process. Therefore, reserve shortages had far-reaching implications for their economic growth and development. For that reason, a link had been suggested between the creation of reserve assets and the provision of development finance. The development function of the SDR could be enhanced by allocating newly created reserve assets to developing countries, in turn helping to reduce existing inequities and to redistribute part of the gains--the seigniorage--resulting from the creation of new reserve assets.

Mr. Nimatallah remarked that in considering the question of the extent to which developments in the functioning of the international monetary system over the past 15 years had affected the role of the SDR, the staff had assumed that one of the originally envisaged roles--that of shoring up confidence in the continued convertibility of dollars into gold--had ended. In a strict sense, that was true, although the concern in the 1960s over convertibility had been nothing other than a manifestation of a more general concern over the stability of the international monetary system. And that wider and more general concern was still present. The past ten years had seen many countries place heavy reliance on international capital markets as a source of borrowed reserves, replacing the prospect of instability as a result of a possible run on the dollar with a prospect of instability stemming from heavy reliance on borrowed reserves. The possibility of sudden interruptions in credit flows to a large country or group of countries, because they were suddenly ruled uncreditworthy, might have a destabilizing impact on the current system. Therefore, the SDR could still play a role in stabilizing the system by diversifying the sources of international reserves. SDRs, along with owned reserves and official credit, could together increase stability and therefore confidence in the system.

A second role assigned to the SDR at its inception was that of complementing other international sources of liquidity, Mr. Nimatallah noted. Some would argue that the importance of that role had been greatly diminished by the recently increased function in generating reserves that capital markets had assumed. In reality, that was not always true for all countries at all times. For example, there were countries which had been ruled uncreditworthy and which had yet to implement appropriate adjustment policies. Other countries that were currently creditworthy might suddenly be cut off from credit because there was no guarantee that they would remain creditworthy. Still others had adopted comprehensive adjustment programs yet banks had denied them access to credit.

The third role assigned to the SDR from the outset had been that of alleviating the asymmetries associated with reserve creation, Mr. Nimatallah recalled. He agreed with the staff that that role had not diminished; on the contrary, it had widened and deepened. It had widened insofar as the number of reserve currencies had increased, the supply of those currencies playing a more predominant role in the provision of reserves at present; it had deepened in the sense that creditworthiness had become more important in gaining access to capital markets. However, he felt that the staff could have developed its concept of asymmetry more fully than it had in the last paragraph on page 17 of SM/85/340. What was important for countries that were not at present creditworthy was the double cost of adjustment: its real economic cost and the cost of financing it, which had previously been the only cost.

His conclusion was that despite the major structural changes that had taken place in the international monetary system over the past 14 years, the SDR should maintain an important and indeed an expanded role in the future, Mr. Nimatallah stated. In that connection, he looked forward to the Board's discussion of the staff paper on the potential contribution of the SDR to economic stability.

Mr. Salehkhou recalled that the staff paper before the Executive Board had been prepared in response to the Interim Committee's request to the Executive Board to review, as a matter of priority, the role of the SDR in the international monetary system. The Committee's recommendation had been made in view of developments in the system and the issues raised in both the G-24 and G-10 reports. While the staff had prepared an informative paper, including historical background as well as a summary of the main issues, a comprehensive appraisal of the recommendations of the Group of Twenty-Four and the Group of Ten was lacking, even though that could have laid the basis for more specific consideration and a fruitful outcome.

The SDR had come into existence when the limited supply of gold, reserve positions in the Fund, and reserve holdings had failed adequately to respond to the increase in the global demand for reserves, Mr. Salehkhou recalled. The slow growth of international reserves, the declining ratio of reserves to imports, the increasing number of restrictions on international transactions and growing recourse to official credit arrangements had presented empirical evidence of the need to supplement existing reserves. Asymmetries in the distribution of the benefits and cost of reserve creation had been two major additional considerations in that regard.

Structural changes in the international monetary system had led to persistent questions about the effectiveness of the role originally envisaged for the SDR, Mr. Salehkhou commented. The SDR's role in helping to strengthen confidence in the convertibility of the U.S. dollar into gold had become irrelevant soon after the suspension of convertibility and the subsequent change in the SDR valuation from a certain weight of gold to a basket of currencies together with the increase in its interest rate. The role of the SDR as a means of relieving reserve shortages had also been weakened due to the lack of allocations since 1981.

A number of G-10 members had been led to conclude that "there is at present no clear evidence of a long-term global need to supplement international reserves," Mr. Salehkhou observed. While that conclusion might apply to reserve currency and other creditworthy countries that had been in a position to finance their balance of payments needs and increase their reserves through borrowing with ease from commercial markets, the same did not hold true for the large majority of the membership, particularly in the past few years. The restoration of creditworthiness in borrowing countries depended largely on the adequacy of reserves, leading thus far to the implementation of austerity programs and the generation of balance of payments surpluses through import compression, with a loss of purchasing power and a reduced rate of growth. Even for those developing countries with access to the market, the cost of such credit was a barely sustainable burden. In spite of a considerable relaxation of various restrictions on the use of SDRs and significant improvements to make the SDR more attractive to acquire and hold, cumulative allocations amounted to only SDR 21.4 billion, constituting about 5 percent of total nongold global reserves. That discouraging falling trend was due to the lack of allocations since 1981.

With respect to the concern that SDR allocation might result in delaying necessary adjustment, Mr. Salehkhou said that he failed to see the relevance of such an argument, considering the meager portion of allocations that would be distributed to the countries concerned. On the contrary, SDR allocations would help those countries undertake painful adjustment programs and replenish their depleted reserves, at a time moreover when the emphasis of adjustment programs had shifted recently to export promotion rather than import compression so as to lay the ground for noninflationary growth and employment. He would appreciate staff comment on that matter.

Changes in the international monetary system had strengthened the argument for the SDR's role in reducing the asymmetries associated with the process of supplying reserves, Mr. Salehkhou remarked. In spite of the discipline that had been expected to result from the Bretton Woods par value system, reserve currency countries had been able to finance their balance of payments needs unconditionally by issuing liabilities while developing countries had had to finance their deficits through the transfer of assets. Those asymmetries had been widened on the one hand because of an increase in the number of reserve currency countries and on the other hand as a result of the distinction made between countries that could and could not acquire reserves by borrowing easily. Even for most developing countries that had undertaken adjustment programs to restore creditworthiness, access to spontaneous borrowing had largely failed to materialize because commercial banks had continued to aim at reducing their exposure in those countries. Concern had been expressed that SDR allocations were not the appropriate tool for providing finance to countries whose access to international credit markets had been jeopardized; yet there appeared to be no satisfactory alternative. Finally, Mr. Salehkhou said that he looked forward to the forthcoming discussions on other SDR-related issues and to substantive consideration of all the recommendations set forth in the G-24 report.

Mr. Pérez observed that the discussion on the implications of changes in the international monetary system for the role of the SDR provided a good starting point for the analysis of the contents of the G-10 and G-24 reports and the proposals therein. It should be possible to identify some of the major problems of the international monetary system--namely, its asymmetric character and its inherent instability. In addition, for those who had been in favor of a new allocation of SDRs during the past few years--with scant success--the discussion offered an excellent opportunity for reassessing whether or not the SDR still had a role to play in the present international financial system, and, most important, in an improved monetary system.

The main changes in the structure of the international monetary system since the early 1970s had been underscored fairly by the staff, Mr. Pérez considered. The suspension of the convertibility of the dollar into gold and breakdown of the system of fixed exchange rates had resulted in the loss of one of the roles of the SDR as an asset that could strengthen confidence in the convertibility of the U.S. dollar into gold. The transformation of the SDR from an asset denominated in gold to an asset whose value was determined by a basket of the principal currencies, which had experienced sharp fluctuations, had represented a serious limitation on the potential role of the SDR as a unit of account in private transactions or as a term of reference for national currency exchange rates. Those limitations had prevented increased use of the SDR, a matter that should be analyzed in depth if the discussion was to result in agreement on a more important role for the SDR in the future. Among other aspects, it seemed important to explore methods of enhancing the stability of SDRs, thereby increasing their attractiveness.

The expansion of the international credit market, the third major change mentioned by the staff, had been a welcome development in the mid-1970s, Mr. Pérez continued. The recycling of finance from countries running surpluses in their balance of payments to those countries incurring deficits had allowed major structural changes to take place in the world economy throughout that decade over a time span that made adjustment to those changes possible. Nevertheless, a significant shift in the control of international liquidity away from domestic monetary authorities and multilateral institutions and more into the domain of market mechanisms had been associated with those developments, with clear implications for the efficiency and symmetry of the system.

The system had gained a measure of flexibility but had been shown to be highly unstable and procyclical, Mr. Pérez stated. Past experience showed that the international banking community had tended to overshoot in the provision of liquidity at a moment when more cautious behavior was called for. In addition, banks had adopted a very restrictive stance toward a certain number of countries in a high risk category which they had not modified in spite of the fact that those countries had started to correct their economic disequilibria. Accordingly, the supply of borrowed reserves tended to contract sharply during periods when countries were experiencing balance of payments difficulties, further complicating the process of adjustment.

In addition, the asymmetric nature of the system had been accentuated because in present circumstances the number of creditworthy countries had been sharply curtailed to include industrial countries and only a few developing countries, Mr. Pérez added. That situation was reflected in the fact that the brunt of the adjustment to the inflationary shocks of the 1970s had fallen during the subsequent decade on developing countries, which were no longer able to borrow reserves in international capital markets. Furthermore, those countries having been qualified as creditworthy by the banking community had been able to postpone the adoption of adjustment measures, with serious consequences for the stability of the international economy, and the present monetary system had been unable to prevent the transmittal of the negative effects from country to country.

In that connection, the role of the SDR as a device to generate reserves and the role that it should play in relation to the control of global liquidity were even more important than at the time the asset had been created, Mr. Pérez continued. The SDR could play a major role in providing liquidity to those countries having restricted access to private capital markets. The lack of creditworthiness had compelled those countries to obtain reserves by generating additional balance of payments surpluses, thus increasing the cost of adjustment. The nature of the SDR made it a very appropriate counterbalance, giving adequate dimensions to the adjustment that was necessary.

From an analysis of past experience and the present situation, the conclusion might well be that a more automatic procedure of allocating SDRs as well as a more flexible use of the instrument to control global liquidity was desirable, Mr. Pérez commented. In considering the factors underlying the assessment of the need for reserve augmentation, and accordingly the desirability of a new SDR allocation, the satisfaction of the demand for global liquidity should not be the only relevant consideration because the distribution of liquidity among different countries was uneven. The SDR should be seen as a device for correcting not only global shortages of liquidity but as a mechanism geared to distributing some resources to the least favored groups of countries.

In conclusion, Mr. Pérez said that he believed that the SDR had a crucial role to play as a means of reserve augmentation, helping at the same time to reduce the asymmetries observed in the functioning of the current system. Through a more active handling of the asset, the Fund could play a more positive role in the control of international liquidity, thereby increasing the stability of the international monetary system.

Mr. Nebbia joined other Directors in welcoming the opportunity to discuss the important issue before them, in line with the mandate of the Interim Committee, which had requested the Board to study the issues raised in the reports of the Group of Ten and the Group of Twenty-Four and to submit to it a progress report on its discussions on the role of the SDR in the international monetary system. He saw the present discussion as an introduction to the one to be held in the coming month on the contribution of the SDR to economic stability.

Most of the original roles envisaged for the SDR at the time of its creation were still valid, in his opinion, in spite of the changes in the international monetary system, Mr. Nebbia continued. Those changes, together with new, imaginative proposals such as the one presented by Mr. Sengupta, would help to ensure a smoother functioning of the system.

As most of the relevant issues had been analyzed in the staff paper, he would refer to three specific points, Mr. Nebbia stated. First, the developments interpreted when the SDR had been created in the late 1960s, as symptoms of a shortage of international reserves as outlined on page 4 of SM/85/340, were illuminating. Three symptoms were mentioned: a decline in the ratio of reserves to imports; an increase in restrictions on current and capital accounts; and increased recourse to bilateral official credit arrangements. Those developments in the late 1960s were present again in the 1980s, particularly in the case of indebted developing countries.

Second, there had not been a decline in the demand for reserves under the current exchange rate system, Mr. Nebbia noted. Adequate international reserves for purposes of intervention had been needed in countries with floating as well as countries with fixed exchange rates. That need had been increased by the recent decision of the Group of Five countries to intervene when required to correct major misalignments and to stabilize exchange markets. Moreover, developing countries needed larger reserves in order to insulate themselves against such adverse shocks as high real interest rates, deteriorating terms of trade, and increasing protectionism.

Third, referring to the asymmetries in the current exchange system, Mr. Nebbia commented that a major change in the international monetary system was the serious constraint on the debt servicing capacity of developing countries created in the difficult external environment of the early 1980s. In 1982, commercial banks had abruptly withdrawn from voluntary lending to many developing countries. Thus, a major weakness of the current system based on borrowed reserves was that commercial banks, which were responsible for supplying that type of reserves, had withdrawn at the very moment when they were most needed. Since 1982, most indebted developing countries had had to confront such behavior by commercial banks. Vigorous adjustment efforts, together with the decline in capital inflows and very high interest rates, had resulted in a massive transfer of resources from developing to developed countries. In that context, the rebuilding of reserves to reduce the vulnerability of developing countries to external shocks and increased creditworthiness could be accomplished only by increasing that negative transfer of resources, which was undermining the prospects for investment and growth in developing countries.

That situation highlighted both the disadvantages for developing countries and the seigniorage advantages for the reserve center countries under the present multicurrency reserve system, Mr. Nebbia stated. The pressure to direct real resources needed for investment and growth into the acquisition of financial instruments that were accepted as international reserves might have unfavorable social and political consequences in many developing countries. He accepted the distinction made by the staff between countries that had and those that did not have access to borrowed resources. The problem was that despite vigorous adjustment policies, leading to a sizable improvement in the current account position of developing countries, creditworthiness had not been restored, nor had there been a reversal of the decline in bank lending. A vicious circle seemed to exist, with creditworthiness being needed for access under the current system to borrowed reserves, while at the same time an adequate level of reserves constituted a necessary condition for regaining creditworthiness. An allocation of SDRs would help to resolve that dilemma and would also avoid an even further increase in the cost of the adjustment process in developing countries.

As the staff had correctly stated, there could be neither a shortage nor an excess of reserves for those countries able to borrow in the capital markets, Mr. Nebbia commented. However, for a second group of countries, comprised of the indebted developing countries, the need for reserves was urgent and acute. That asymmetric situation raised once again the need for the link. A link between the allocation of SDRs and development finance would not only meet the unfulfilled capacity of developing countries to absorb reserves but would also reduce the pressures on industrial countries to accommodate an improvement in the current account balances of developing countries.

He had concentrated on some of the issues relevant to the developing countries since those countries bore the burden of the most negative features of the system as it existed, Mr. Nebbia concluded. He agreed with Mr. Polak that it was necessary to consider appropriate changes in the SDR mechanism to enhance the scope of the SDR and hence to broaden the consensus on a future allocation. Such changes, together with other imaginative proposals, like the one put forward by Mr. Sengupta at the present meeting, would certainly help to ensure a smoother functioning of the international monetary system.

The Chairman said that he did not intend to sum up the discussion, which was of a preliminary nature and which also touched more on the historical aspects of the SDR system. The views of the Board would be summarized in an overall way when the two other staff papers on the SDR had been discussed later in February. For the time being, he would offer a few thoughts in reaction to the discussion at the present meeting.

He had been struck during the discussion by a number of interesting and stimulating questions on the shift from an owned reserve system to a system of reserves borrowed from private markets, the Chairman continued. One important question raised was whether the market mechanism had worked satisfactorily, from the point of view of the soundness of the system, in providing international reserves. A number of Directors had alluded to the heavy bank lending in the 1970s and early 1980s, some remarking that the market had not been consistently right and others actually indicating that it had often been wrong in its assessment of country risk. In those circumstances, the link between creditworthiness and the fundamental economic policies that should underlie it had not been clearly drawn by the financial markets. It was in that vein that some Directors had asked whether such excessive reliance on borrowed reserves had not weakened the system and impaired the mechanism for exercising discipline and evaluating creditworthiness. A further question raised was whether the reduction or withdrawal of credit by financial markets since the debt crisis had exploded was not imposing a heavy cost, both for borrowing countries in terms of spreads and maturities and for the operation of a system that had moved in the direction of placing heavy reliance on borrowing through financial markets.

A related question raised by some Directors was whether the recessionary bias that they perceived in the system at the present time was not excessive or unnecessary to the extent that commercial banks might be overreacting in a negative way after having perhaps overreacted on the lending side, the Chairman said. It had been suggested that perhaps banks were not always taking into account the adjustment efforts that some indebted countries had been embarking upon. Reference had also been made to the Baker initiative, with some Directors expressing the view that the mere necessity to call on banks to provide more financial assistance to countries that were following the right policies might well be a manifestation of some insufficiency in the spontaneous generation of liquidity. As some Directors had observed, developing countries in the aggregate were at present generating surpluses on their trade and nonfinancial services accounts, a trend that was difficult to reconcile with the concept of growth in the developing world.

The rationale for an allocation of SDRs under present conditions had been questioned by some Directors, the Chairman observed. In their view, the SDR was an inadequate or unsuitable instrument for tackling the liquidity problem of a group of countries, which was not one of a global long-term need for liquidity. The SDR had not been intended to ease the terms on which liquidity was supplied to countries having difficulty in finding access to financial markets. Several Directors considered rather that conditional financing or official development assistance would be a more suitable means of tackling that problem. Some Directors also doubted whether SDR allocations in present circumstances would in fact reduce the need of countries to have recourse to financial markets.

In the comments that had been made on the idea of a safety net, the Chairman said, he had gathered that Directors believed that it might be useful to keep in mind the potential contribution of the SDR in avoiding, if that were judged necessary, an excessive deflationary or recessionary trend in the world economy, in circumstances in which liquidity would become excessively stringent and financial markets would be failing to provide resources to countries that were pursuing the right types of policies. The SDR could not be a substitute for market financing but it could help alleviate such conditions and boost reserves when needed, some Directors had observed. The idea of a safety net and how it could be put in place would have to be considered at the appropriate time.

The basic issue of the discussion concerned the shift toward a non-gold based system, one of floating exchange rates, which by definition had a less automatic disciplinary content and multiple reserve currencies, the Chairman stated. Views were divided on the question of whether that shift had changed the fundamental place of the SDR in the system. Views also diverged somewhat on the question of the extent to which the flexible exchange rate system had reduced the demand for reserves, although most Directors had recognized that that demand had certainly not been eliminated. If anything, some Directors believed that the demand for reserves had been augmented because of the uncertainties surrounding the emergence of new developments in the system.

Views were also divided on the issue of the stability of a multicurrency system as opposed to the dollar-based gold exchange standard, the Chairman noted. A number of Directors had noted that the existing system was not more unstable than the old one, which had also had its shortcomings, proving to be so rigid that it had eventually broken down and led to instability. Views diverged also on the potential of the SDR to help stabilize a multicurrency floating system.

Among the other points raised, the Chairman mentioned the acceptance of a reserve currency role by other countries than the traditional reserve center, the United States; the question of SDR substitution in order to neutralize the potential instability stemming from shifts between different categories of assets; the possible limitations, based on the experience of recent years, of full reliance on surveillance and a better convergence of domestic economic and external economic policies of countries to ensure the stability of the system; the liquidity consequences for the system if a reduction in the U.S. balance of payments deficit was not at least partially offset by the willingness of other major industrial countries to increase their imports and reduce their balance of payments surpluses; and the effect on the system and more generally of the growth-oriented strategy if developing countries could no longer finance trade deficits--as at present--as a result of a reduction in imports by the United States and an increase in U.S. exports.

The possible role of the SDR, if the latter scenario were to unfold, led him to refer to the fundamental questions that Directors had raised relating to the possible functions of the SDR in the imperfect system as it existed at present, the Chairman observed. First, there was the classical role of reserve supplementation in case of a global need for liquidity, with all the different views that had been expressed on how to define global liquidity. The idea of a link, as a mechanism for the transfer of resources, had not recommended itself as a way to encourage member countries to take a more favorable view of the SDR. In that vein, Mr. Polak had made the interesting observation--which had not been shared by Mr. Sengupta--that there was strong resistance to shifting from a monetary instrument based on the concept of global liquidity toward a mechanism for transferring resources, whether permanently, long term, or medium term. Another issue was whether the SDR should assume the function of financing the Fund's operations, and if so, what relationship such a function would have to conditionality. Mr. Sengupta's proposal in that connection should be studied further.

Going beyond the contribution that the SDR might possibly make toward the stability of the present system by diversifying the composition of reserves, the question had been posed of whether the SDR could be used as an instrument of intervention, the Chairman noted. Furthermore, how could the characteristics of the SDR be improved so as to benefit the system? Should the focus be on improving the attractiveness of the instrument, as some Directors had suggested? Should the reconstitution provision be reconsidered? It might indeed be of some interest to think of reconstitution or similar concepts to ensure that the SDR behaved as a monetary asset, namely, one that was not held permanently by those who received it but that could be used temporarily by those in need.

Differing views had been expressed on the asymmetries of the present system, the Chairman observed.

The questions of which he had taken note in his concluding remarks were not a summing up of the discussion, the Chairman reiterated, which would have required him to weigh carefully the positions taken on various matters. Although some Directors had alluded to the question of an SDR allocation, in referring to the stringency or lack of stringency under the present system for creating international liquidity, positions on that question had not on the whole been restated as such. Rather, attention had been focused on issues of substance, related more to the basic discussion of the evolution of international monetary conditions and the system since the end of the 1960s, and whether the concept and role of the SDR had been affected by that evolution.

The Executive Board agreed to resume the discussion at its next meeting.

APPROVED: September 25, 1986

LEO VAN HOUTVEN
Secretary