NOT FOR PUBLIC USE

MASTER FILES

ROOM C-120 04

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/35

10:00 a.m., February 26, 1986

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

Executive Directors	Alternate Executive Directors
	Mawakani Samba
	M. K. Bush
J. de Groote	
M. Finaish	
	M. Sugita
G. Grosche	
Huang F.	
J. E. Ismael	
A. Kafka	
	M. Foot
H. Lundstrom	
	G. D. Hodgson, Temporary
E. I. M. Mtei	A. Abdallah
F. L. Nebbia	
Y. A. Nimatallah	J. E. Suraisry
P. Pérez	
H. Ploix	
J. J. Polak	J. de Beaufort Wijnholds
C. R. Rye	
	O. Kabbaj
A. K. Sengupta	
S. Zecchini	N. Coumbis

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

Also Present

European Department: R. A. Feldman, H. Ungerer. External Relations Department: I. S. McDonald. Legal Department: F. P. Gianviti, Director; Ph. Lachman, A. O. Liuksila. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director; M. L. Dooley, D. Folkerts-Landau, 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. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: P. E. Archibong, W.-R. Bengs, M. B. Chatah, L. P. Ebrill, S. Ganjarerndee, J. Hospedales, G. Nguyen, A. Ouanes, P. Pêterfalvy, I. Puro, M. Z. M. Qureshi, D. C. Templeman, N. Toé. Assistants to Executive Directors: J. R. N. Almeida, J. de la Herrân, F. Di Mauro, G. Ercel, V. Govindarajan, L. Hubloue, S. King, H. Kobayashi, M. Lundsager, K. Murakami, A. H. Mustafa, J. Reddy, L. Tornetta, H. van der Burg, B. D. White, Yang W.

1. SDR - POTENTIAL CONTRIBUTION TO ECONOMIC STABILITY; AND SDR AND ECU - A COMPARATIVE ANALYSIS

The Executive Directors considered a staff paper on the potential contribution of the SDR to economic stability (SM/86/17, 1/29/86), together with a staff paper containing a comparative analysis of the functioning of the SDR and the ECU (SM/86/20, 2/3/86; and Sup. 1, 2/24/86).

Mr. Polak made the following statement:

I welcome this opportunity to resume our discussion on the merits of the SDR in its various roles in the system. Because the earlier staff paper on the complications of changes in the international monetry system for the role of the SDR (SM/85/340, 12/27/85) dealt with only some of the aspects of the SDR, I, like most Directors, gave only a partial presentation of my view on the SDR. I should like to use this occasion to round out that view, drawing on the material presented in the present paper (SM/86/17).

I shall organize my presentation in terms of the four actual or potential roles that I listed in my statement of January 31 (EBM/86/17 and EBM/86/18, 1/31/86)--namely, the provision of reserves through allocation of SDRs; the SDR as a distinct reserve asset, consisting of a basket of currencies; the SDR as a unit of account; and the SDR as a mechanism to finance the Fund.

1. Allocation

SDR allocation can be used in the event that the current multicurrency reserve system would not provide an adequate "amount of liquidity for conducting international trade and financial transactions at an acceptable level" (page 13, SM/86/17). The staff refers, not to "an adequate amount," but to "even a minimum amount," which ssems to restrict the case too narrowly. This condition is unlikely to develop but it is useful to have the SDR allocation mechanism available for this eventuality as a "safety net."

Allocation/cancellation cannot be used to bring the process of reserve creation under international control (pages 13 and 20). But the staff's statement that "in present circumstances, international surveillance over the policies of all members presents the only practical mechanism for control over international liquidity" strikes me as less than realistic.

Generally, in a growing world economy all or most members will have a need to increase their reserves over time. I presume that the reference to the question "how large a number of members must have a need for additional reserves..." (Page 16) is not intended to deny this well-established proposition--which many of them could meet by means other than SDR creation. However, meeting part of this need by SDR allocation serves two purposes.

(i) it reduces the cost of acquisition of needed reserves for members that cannot readily borrow reserves at a rate close to LIBOR, or indeed cannot borrow them at all, as I stated at EBM/86/17 and EBM/86/18 (1/31/86).

(ii) it enhances the share of SDRs in reserves (see section 2 below).

A contrary consideration is whether or to what extent allocation undermines adjustment and whether measures can be taken to mitigate any such effects; for example, by reinstating some form of reconstitution.

A further interesting idea suggested by the staff (page 22) is that decisions to allocate might be taken with less hesitation if they had a built-in safeguard clause to the effect that cancellation would take place without a new decision--requiring an 85 percent majority--if reserve levels at some future date exceeded a specified level.

2. The SDR as a reserve asset

For the creation of SDRs to be desirable, it is not only necessary that the process of creation--that is, allocation--has on balance desirable effects for the system and for members but also that the resulting SDRs constitute a reserve asset that serves the purposes of individual members and the stability of the system. The advantages of SDRs over other assets are twofold.

First, as compared with reserves created by borrowing, SDRs have the advantage that they are not subjet to the risk of melting away as the international banking system changes its views on the creditworthiness of groups of countries or wants to meet an increased domestic demand for credit.

Second, the SDR, defined as a basket of currencies, presents central banks with a balanced reserve asset whose value in terms of alternative reserve currencies is more stable than any one of these. The SDR can thus play the role, somewhat reminiscent of the role of gold before 1968, of the nonspeculative reserve asset; and to the extent that central banks hold their reserves in the form of SDRs as a long-term choice, the risk that central bank currency switching will contribute to exchange rate instability is reduced. This gives a systemic value to the SDR as a reserve asset, that the staff paper overlooks when it observes that reserve holders can easily make up their own currency baskets (page 14).

Against these benefits to the system one would have to weigh any shortcomings that SDRs have as fully usable reserve assets, and consider measures to overcome these shortcomings--namely, by seeking ways to make the SDR usable in intervention.

It should be noted that depending on the merits attached to SDRs as reserve assets, it might be desirable to consider increasing the stock of them more rapidly than would follow from a prudent policy of allocation. Three measures that have been considered for this purpose are: (a) substitution; (b) the Belgian proposal on the conditional SDR (see Section 4 below); and (c) conducting all the Fund's credit operations in SDRs. I agree with the staff that (a) does not seem a practical possibility at present (page 19); (b) and (c) would not have as large an impact on the world reserve structure since the reserve assets that are now being created as the counterpart of the Fund's credit operations are already expressed in SDRs (see Section 3 below).

3. The SDR as a unit of account

The SDR is indispensable as "the international unit of account...for the Fund's own accounts, in particular its claims on and liabilities to its members. As members hold claims on the Fund as part of their reserves, the SDR denomination of these claims adds a further element of stability to the reserve system" (page 21, last paragraph).

4. The SDR as a means of financing the Fund

This is entirely in the realm of new departures. It deserves brief discussion primarily to clarify certain concepts mentioned in the staff paper.

(a) The proposal for conditional SDRs (page 19), which was fully described in EBS/84/19, is not in fact designed to allocate SDRs on a conditional basis but to channel SDRs allocated under the normal provisions as loans to the Fund, which the Fund could then use in its conditional transactions. The description on page 19 as "tying the issuance of SDRs to the implementation of adjustment programs" might be misread as referring to conditional allocation of SDRs, a form of discrimination for which the Articles do not provide.

The proposal can be seen either as a technique to facilitate loans to the Fund by combining them with SDR allocations, or as enhancing the stock of SDRs without giving members the benefit of SDR allocations, since such allocations would be immediately lent to the Fund.

(b) The staff paper refers to the safety net in a number of places (pages 17, 19, 22, and 23) as a means to deal with an acute liquidity crisis, without trying to define it. Conceivably, SDR allocation could be used in two ways to help overcome such a crisis, depending on the extent of the reserve shortage. The aim of large-scale allocation could be either to replenish the reserves of all members; or, if the crisis was less pervasive, to channel resources to the Fund for massive operations for the benefit of affected members, along the lines suggested under (a).

Since the contingency against which either form of safety net would be used cannot be envisaged in advance, it would probably serve little purpose to discuss the merits or particulars of the two possible schemes; if the need for something of this nature presented itself, it would not take much time to work out the mechanics, provided always that the Fund had a functioning SDR alloction mechanism in place. The question whether any activation of a safety net scheme through SDR allocations should be accompanied by a simultaneous decision for cancellation once the emergency had passed would also seem too hypothetical for fruitful discussion in advance.

Extending his statement, Mr. Polak said that he had limited his remarks to an analysis of the pros and cons of the SDR in its various roles that he had begun at the Executive Board's previous discussion of the implications of changes in the international monetary system for the role of the SDR (EBM/86/17 and EBM/86/18, 1/31/86; and EBM/86/19, 2/3/86). In the process of making that analysis, he had drawn on the useful arguments and observations in SM/86/17, although, he had not found it necessary to address the more philosophical part of that paper which dealt with such questions as the functions of a reserve system--for instance, the statement on page 4 of SM/86/17 that a reserve system must "on the one hand, permit and encourage the continuous pursuit of stabilizing policies in the face of domestic and external disturbances; but it must, on the other hand, avoid any undue inducement of policies that might destabilize the participating economies...." As an incidental comment, he noted that those desiderata were, if anything, applicable to the international monetary system as a whole, including especially the exchange rate system, rather than just to the reserve system. The gold standard, which the staff paper had used as some kind of reference standard, had of course been not only a reserve system but an exchange rate system and a code of adjustment policy.

Leaving those profound questions for what they were, he had concentrated in his opening remarks on a practical, or what might perhaps be called an incremental question, Mr. Polak continued. Given the fact that the existing multicurrency reserve system included some SDRs, what were the merits and/or demerits, not of replacing the system by an SDR-only system but of a larger SDR component within the present system? The two main subquestions were, first, the merits and demerits of the injection of SDRs, in particular through allocation; and, second, the merits or demerits of having a stock of reserves which consisted to a larger extent than at present of SDRs rather than reserve currencies.

The discussion might possibly be clarified, Mr. Polak added, if he put forward--without presenting arguments for them--three propositions about the existing system that he believed were well established but that had not, as far as he could see, found a place in the staff paper. First, the main force controlling the total supply of credit available in the world was the credit policy of the central banks in the major countries; that was the governor--admittedly not the automatic governors, the absence of which was lamented on page 13 of SM/86/17. Second, even when that total supply was kept within satisfactory, noninflationary limits, the supply to particular groups of debtors--for example, farmers or developing countries--might at times be excessive or inadequate, unless an all-wise, all-powerful credit allocation mechanism were postulated. Third, while the supply of credit in general or to groups of countries had some influence on the level of reserves, that level was essentially determined over the medium term by the choices made by governments in the light of their current and prospective situations. In other words, control over credit, even international credit, and control over reserves were two very different things.

Referring briefly to the staff paper on the comparison of the SDR and the ECU, Mr. Polak observed that the expansion of the private ECU market was not only--or even primarily--due to official encouragement but also just as much to the stable rates on each other of most of the currencies in the ECU. European investors thus had the impression--or illusion--of a limited exchange rate risk against their own currency. Any experience disturbing that impression could put a brake on the expansion in the demand for ECUs. That had become evident in the Netherlands in the second half of 1985 following the sudden fall of the lira and the sharp decline of sterling. In terms of their own currency, the SDR was less attractive to European investors as a stable asset than the ECU because of its large dollar component.

The limited role of the private SDR was probably due mostly to market factors, Mr. Polak said. To the extent that the market needed the private SDR as an international unit of account or as a balanced asset, the stock of private SDRs would expand by itself. It was not clear that a wider role for the private SDR would enhance the usability of the official SDR: that would require a much more profound step--namely, the private holding of official SDRs--or something akin to certificates of official SDRs. Such a step would require a great deal of study, for which he had made a plea from time to time, although he noted that that step had not been taken and did not seem contemplated for the ECU.

Mr. Nimatallah made the following statement:

1. Introduction

The Executive Board is currently examining, in parallel, the three major components of the international monetary system with a view to improving its functioning. These components are the system of floating exchange rates, surveillance, and international liquidity. In this first round of discussions, the Board has made an initial evaluation of floating exchange rates and surveillance. With respect to the exchange rate system, the Board attempted to see if it could find additional elements that would reduce the instability in the present system. On surveillance, the Board geared its efforts toward finding the additional elements that will enhance the effectiveness of surveillance. Today, the Board turns its attention to the third major component of the international monetary system--namely, international liquidity.

Although our discussion is expected to focus only on the potential contribution of the SDR to the stability of the international liquidity system, I believe that a more meaningful approach would be to consider all possible alternatives that might make a potential contribution to stability in the system. Both the G-10 and G-24 reports agree that the functioning of the present liquidity system has not been entirely satisfactory. But they do not agree on whether the SDR is the element that can make it satisfactory. That is why I was hoping that the staff, as it did in the previous papers on the exchange rate system and surveillance, would produce a more general paper addressing the broader issue of stabilizing the international liquidity system. I trust, however, that this will be done in time for the second round of discussions on this issue.

After making some observations about the systemic weaknesses of the present international liquidity system, I will focus on the potential role of the SDR in introducing stability into the present system. I will also explore the potential role of other alternatives.

2. The major shortcomings of the present international reserve system

The staff's analysis has usefully isolated the systemic shortcomings from the limited distributional weaknesses of the international reserve system. The present system depends overwhelmingly on private capital markets for generating the bulk of international reserves. This has meant, in practice, that the world economy has been subjected, at times, to too much liquidity, and at other times, to too little of it. The result of these wide fluctuations in the availability of liquidity has been costly in that it caused the world economy, at times, to suffer from too much inflation, and, at other times, from excessive contraction. In contrast to the automaticity of adjustment under the gold standard, the present system can create unnecessary liquidity to finance external deficits, leading to the perpetuation of inappropriate policies and inflation. This suggests that there is a basic problem owing to the volatility of judgment at the decision-making level of private capital markets about the scale of liquidity needed by the system. Many banks with imperfect information about countries in the system make incoherent and uncoordinated decisions about the bulk of the liquidity created in the system. In other words, what constitute, in my judgment, the major flaws in the present reserve-generating system are the high degree of decentralization in the decision-making process in private capital markets and the lack of coordination between the two major players in the system, both official and private.

The question then is how to rectify these flaws and enhance stability. At this stage I can see two possible options open to the official side of the system, (1) increase the stock of SDRs sufficiently to make the Fund the swing supplier of liquidity for the purpose of stabilizing the system. And, (2) improve coordination between the official and private sides to exert concerted official efforts to influence the decision-making process of private capital markets.

3. Potential contribution of the SDR to the stability of the system: Option 1

With respect to the first option, I come now to the focus of the staff paper and ask if the SDR can contribute to the stability of the international liquidity system. In answering this question, I will now take a closer look at the functions of the SDR.

As a unit of account, the SDR has performed very well. It is recognized as an international unit of account for all the Fund's own accounts, and in particular, for its claims on, and liabilities to, its members. Since members hold claims on the Fund as part of their reserves, the SDR denomination of these claims adds a further element of stability to the reserve system.

As a means of payment, the SDR has had limited success. As explained in the paper of the Treasurer's Department, "A Comparative Analysis of the Functioning of the SDR and the ECU," the SDR can be used as a means of payment among official users and in settling obligations to the Fund. Owing to the lack of political support, however, the SDR, unfortunately, has not had the opportunity to be used widely by private financial institutions and corporations, either in denominating their claims or in using it directly as a means of payment. The point, therefore, is that as a means of exchange or payment, the SDR has not done well when compared with other alternative means.

As a reserve asset, the SDR--when compared to other available reserve assets that can be used as a store of value like, say, the U.S. dollar--does not, unfortunately, compare favorably. While the SDR can offer official holders more stability and protection against exchange rate fluctuations, its competitiveness in terms of yield is open to question.

More fundamentally, however, it is the limited supply of, and demand for, SDRs that account for its lack of stature. It is the small stock of SDRs in the system in relation to the total stock of liquidity that is leaving the SDR in an inferior position. I think the basic reason why some of the SDR's functions are not performed well is because of its small stock. For this reason, I shall address myself from now on mainly to the volume of SDRs in the system.

In this context, I ask if the present relatively limited volume of SDRs can be entrusted with the task of reducing instability in the liquidity system. I, for one, do not think so. The present amount of SDRs in the system cannot fulfill such a tall order. The SDR can contribute effectively to the scale and thus the stability of the international monetary system only if the stock of SDRs is so large as to be the swing source of liquidity. Thus, what seems to be required under this option is a sizable increase in the stock of SDRs through steady and substantial allocation.

Obviously, the first and the essential step required for this option is a political decision to move in that direction before considering in detail any specific proposals about the conditional use of the SDR or otherwise. Once this political decision is made and allocation is resumed at a sizable rate to enhance the supply of SDRs in the system, one can meaningfully address the demand for these SDRs.

There are several proposals floating around aimed at enhancing the demand for SDRs. Among these are the utilization of SDRs on a conditional basis, the Substitution Account, the conduct of all Fund credit operations in SDRs, and the extension of SDR credit lines by the Fund to members for specific periods of time. There are also ways, which have been suggested by many, for encouraging private demand for SDRs.

It should be recognized that once the political decision to move in the direction of giving the SDR greater prominence and stature is made, a mechanism for the functioning of its own system must first be perfected. For example, the concept of a safety net has to be clearly identified. Should there be a role for the SDR as a safety net, or as I call it, a swing source of international liquidity, the mechanics of this broadly defined safety net would need to be worked out on both the supply and demand sides. On the supply side of the safety net, there has to be a clear mechanism according to which the approximate amounts of allocation or cancellation will be determined in the light of the probable shortage or excess of liquidity. On the demand side of the safety net, there also has to be a mechanism for the utilization of allocated SDRs, and the repurchase of canceled SDRs, perhaps along the lines of an implied mechanism for the use of conditional SDRs, as Mr. Polak has suggested.

4. The decision-making process of private capital markets: Option 2

Now, suppose that the international community finds it extremely difficult to give the SDR such a prominent role in stabilizing the international reserve system. The question then is where do we go from here. I think other alternatives must be explored. In this connection, one might want to accept the private capital market as the main generator of liquidity but attempt to alleviate its weaknesses which, as I indicated, emanate from the high degree of decentralization and the related lack of coordination. Thus, in stabilizing the international liquidity system, an alternative to making the SDR prominent could take the form of increased involvement on the official side in the decision-making process of private capital markets. Such an alternative would mean that a mechanism would have to be created to make it possible for the official authorities to influence the decision-making process of private capital markets in providing international liquidity. For example, the Baker initiative of encouraging banks to come forward with credit to certain countries seems to fall into this general approach. But what I have in mind is a broader mechanism of communication and coordination, on a regular basis, between the official and private sides in order to supply liquidity of the system in a manner consistent with sustained noninflationary growth. This mechanism should help anticipate and prevent problems before they occur, instead of reacting to crises as is the case today.

Actually, the rudiments of such a mechanism already exist; however, considerable improvement is needed in at least the following areas. Supervision over commercial banks by central banks and other supervisory and regulatory authorities must be strengthened. The role of the Institute of International Finance (IIF) has to be enhanced to make it the focal point of communication between banks, on the one hand, and the Fund and its members, on the other. The amount and dissemination of information available to banks about countries must be improved, so as to achieve a better evaluation of countries' creditworthiness by banks.

As in the case of the large increase in the stock of SDRs, there has to be a political decision first, before efforts are exerted to work out a mechanism that functions, on a regular basis, to bring about coordination between the official and private players in the system. The difficulty with such a mechanism is that it requires coordination among the governments of the large countries themselves, first, and then between those countries and the borrowing countries--assuming that the large countries themselves are not borrowers--then all these governments are to find a common position that has to be conveyed--perhaps through the Fund to the groups of bankers, who are also supposed to be organized under one umbrella, say, that of the IIF. More importantly, this has to be done repeatedly on a regular basis, if the official side wants to succeed in bringing pressure to bear on bankers and influence their decisions about the scale and direction of their lending.

Furthermore, while it might take only a few years to strengthen supervision over banks, it could take many years before information about countries is perfected and the role of the IIF is enhanced. In other words, the basic means of coordination and communication among the decision makers, official and private, will not be readily available soon for the official side to influence the decision-making process of the private capital markets.

Obviously, this is an ambitious project that may prove very difficult to implement in its entirety in the foreseeable future. Suppose it, too, like Option 1 does not get the political decision it needs for launching. Again, where do we go from here? Let me try for one more alternative.

5. Option 3

In view of the present circumstances, adopting either of the above two options could prove to be extremely difficult in the foreseeable future. This, however, should not discourage our search for ways and means to enhance the stability of the international liquidity system. A more pragmatic and acceptable approach may be constructed by combining some of the features of each of the two options into one third alternative.

This alternative assigns the stabilizing role of the international reserve system to both a stock of SDRs and the exertion of official influence on the decision-making process of the private capital markets. This alternative should, however, assume a much smaller role for the SDR, at a much smaller volume of SDRs, than that assumed under Option 1. It also assumes a much lower degree, and less frequent coordination, between the official and private sides of markets.

This alternative gives the SDR a middle-of-the-road role between its present position and that envisaged under Option 1. This will require, of course, a limited increase in the stock SDRs, which can be achieved through a modest rate of allocation. On the demand side, it implies a much more modest potential use of the SDR on a conditional basis or otherwise. However, since it will be difficult to accomplish quickly a sufficient and satisfactory degree of coordination between the official and private sides on managing the capital markets, it may be practicable at this stage to accept only a modest move in that direction.

For example, the Fund membership could adopt a procedure according to which the Managing Directors of the Fund and the IIF would initiate, once every year, discussions on the state of the liquidity in the system, and report to their memberships. After discussion of the reports by the appropriate Boards of the two institutions, messages would be communicated between the two institutions about their views on liquidity and what is or is not to be done about it. At the same time, effort would continue to strengthen the three areas of bank supervision, better information, and a more effective IIF.

Although it could be argued that the potential impact of a large stock of SDRs under Option 1 on the scale of liquidity in the system is lost under this option, a smaller volume of SDRs can still have an impact on the stability of liquidity through the distribution effect, if a version of either the conditional use of SDRs, or the demand side of the safety net along the same lines, is adopted. The official side under this alternative may not possess the large swing source than can offset the total scale of liquidity, but it can have the power to create a reasonable volume of SDRs that could be used, from time to time, to counteract the long-term, undesirable, distributional distortions in the system liquidity. I believe that a combination of a modest degree of influence over the decision-making process of private capital markets and a modest increase in the stature and role of the SDR in influencing the volume of liquidity, can provide the system with reasonable elements of stability.

Moreover, this middle-of-the-road option has the potential of bringing together some of the views expressed in the G-10 and G-24 reports on how to improve the international liquidity system.

6. Conclusion

In conclusion, the present international liquidity system is in need of elements to reduce its instability. I have explored three options in my presentation. If they all turn out to be unsatisfactory, I hope that other options can be explored by my colleagues and the staff. The important point is that the Board should not miss this opportunity to recommend an option to the Interim Committee that can help to introduce elements of stability which would ultimately improve the functioning of the international monetary system.

Extending his statement, Mr. Nimatallah explained that his intention had been to provoke ideas that went beyond the possible contribution of the SDR to the stability of the system to a system that would provide the optimal amount of liquidity for growth without inflation. As he saw it, private decision makers--private bankers--were responsible for the larger of the two main bodies of liquidity in the present system, although as Mr. Polak had noted, official decisions--by central bankers--were also responsible, but for a smaller amount of liquidity. It was obvious that both short-term and long-term fluctuations in the provision of liquidity from both those sources made it impossible to meet the objective of creating an optimal supply of liquidity. That objective could be met in one or two ways, or in a combination of them, as he had noted in his statement. The smaller body of officially controlled liquidity--mainly in the form of official credit and the creation of SDRs--should be made sizable enough to play a swing role, a role akin to that of Saudi Arabia in the oil market. It would then be possible to contract the supply of liquidity when it became excessive and led to inflation in the same way as, theoretically, it was expanded when there was a need for liquidity. The official suppliers would be assisted in supplying liquidity to promote noninflationary growth if their role in the process of generating reserves was better coordinated with that of the large suppliers of liquidity in the private markets. The rudiments of such a system were already in place: a certain volume of SDRs was in existence and attempts were being made to coordinate, through approaches such as the Baker initiative, the supply of credit provided by private decision makers. He envisaged an intensification of efforts by the official and the private sectors to communicate with each other and coordinate the creation of liquidity in order to control its amount and avoid fluctuations in its supply.

Mr. Sengupta recalled that in his statement at EBM/86/18 (1/31/86) he had covered some of the main reasons in support of a strong role for the SDR in the international monetary system. He had also outlined some ideas for helping to refute the consensus that an SDR allocation would have an adverse impact on the world economy. In that context, he had raised several questions, including those relating to the functioning of private markets as providers of international liquidity and the deficiencies of such a system, especially with respect to the commercial banks' perception of creditworthiness of countries and other matters. For the sake of continuity, he would briefly note the points he had made during the earlier discussion.

First, there were several shortcomings in the manner in which the international liquidity system was functioning at present, Mr. Sengupta noted. Second, the performance of private capital markets in providing liquidity continued to be unsatisfactory; excessive reliance on them for liquidity was fraught with difficulties, especially for developing countries. Third, the provision of liquidity through markets was dependent, as noted in the report of the Group of Twenty-Four, on exchange rate movements, rates of inflation, and growth of output and trade, all of which affected the balance of payments of developing countries. In turn, those trends were dependent on the implementation of consistent and coordinated domestic policies by the industrial countries, coordination that had not materialized, as experience had shown; Mr. Polak had noted in his most recent statement that to expect international surveillance to be effective for that purpose was unrealistic. Fourth, while improvements to the functioning of private markets could be studied, as suggested in the report of the Group of Ten, such improvements, even if implemented, were unlikely to improve the international liquidity mechanism significantly, at least not in the near future. Therefore, the Fund needed the power to influence the world economy's demand for liquidity through a more efficient creation and distribution of SDRs. Fifth, in that context he had made some suggestions that could meet some of the concerns of those who were opposed to an SDR allocation at the present time, underlining the need for more efficient distribution of the allocated SDRs. According to his proposals, SDRs would meet the reserve requirements of the system by being made available as an overdraft facility on which countries could draw but without taking the form of long-term development finance.

At the end of the discussion at EBM/86/19, the Director of the Research Department had outlined a number of areas for further examination by the staff, Mr. Sengupta noted. He felt sure that the studies to be undertaken would also examine the proposals made at the present meeting by Mr. Polak and Mr. Nimatallah, including the points that would be made during the present discussion. His own remarks on the two papers before the Executive Board would be limited to some points that had not been covered earlier or that deserved additional clarification or attention.

Referring to the mechanism suggested by the staff for SDR allocation and cancellation, which Mr. Polak had mentioned, Mr. Sengupta said that he could understand in theory the staff explanation of how SDRs could be allocated on the basis of a global need to supplement reserves and, by the same logic, canceled in accordance with the Articles of Agreement when there was excess liquidity in the system. However, it was not clear to him how in practice decisions could be made simultaneously on allocation and cancellation. If at a particular point of time there was a global need for reserves, the Fund could decide to allocate SDRs, but it was not clear how it could take at the same time a decision on cancellation--possibly to take effect on a future date. If for that purpose the staff had to develop a set of indicators that would trigger the cancellation mechanism, then possibly indicators could also be developed to operate in the same way to trigger an allocation. He could agree to the use of such indicators for allocation, which could be applied in reverse when the need for cancellation arose but surely as a separate decision when the cancellation was effected. He would be interested to have further information from the staff on what it had in mind in suggesting that mechanism.

The view of his authorities was that cancellation should not be linked automatically to allocation decisions in order to avoid giving a number of undesirable signals, Mr. Sengupta added. The quality of the SDR as an assured, owned reserve asset in the recipient country would be adversely affected if the possibility of a cancellation loomed large from the time an allocation was made. In addition, markets that rated a country's creditworthiness in part by taking into account its reserves were unlikely to count much on its SDR holdings if a cancellation mechanism were to be actively implemented, in turn undervaluing the quality of the SDR itself. Finally, the role of the SDR in promoting world economic stability would be weakened because its share in world reserves would be uncertain.

To clarify his remarks on several earlier occasions on the SDR-link proposal, which he continued to support, Mr. Sengupta explained that in asking for a more detailed study on the SDR link, he had in mind that, when the Fund was undertaking a comprehensive study on the SDR, it would not be correct to omit an examination of an aspect of the SDR to which developing countries had attached great importance for a long time. That did not mean, however, that he was asking that the link proposal be a matter for negotiation when the question of an SDR allocation was taken up in the near future. Agreement could be reached on an allocation of SDRs on the basis of the present mechanism, but the Fund should continue to look for an optimal method of distributing SDRs. A number of proposals had been made in that connection, not only for the SDR link but for the conditional use of SDRs--by Mr. de Maulde and Mr. de Groote--and, as he had just suggested, for reallocating the SDRs of surplus countries to those in need of reserves in the form of an overdraft facility.

On the suggestions made for improving the quality of the SDR, Mr. Sengupta stated that he fully supported an examination of the wider use of the SDR in international transactions, including private transactions.

Finally, Mr. Sengupta observed that the central message of the staff paper on the comparison of the SDR with the ECU was that the latter had become operationally more relevant because of its strong backing by the entities and governments that had created it. Clearly, even though the Articles provided that the SDR should be made the principal reserve asset, not much progress had been made because that objective had not received the wholehearted support of its members--especially those with a major share in world transactions. He hoped that, after the Board's discussions on the role of the SDR had been completed and agreement reached, a similar commitment to that made by those countries backing the ECU would be given by all Fund members to the SDR. In his view, such a commitment was in the best interest of all.

Mr. Pérez observed that the Group of Ten and the Group of Twenty-Four had stressed in their reports, although with different emphasis, that the creation and management of international liquidity had been far from satisfactory during the past decade. Experience showed that the international financial situation had tended to overshoot in providing liquidity when more cautious behavior would have been called for, leading to excess demand, inflation, and debt accumulation. In addition, periods of high liquidity had been followed by periods during which international liquidity had become unduly tight, provoking a shrinkage in international trade and sluggish growth. It had to be recognized that it was not only bankers' perceptions of countries' creditworthiness that had been largely responsible for such fluctuations. The monetary policy implemented in key currency countries, leading to sharp fluctuations in the money supply and in real interest rates, along with a lack of coordination among countries on domestic banking regulations, had been contributing factors to the abrupt changes in the provision of international liquidity.

The staff had rightly emphasized the importance of adequate reserves in implementing economic policy that permitted the effects of sharp changes in countries' external positions to be mitigated, Mr. Pérez remarked. By providing a shock absorber, reserves allowed for a more gradual adjustment to changing circumstances, to the benefit both of the country and the world economy as a whole because the effects of those sudden changes in external economic conditions and their transfer from country to country were smoothed out. That was why it was so important to have a system that efficiently supplied reserves in an adequate and symmetrical fashion to all countries, fostering at the same time the pursuit of stabilizing policies in the face of domestic and external imbalances.

In assessing the manner in which the present reserve system contributed to the stability of the world economy, Mr. Pérez went on, the staff had shown conclusively in the relevant section on pages 7-12 of SM/86/17 that its asymmetric character allowed for the postponement of adjustment in key currency countries and in those countries that were qualified as creditworthy by commercial banks. Other countries, on the contrary, were compelled to attain an appropriate level of reserves by running surpluses in their balance of payments.

Among the main weaknesses of an international monetary system based on private capital markets, the staff had cited the difficulty that financial institutions had in assessing country risk due to the lack of complete and accurate information, Mr. Pérez noted. That deficiency led, on the one hand, to delays in signaling effectively that some countries needed to adopt adjustment measures and, on the other hand, to delays in restoring creditworthiness in those countries that had regained a more balanced economic position. All those elements led to the conclusion that while international credit markets had generally been quite flexible in the past--a quality that should be retained--they had not been efficient enough in providing the necessary liquidity in adequate amounts and appropriately distributed to meet the world's needs.

To correct those shortcomings and improve economic stability, three major conditions had to be met, Mr. Pérez considered. First, stable, noninflationary, sound, and coordinated economic policies on the part of key currency countries were a prerequisite for the smooth and efficient functioning of any international monetary system. Second, the Fund should pay more attention, through its surveillance policy, to the evolution of domestic bank regulations, country risk financial policy, and export credit insurance policy. The Fund should also provide advice on those matters with a view to fostering policy coordination and preventing abrupt changes in policies while supporting sound financing performance geared to safeguarding the health of domestic financial systems. It should be recognized that the Group of Ten had made significant progress in the recent past in exchanging information and in fostering coordination among its members. But given the relevance of those policies for the appropriate behavior of international liquidity, the Fund should take a more active role in regard to those matters.

Third, a more active role of the SDR through more automatic but flexible procedures to allocate and cancel SDRs would help to prevent fluctuations in international liquidity, Mr. Pérez said. At present, the SDR played a limited or almost negligible role in managing international liquidity. That very limited role was the result of the scant share of SDRs in the liquidity structure, a consequence of a more than cautious allocation policy. A more relevant role for the SDR would entail, as a first step, a strategy geared to gradually increasing the SDR's share in the portfolio of monetary authorities over the longer term. It could be argued, as in past discussions on SDR allocations, that such a strategy might fuel inflation and lead to a relaxation of the stabilization efforts of countries implementing adjustment measures. He would not repeat the arguments put forward during those discussions in an attempt to dispel those concerns but observed that action directed at increasing the attractiveness of the SDR would automatically be anti-inflationary because it would encourage monetary authorities to hold SDRs and to increase their share in reserve portfolios. In that connection, any action aimed at increasing the stability and profitability of the SDR would help to improve its attractiveness, a matter to which he would refer in connection with the comparative analysis of the functioning of the SDR and the ECU.

Two types of distributional shortcomings in the current reserve system had been underscored by the staff, Mr. Pérez commented. The first was related to the different degree of access of countries to international credit and the second, to the different cost of lending for countries in similar circumstances. The latter was a clear signal of the inefficiency of the market, which the SDR had little potential for improving; that could be done only if more complete and accurate information on countries' economic situation and prospects was available. The former shortcoming could however be mitigated by means of certain modifications in the Fund's current policy and procedures on access to its resources. In that connection, he had been attracted by the idea put forward by the staff on page 15 of SM/86/17 that "extension of credit through the Fund's General

Department, which is of course also denominated in SDRs, would appear to be a more flexible instrument to use for the purpose under discussion. If--the intended recipients'--policies were, in fact, adequate and the absence of creditworthiness resulted from a collective error of private financial institutions, Fund assistance would not need to be subject to burdensome conditionality and might be less costly than credit from the capital markets." In that manner, in addition to solving a problem of reserve shortage by providing unconditional SDRs, the Fund would be sending a clear signal to the market of how it viewed the creditworthiness of the country in question. His chair was of the opinion that that idea should be explored in greater depth to reveal all its financial implications and to determine how it would work in practice.

With respect to the possible role of the SDR in providing a safety net to deal with an international financial emergency, an idea put forward by the Group of Ten, he looked forward to a more precise analysis of the characteristics of possible emergencies and how the mechanism might work, Mr. Pérez said. In the meantime, he noted that any precautionary device automatically served to decrease uncertainties in the market, thereby contributing to greater stability in the world economy. But once again, a necessary precondition for the mechanism to operate effectively seemed to be greater activity on the part of monetary authorities in SDRs and an increase in the share of SDRs in their reserve portfolios.

As to whether a substitution account and proposals for conditional SDRs would help to improve the stability of the system, Mr. Pérez noted that his authorities had not been fully convinced of the benefits to be derived from those mechanisms. On the contrary, substitution proposals, as the staff had pointed out, could adversely affect expectations in foreign exchange markets about the strength of individual reserve currency countries, inducing private speculative movements and increasing instability. As for conditional SDRs, it was more appropriate for members to have normal access to Fund resources in the form of conditional lending.

The correct approach to the SDR link--an idea with a long history of controversy--was to consider the appropriateness of fostering more rapid growth in the developing world and its contribution to the stability of the world economy, Mr. Pérez stated. If it were agreed that that objective was appropriate, the Fund could help to meet the consequent need for a better distribution of international liquidity by temporarily amending its current procedure for allocating SDRs. That could be done either by making a temporary transfer of SDRs to needy developing countries, as suggested by Mr. Sengupta during the Board's previous discussion of the role of the SDR or by whatever other option might be available to modify the strict formula of allocating SDRs in proportion to quota whenever the Fund considered that a problem of reserve distribution existed and that it could be solved by such a temporary modification of the normal formula.

The first conclusion that he had drawn from the comparative analysis of the functioning of the SDR and the ECU, Mr. Pérez said, was that political support from member countries was a crucial element for more extensive use of the SDR in both official and private sectors. A second conclusion that could be inferred from experience with the ECU was that the great stability of currencies participating in the European Monetary System, along with the significant and rather stable yield of the ECU, had been relevant factors contributing to the attraction of that composite asset in private use. By accepting a high degree of monetary discipline, members of the European Monetary System (EMS) had been able to maintain a considerable degree of stability in their exchange rates. At the same time, the differences in interest rates among EMS countries had given the ECU an attractive yield.

Experience with the ECU raised the question of the composition of the SDR basket and the mechanism for determining the SDR valuation as well as its interest rate, Mr. Pérez concluded. By increasing the number of currencies in the SDR basket with a view to enhancing both the share and weight of the currencies of countries that had accepted greater monetary discipline and that historically had had high interest rates, the SDR's attractiveness to official and private users could be improved, making SDR allocations less inflationary and contributing to a more stable international monetary system.

Mr. Nimatallah asked whether Mr. Sengupta, in mentioning that the staff give further thought to various proposals for conditional use of the SDR, was more open to suggestion in those respects than previously. If not, it might not be worthwhile asking the staff to take the time to reconsider those proposals.

Mr. Sengupta responded that no position should ever be taken permanently but to move from one position to others it was necessary to consider the implications of different proposals. For that reason, he had mentioned the original SDR-link idea, which unfortunately had not been taken up since the Committee of Twenty had examined it. In the present situation, certain implications of that lack of interest had to be considered. Mr. de Groote's concept was basically a matter of the conditional redistribution of surplus liquidity. Mr. de Maulde's idea was basically related to reconstitution. His own suggestion was for an unconditional allocation of SDRs to developing countries by means of an overdraft facility. The implications of all those proposals could be examined with a view to finding an optimal method for distributing SDRs. He had tried to highlight the point that in earlier times, the Fund had considered the distribution of the SDR to be as important as the actual volume of SDRs, and he had suggested that that particular issue be examined in order to bring out all the implications. He did not wish to leave any misunderstanding with respect to the attitude of his authorities toward the discussion of SDR allocations; his suggestion to examine various proposals for conditional use of the SDR was not intended as a pretext for not considering SDR allocations according to the existing procedures.

Mr. Polak said that he agreed with Mr. Sengupta that while it was possible in the long run to study all sorts of ideas, the issue at present was whether the SDR was to continue as it was.

Mr. Hodgson said that on the whole he could agree with much of the analysis in the staff paper on the potential contribution of the SDR to economic stability, which emphasized the shortcomings of the present international reserve system and the potential effects of those shortcomings on global economic stability. As his chair had noted during the previous discussion on the role of the SDR, both the decentralized control and supply of global reserves and delays in signaling the need for adjustment measures could give rise to systemic weaknesses. The gradual shift away from owned reserves toward borrowed reserves had given many countries access to sizable foreign exchange resources. However, that access had often been unavailable when most needed. Foreign exchange markets had also been prone to overshooting. Excessive lending had occurred during the late 1970s, and even the more creditworthy developing countries were at present experiencing difficulty in gaining access to financial markets on a voluntary basis. Similarly, long lags in regaining access to borrowed reserves could occur even if countries had been successful in adjusting their external balances.

Therefore, his chair continued to feel that the SDR had a role as a reserve asset and that allocations by the Fund in one form or another would be necessary to preserve that role in the system, Mr. Hodgson continued. Allocations of SDRs over the medium term and long term would help to reduce the cost of acquiring reserves for those members that could not borrow at market rates and thereby enhance the SDR's share in total reserves. At the same time, the international community would attain some measure of control over the composition of reserves even if it could not control the overall level of reserves. He emphasized that if the SDR's share in total reserves was not at least maintained over the few years ahead, its future role might be prejudiced, including any potential role as a safety net.

However, the staff paper could have given more weight to the importance of maintaining creditworthiness in order to ensure access to borrowed reserves, Mr. Hodgson considered. Many members of the Fund had been able to maintain access--and some had regained it--to private capital markets by pursuing appropriate policies or by carrying out adjustments when needed. Those members had also been subjected to unanticipated shocks, and yet, by pursuing appropriate policies or by adjusting rapidly, they had been able to withstand those shocks to a much greater degree than countries that had not adjusted as necessary.

Capital markets had not remained static over the past decade, Mr. Hodgson emphasized. The integration of capital markets, the removal of capital controls, and other regulatory changes in a number of countries had helped to increase market efficiency and the international mobility of capital. Financial innovations had also taken place that had helped to increase the ability of the market to diversify risk. As a result of those developments, capital markets in future might well be better able to ensure adequate and continued access to reserves.

Commenting briefly on possible new roles for the SDR, Mr. Hodgson recalled that, as Mr. Massé had mentioned during the previous discussion, the views of his authorities, who had given thought to possible innovative roles, were not yet firm. However, they strongly supported the safety net function to which reference was made at a number of points in the staff paper. Mr. Polak had emphasized that it was difficult and not very useful to discuss the merits of a safety net in advance since its precise form would depend to a great degree on the circumstances calling for its use. Nonetheless, it was clear that an SDR safety net must be kept in good repair and that it would be of use only if the SDR had a continuing presence in the system.

As for a link between allocations and cancellations, his only comment would be that the Fund should definitely avoid driving with one foot on the gas pedal and the other on the brake, Mr. Hodgson remarked. SDR allocations of a prudent size would help to obviate the need to withdraw SDRs from the system at a later date.

The discussion in the comparative study of the SDR and the ECU, particularly of the growth of the ECU in private markets, was of considerable interest, Mr. Hodgson observed. Since 1981, especially, the ECU had flourished in private markets while the role of the SDR had diminished. However, some of his authorities found the paper's emphasis on steps taken by governments of the European Communities to foster the private ECU to be overstated. The key impetus had come from the private sector--particularly the commercial banks--through its identification of the potential for the ECU to meet the needs of customers. His Irish authorities in particular emphasized that until relatively recently, many European governments had been quite wary of the ECU and had begun to use it--for instance, as an instrument to denominate debt--only after it had become established. Moreover, proposals of the European Commission did not necessary reflect the views of all the member states. Contrary to the views expressed in the staff paper, his authorities felt that it was not up to governments actively to promote a private ECU and that the market itself should determine its progress. Therefore, he tended to place weight on the actual currency composition of the ECU as the principal determining factor in its rapid development in private markets rather than the official encouragement of member governments.

One major difference between the ECU and the SDR was the stability of the currencies included in the relevant baskets, Mr. Hodgson noted. The currencies making up the ECU had been relatively stable in relation to each other in recent years due to such factors as the degree of integration of the member economies and the volume of trade within the community. Currencies making up the SDR, on the other hand, had experienced wide fluctuations. It was in those differences that most of the explanation for the development of the private ECU was to be found.

Finally, Mr. Hodgson observed that before an answer could be given to the interesting question raised in the last paragraph of SM/86/20 concerning whether or not development of the private SDR should be promoted and fostered, the Fund membership must decide more clearly what role the SDR was to play within the system. In any case, if private use of the SDR was to evolve, it should be on the basis of the SDR's ability to meet the perceived needs of the private sector rather than through artificial stimulus or pressure from the Fund or member governments. Recent developments in financial markets suggested that the private sector was well able to identify and avail itself of any beneficial new mechanisms without any official encouragement.

Mrs. Ploix remarked that as the subject under discussion was the mirror image of the one that had been discussed four weeks previously at EBM/86/18 and EBM/86/19, she would not repeat but would add to her statement at that time. All the main elements relating to the issue were covered in the staff paper, which was part of a long line going back 15 years or more of competent and imaginative papers by various authors on the whole problem of the functioning of the international monetary system and the flaws and virtues of the SDR within the system. The statements made at the recent meetings by Mr. Polak, Mr. Nimatallah, and Mr. Sengupta had added additional interesting elements. She herself would present a brief summary of the views of her authorities.

First of all, her authorities agreed fully with the appraisal by the staff in the summary in SM/86/17 of the present contribution of the SDR to stability, Mrs. Ploix said. The basic characteristics of the SDR were clearly presented, and the need to seek further improvement of the SDR's role was highlighted.

Second, Mrs. Ploix noted that the word "stability" had two different meanings in the context of the general issue of the stability of the system. The first one referred to the role of SDRs in a system which it was considered desirable to maintain. In accordance with circumstances, allocations or cancellations of SDRs could generally play an important role in that respect. However, she shared the judgment of Mr. Nimatallah that "the SDR can contribute effectively to the scale and thus the stability of the international monetary system only if the stock of SDRs is so large as to be the swing source of liquidity. Thus, what seems to be required under this option is a sizable increase in the stock of SDRs through steady and substantial allocation." More precisely, she shared the view first, that there was a structural need for large amounts of SDRs, and second, that there was a present need for SDR allocations, the *amount of which could be moderate and which could be considered as a* complementary pool, as she had stated in the previous meetings. The second meaning of the word stability referred to the role the SDR could play in case of a sudden crisis in international liquidity calling for the deployment of an emergency plan, or a safety net. Independently of the precise form of the emergency, such a plan would be totally successful only if all the participants in the system were used to handling SDRs under either well-known or still unknown conditions. Total improvisation should be avoided in exceptional circumstances, particularly with an unfamiliar mechanism. That was another reason for her desire to find more uses for SDRs and for new allocations. She agreed with Mr. Polak's comments in that respect and, more particularly, with his statement that "if the need for something of this nature presented itself, it would not take much time to work out the mechanics, provided always that the Fund had a functioning SDR allocation mechanism in place."

Nevertheless, the problem of scale was not the only issue to be addressed, Mrs. Ploix observed. With respect to the distribution of SDRs, there had been considerable discussion of the provisions of Article XVIII, Section 1(a) requiring a global need to supplement reserves before SDRs could be allocated or canceled. The dispute had been focused largely on the word "global." The staff's interpretation enabled the issue to be tackled in an interesting way, its negative presumption being that the need was global "if the adverse consequences of not satisfying the need would be global in the sense of affecting most or all countries or impairing the functioning of the international financial system." That interpretation was particularly useful at a time when an increasing number of countries were encountering difficulties in obtaining access to financial markets, when there were sharp movements on those markets, and when there was a sharp drop in the reserves of an entire continent, such as the 18 percent decline in reserves in South America.

The French position on the distributional problem, was not far from either the Belgian proposal or from that taken by Mr. Sengupta at EBM/86/18, which he had more or less confirmed at the present meeting, Mrs. Ploix concluded. The French proposal was aimed at enlarging the share of indebted countries in an SDR allocation without entailing a new operation to fund the Fund; its origin lay in Article XIX, Section 2(c), and its implementation required a 70 percent majority. A part of the newly allocated amounts could be lent by the industrial countries to developing countries; the SDRs lent would actually be used to strengthen the reserves of the borrower as it proceeded to implement stabilization and development policies.

Mr. Polak questioned that it would be necessary for the Executive Board to take a decision to implement the French proposal on lending of SDRs, since that was permitted by the Articles of Agreement.

The Treasurer explained that the Executive Board had already taken a decision authorizing participants to lend SDRs (Decision No. 6001-(79/1) S, 12/28/79).

Mr. de Groote recalled that the compatibility of the Belgian plan with the nature of the SDR as a reserve asset and with the provisions of the Fund's Articles relating to the allocation and use of SDRs had been dealt with fully in a memorandum by the Legal Department (EBS/84/191, 9/5/84). The Fund could not borrow SDRs and a member therefore could not lend SDRs to the Fund. The terms lending and borrowing could be used only in the context of the more complicated mechanism that he had first put forward earlier in 1984. Under that proposal the Fund would borrow currency and simultaneously purchase an equivalent amount of SDRs from a participant that had agreed to make them available. The SDRs so acquired would be held in the General Resources Account for use to provide assistance to members of whatever type--namely, as envisaged under either the de Groote, de Maulde, or Sengupta plans. Without success, long hours had been devoted to debating the issue whether it was legally possible for the Fund to borrow and for members to lend SDRs to the Fund. Obviously, as Mr. Polak had noted, one member could lend SDRs to another member; in fact, members made such loans all the time.

Mr. Zecchini said that it was not clear to him that a temporary transfer of SDRs from one country to another, along the lines mentioned by Mrs. Ploix, could be called a loan if no costs were involved in the operation. As he understood it, a transfer carried out for the purpose of helping another country, in a spirit of cooperation, would not involve a cost. Mr. de Groote had introduced a third party--the Fund--into the operation, which was thus made more complex and completely different from a bilateral transfer. It would be helpful to have a fuller explanation and disentanglement by the staff of the various options.

Mr. Polak considered that the various proposals were not so different or complicated, nor did they call for a new legal interpretation. As he understood them, the Belgian proposal called for creditor or industrial countries to lend, so to say, SDRs to the Fund, using a special technique. There was a parallel French proposal, which seemed similar to Mr. Sengupta's proposal that countries not greatly in need of SDRs should lend them for a certain period--perhaps in a collective way--to other countries having a reserve need. Such collective loans could be administered in some way by the Fund.

The Chairman remarked that he had understood the French proposal as being closer to the Belgian one in that it funneled the SDRs through the Fund for lending to developing countries rather than to specific country borrowers on a bilateral basis.

Mr. de Groote recalled that Mr. de Maulde's proposal had diverged from his own in respect of a specific consideration--namely, whether or not countries would have to seek parliamentary approval. Mr. de Maulde's assertion that his proposal would dispense with the need for parliamentary approval had been questioned. When the two proposals had been compared, he had stated at EBM/84/138 (8/31/84) that:

> Mr. de Maulde's objectives deserved strong support. The proposal to direct the allocation to countries where there was a need for additional liquidity, in the context of a Fund appraisal of the economic policy of members, had much in common with his own proposal put forward at EBM/84/45. However, Mr. de Maulde considered that an important difference between the two proposals was that his idea would "probably" avoid the need for parliamentary approval because it involved lending to member countries, a possibility already allowed for in the Articles of Agreement. In the five countries of his own constituency, lending SDRs in the way suggested by Mr. de Maulde would be possible without

parliamentary approval. But although he understood that the U.S. Exchange Stabilization Fund, which would receive an allocation, could lend SDRs to the monetary authorities of other countries in short-term swap operations for up to a maximum of three months, it might be difficult to regard the continuous renewal of such swaps as a short-term operation. Irrespective of the legal requirements, it would be surprising if a responsible government did not seek parliamentary approval for a scheme that in substance represented precisely the case for which approval was required. Because he considered that his own scheme was similar to Mr. de Maulde's with regard to the need for parliamentary approval, he preferred to move toward their shared objective through a more straightforward solution that would permit a possible change in the role of the SDR and of the Fund.

Mr. Sengupta remarked that his proposal was indeed closer to Mr. de Groote's proposal. Rather like Mr. Zecchini, who had used the word transfer, he had used the word reallocate, avoiding reference to loans. The whole idea was to reallocate SDRs to developing countries in the form of a permanent overdraft facility on which interest would be paid and which would have to be replenished within three years. As long as that facility was not used, there would be no cost, as Mr. Zecchini had said. But use of the overdraft facility would require the payment of interest to the countries that had given back the SDRs for redistribution by the Fund, which would essentially be the intermediary. The replenishment obligation would be somewhat different from the old reconstitution formula.

Mr. Kafka asked whether Mr. Sengupta's proposal was not simply a combination of a link and a 100 percent reconstitution formula.

Mr. Sengupta noted that the main difference was that developing countries would not be able to use the facility for purposes of long-term development assistance but would have to hold the SDRs like reserves. However, at the point of need, the facility could be drawn upon as long as it was replenished within a certain period.

Mr. Zecchini noted that it would be a mistake to dismiss the issue under discussion as being a simple one, even though everything was possible provided the political will existed to implement what would have to be a clearly understood approach.

As for the technical implications of Mr. Sengupta's proposal, Mr. Zecchini considered that they differed considerably from the implications of the French proposal. First of all, an outright SDR allocation would not be involved because the overdraft facility might not be used for some time. Consequently, there would be no addition to reserves but a credit line for the purpose of strengthening the external image of the country in financial markets, for various purposes, including borrowing in private markets. A comparable mechanism was the market for commercial paper in the United States, which had freed many large corporations from the need to resort to banking credit, although the paper issued by commercial banks was backed by substantial credit lines. All the technicalities of Mr. Sengupta's proposal and of other proposals would have to be clearly stated in the summing up of the discussion.

Mr. Sengupta, in response to a question by the Chairman, noted that in the technical sense, there would not need to be an outright allocation of SDRs. However, each country would know that it had available an overdraft facility. It would not simply be a matter of lending by one country to another; the Fund would have to establish a mechanism through which to channel the SDRs to developing countries in need of them. Therefore, in some manner, the Fund would have to obtain extra SDRs.

The Chairman noted that SDR allocation would therefore be necessary in the system that Mr. Sengputa had in mind.

Mr. de Groote remarked that the issue was not very complex. Both his proposal and that of Mr. Sengupta would call for an SDR allocation; a group of countries--say, industrial, OECD, or any other group of countries, according to circumstances--would decide to transfer, or to lend, their allocation to the Fund, under the mechanisms already discussed, which would then use the SDRs to finance operations. The difference between his original proposal and Mr. Sengupta's proposal arose at that point. He himself had originally suggested that the Fund should use the resources to finance its normal operations; in other words, the effect would be equivalent to borrowing by the Fund. Mr. Sengupta had proposed that those resources should be transferred through the Fund to developing countries in the form of owned reserves; presumably, those countries would receive a direct and automatic increase in reserves rather than obtaining additional resources as a by-product of credit operations or stand-by arrangements. Thus, the allocation of SDRs would have a dual nature: industrial countries would keep the reserves allocated to them, and developing countries would receive additional resources, thanks to the Fund. The question that then arose was whether a decision on the reimbursement of those SDRs by the developing countries would be taken at the time of allocation.

Mr. Sengupta remarked that an initial allocation of SDRs based on quotas was clearly necessary. However, he had accepted Mr. Zecchini's suggestion that the precise point in time at which the allocation was made could be a matter for decision when the overdraft facility was actually used, if the Fund were given the authority to transfer the initially allocated reserves or SDRs from the developed countries to the developing countries. Some flexibility could be introduced into the mechanism in that way.

Mr. Zecchini observed that one of the various possible interpretations of such a mechanism was that it was a very close substitute for the enlarged access policy. Certain countries could be allowed to draw more SDRs than they were entitled to, thereby offsetting the phasing out of the enlarged access policy.

The Treasurer said that it would be essential to decide at a specific point whether the resources to be gained through the process of allocation should be used in part or in their totality in a certain way, depending on the proposal. The precise technicalities would differ in respect of each of the proposals made, and for a variety of reasons. The staff would need to have a clearer understanding of the various proposals put forward by Executive Directors in the process of carrying out the staff study that had been requested and before the various technical modalities could be examined. For instance, he had not understood Mr. Sengupta's proposal to require that the SDRs be transferred into the ownership of the Fund; rather, the individual transferor of the SDRs or creditor--the surplus countries--would delegate authority to the Fund to administer the scheme. The Fund would establish when developing countries had a need to be put on the list of potential users of the overdraft facility, and when individual countries would be authorized to draw. It would be necessary to decide whether the assets were transferred permanently or loaned; one difference could be that of the interest rate. Presumably, those Directors who had in mind a transfer of SDRs would impose no other interest rate than the SDR interest rate, whereas those who had loans in mind might want an interest rate that was either higher or lower than the SDR interest rate.

The Director of the Legal Department noted that the loans of SDRs between participants that were specifically authorized under Decision No. 6001-(79/1) S, were transactions to which the Fund itself was not a party. The general decision had been taken by a 70 percent majority but the decisions of individual participants to enter into such transactions were reached by agreement between the participants without there being any need for a Fund decision. While the Fund could not borrow SDRs, it was able to borrow currencies with which to purchase SDRs. There would thus be no question of SDR loans to the Fund. The proposal for an overdraft mechanism, which would presumably entail an agreement between the Fund and individual members, would not be consistent with the Articles of Agreement, whereas an overdraft facility between members would be covered by the decision already adopted by the Fund.

One possible technique for the use of SDRs by developing countries that could be explored was the possibility offered by Article V, Section 2(b), which authorized the Fund to set up an independent facility similar to the original Trust Fund but with assets that were not its own, the Director of the Legal Department added. The Fund had the power under Article V, Section 2(b) to perform financial services, including the administration of resources contributed by members. Resources would be transferred to the new facility, which could then enter into transactions with members that would not be subject to the rules governing the use of the Fund's general resources but could be subject to special rules.

The Treasurer remarked that if there were a sufficient number of willing lenders as well as of willing borrowers of SDRs, it might be worth considering whether a way could not be found to allow those parties not only to agree with each other on the terms and conditions of the loans but to ask the Fund to administer the loans. The Fund would then agree to perform those services.

The Director of the Legal Department noted that Decision No. 6001-(79/1) S authorized participants to lend to each other SDRs that were the property of the participants and that were transferred by agreement between one participant to another. Resources transferred to the Fund as "Trustee," under Article V, Section 2(b), were no longer the property of the contributing members, there having been a prior transfer of ownership to the Trustee, which would administer the assets.

The Treasurer added that proposals along the lines suggested by Mr. Sengupta would be difficult to implement unless the Fund were able to render its services without having to accept the transfer of the assets into its ownership.

Mr. de Groote remarked that exploratory as it was, the present exchange of views on the various proposals was useful. He had come to the conclusion, much as Mr. Polak and Mr. Zecchini had, that the Fund's intervention was not an essential requirement of Mr. Sengupta's proposal. It was possible for countries, individually or collectively, to decide to lend SDRs from their new allocation to other developing countries without the Fund's involvement. The purpose of his own proposal, on the contrary, was to associate the Fund in the use of that new allocation. Therefore, it had been useful to draw the distinction between Mr. Sengupta's proposal, which was somewhat closer to the French proposal than to the Belgian proposal.

Referring to the remarks of the Treasurer on the use that would be made under the various proposals of part of the SDR allocations, Mr. de Groote said that it should not be forgotten that the main purpose of the different proposals was not to obtain an allocation of SDRs for its own sake. The fundamental purpose was to demonstrate that the main argument against an SDR allocation--that it would go to countries that did not need additional reserves--no longer had any foundation because the SDRs would be reallocated toward those countries needing them, either as reserves to hold or as the by-product of a Fund lending operation.

Finally, Mr. de Groote wondered whether it might not be useful to reissue some of the papers that had been prepared in the past on the issue, including the original Belgian and French proposals, and the Legal Department's note on the Belgian proposal together with his reply, perhaps as part of the staff paper to be prepared as a result of the present discussion.

Mr. Sengupta commented that although many aspects of the proposal he had put forward would have to be clarified, it was plainly not possible to implement his proposals in the way suggested by Mr. Zecchini--the Fund's involvement was essential. The critical point that had been raised was whether the Articles of Agreement would allow the Fund to provide the necessary service. As he had mentioned in submitting his proposal, the SDRs being allocated in the form of overdraft facilities to developing countries should become owned reserves subject only to the restraint that the developing countries could not use them for more than a specific period. Whether the overdraft facility that he had in mind would take the form of a mechanism transferring the SDRs in their totality to the developing countries in the first place, or whether the SDRs would be assigned to the Fund, which would then administer their use, were issues that would have to be examined in the light of the Fund's rules and the Articles of Agreement.

The Deputy Managing Director remarked that as he understood Mr. Sengupta's proposal, the SDRs would be a grant from one country to another, not a loan. The ownership of those SDRs would simply be transferred subject to a condition--the reconstitution provision--that would be enforced on the SDR grant.

Mr. Sengupta remarked that to the extent that countries used the SDRs transferred and incurred the obligation to pay interest, the transfer would not remain a grant. In other words, the Fund should not have the right to reclaim the SDRs transferred; the title to them would be transferred as a right of ownership.

Mr. Zecchini observed that the Deputy Managing Director's interpretation came very close to capturing the spirit of Mr. Sengupta's proposal, which was not an overdraft in the technical sense but an allocation subject to certain conditions. That allocation was considered an addition to the reserves of the country, which had the full right to use them.

Mr. Polak stated that the issues would be clouded rather than cleared up if the discussion continued to explore all the interesting ideas that had been put forward before the staff had had an opportunity to evaluate them in legal and operational terms.

The Director of the Research Department noted that Mr. Sengupta's proposal could take various forms. A permanent overdraft or drawing facility, and donations, were two that had been suggested. In the former, country A would make available a line of credit to country B that was equal to or a portion of the allocation of SDRs that had been made to the offerer, country A. Country A would not make a charge for the use of those resources and the Fund would keep track of when and under what circumstances country B could take advantage of that overdraft. In the usual way in which reserves were calculated, country A would be recorded as holding the reserves until country B had exercised its right to draw on the line of credit, when the accounting would probably have to be modified. In the latter form, which he understood to have been Mr. Sengupta's intention, country A would make a grant of its allocation to country B, which would then become the owner. However, country B would make some undertaking to country A that it would only use the new reserves, which would be recorded in its reserves and not in the reserves of country A, under certain circumstances. It would be part of the Fund's role to determine those circumstances, which had never been clearly specified.

The Treasurer noted that once country A had donated SDRs allocated to it to country B, country A would have to pay interest because its SDR holdings would be reduced below its allocation. For that reason, he had considered the transfer to be a loan composed of two elements. First, the offer by country A to make a loan of SDRs to country B under specified circumstances. The loan would take the form of a transfer under the overdraft facility and it would be repayable after a certain period of time, say, three years. The interest paid on the loan by country B to country A could fully compensate the latter's obligation to pay interest on the SDRs it had used in extending the loan. Decision No. 6001-(79/1) S authorizing loans in SDRs between participants foresaw that outcome except that it did not specify the interest rate, which could be equal to the rate payable on the use of SDRs, less, or more than that rate. Participants in the SDR Department had made such loans to each other at varying rates of interest, and participants had also made loans in SDRs to other international institutions which, unlike the Fund, could borrow in SDRs. Thus, the idea underlying Mr. Sengupta's proposal came closer to being an offer of a line of credit which, when it was used, was repayable.

Mr. Nimatallah said that although country B would acquire the power to utilize the SDRs transferred to it, in a form that he considered to be a loan, it would not own the allocations outright. The original ownership would remain with country A.

The Treasurer noted, in response to remarks by the Deputy Managing Director and the Chairman, that a country could in fact donate its SDR assets and pay the interest rate on that use.

Mr. Sengupta reiterated that his main idea, which he would like to see kept intact, had two objectives. First, the developing countries would receive the SDRs--whether they were reallocated, transferred, donated, or lent--and would pay interest on them to the countries that had given up their initial SDR allocation. Second, the developing country concerned should be given a permanent line of credit in the sense that even if its use was reconstituted after, say, three years, it would be able to draw on it again at the beginning of a subsequent three-year period. If the resources were defined, as closely as possible, as reserves, the developing country's reserves would show an increase, enabling it to use reserves but not for long-term development purposes. The issue of ownership did therefore arise in some sense, but the timing and form in which developing countries could use the reserves would have to be discussed.

The Chairman remarked that the reserves might conceivably never be used. One advantage of Mr. Sengupta's proposal was that it would enable the Fund and its membership to help a number of developing countries with an obvious need for reserves to replenish those reserves without necessarily having to run surpluses on their current accounts. Systemic surpluses for developing countries were not easy to reconcile with world economic development. Of course, it would be important for developing country members to accept that the resources being transferred to them were not to be used immediately, the purpose of the proposal being to bolster their reserves rather than to effect a transfer of real resources. Ideally, the developing countries would not use the additional reserves and there would be no need for making use of a reconstitution provision.

Mr. Sengupta remarked that reserves were, of course, meant to be held but, also, in contingencies to be used.

The Chairman noted that Mr. Sengupta's proposal and the way in which it would work would need to be examined by the staff, alongside the Belgian and the French proposals, which had already been examined and which could be reproduced in an annex to the staff paper.

In response to a further remark by Mr. Sengupta, the Chairman added that Mr. de Groote's proposal was fundamentally different from the overdraft facility suggested by Mr. Sengupta. The purpose of Mr. de Groote's proposal was to channel resources into the Fund to facilitate the financing of the Fund's conditional lending operations. The allocation of SDRs for that purpose--as opposed to the quota increases or borrowing--was interesting but differed from Mr. Sengupta's proposal, under which the reserves of certain member countries would be bolstered. SDRs would be utilized unconditionally--rather than conditionally--to increase the depleted reserves of a group of countries, thereby avoiding excessively recessionary adjustment policies for the sole purpose of increasing reserves. The proposal had systemic implications that would have to be studied, as would the complications that would arise in putting it into effect.

To be worthwhile, any of the schemes proposed presumably would have to involve the transfer of control over real resources, since it was still not possible to create something out of nothing.

His starting point was the question of how special drawing rights differed from ordinary drawing rights--namely, the credit facilities in the General Department, Mr. Rye said, since it was necessary to assess, in relation to the various possible future roles for the SDR, whether the General Department could do the job equally well, or even better. As far as he could see, the answer rested on two key points. First, the exercise of special drawing rights--namely, making net use of SDR allocations, was unconditional--the balance of payments needs test aside--whereas drawings in the General Department were conditional; and second, SDRs could be drawn for an unlimited duration in contrast with the revolving nature of the resources of the General Department. In other respects, however, special and ordinary drawing rights seemed to be essentially the same.

Two obstacles stood in the way of a reaffirmation of the original role for the SDR: to supplement global reserves as and when required with the objective of making the SDR the principal reserve asset in the system, Mr. Rye continued. There was first the view--with which he agreed, although many in his constituency did not--that the current international monetary system was capable of meeting, in the aggregate, the system's demand for reserves. There was no longer, as there had been in the years leading up to the creation of the SDR mechanism, any inherent tendency to reserve shortage. Of course, not all countries had access to all the reserves they would like to have all the time; nor should they. He agreed with the staff that there had to be limits on the ability of the system to supply reserves if disciplined policies were to be encouraged. Equally, the phenomenon of a lack of access to reserves owing to a lack of creditworthiness was not usually a reflection of weakness or flaws in the present system. It was nonetheless possible that a few countries that had re-established sound policies might be unable in good time to regain access to credit. Clearly, any such countries should be assisted through international action. But it seemed to him that the General Department was better structured than the SDR mechanism to provide that assistance because it was capable of targeting and of attaching conditions appropriate to the circumstances. Naturally, where sound policies were already in place, conditionality need amount to no more than an injunction to continue to follow those policies.

The other obstacle was that, given the existing structure of the international monetary system, it was difficult to see how the SDR could become the principal reserve asset, Mr. Rye added. For one thing, the ability of private markets to create reserves would have to be limited, and he had yet to hear a convincing exposition of how that could be done.

The second possible role for the SDR was a stabilizing or countercyclical role, Mr. Rye commented. SDRs would be allocated when markets were unduly constricted and withdrawn when they were unduly flush. There would be a change in focus from long-term supplementation of reserves to shorter-term stabilization. One key issue would be how market suppliers of reserves would react to variations in the supply of SDRs. There seemed to be some risk, although he did not know how to evaluate it, of the market allowing SDR allocations to substitute for its credit when conditions were unfavorable, and of responding to SDR cancellations in flush conditions by greater lending. In other words, market cycles might be amplified rather than subdued. The staff had raised the question whether such a role would be consistent with promoting the owned status of SDRs, which, if they were to be subject to periodic cancellation, might not be viewed by holders as a solid component of their reserves. A related question concerned the basis on which SDRs would be canceled. It might be thought that that basis should be the same as that on which SDRs were allocated--namely, in proportion to quota, but he suspected that it might prove much more difficult to take SDRs away from those who did not have them than it was to give them to those who did not need them. In passing, he joined Mrs. Ploix in endorsing the staff proposal to define the global need for reserves.

As international base money, the SDR would have a central and stable rather than a marginal and reactive role, Mr. Rye observed. The stock of SDRs in circulation would in effect become the anchor of the system, imposing a constraint on other sources of reserve supply. The key question, which the staff understandably had not attempted to answer, was how other sources of reserve supply could be constrained. Would the SDR become a special--or even sole--means of international settlement, or would maximum ratios of non-SDR reserves to SDRs be prescribed for individual countries? Further exploration of those issues was needed.

The SDR as safety net, or international lender of last resort, represented a distinct role amounting to contingency planning for a future emergency, Mr. Rye remarked. He noted that Mr. Polak preferred to see that role within the framework of the failure of the system to provide an adequate rather than even a minimum amount of liquidity. He felt the need to ask Mr. Polak to explain how that would differ from a reaffirmation of the original role for the SDR. If the issue were confined to emergency situations, he doubted whether it would be useful to attempt to establish precise guidelines. Emergencies called for maximum flexibility of response. Moreover, by definition, they could not be foreseen precisely. One set of questions that would arise would be how to minimize problems of moral hazard, for both banks and countries. If banks knew that there was a mechanism to bail out the system, would they be as careful in their lending policies? Would incentives to maintain a presence in debtor countries when the environment became difficult be reduced? For borrowers, would the discipline implied by the potential loss of creditworthiness be eroded? Taken together, those considerations led him to think that it would be better not to attempt to develop a safety net role in any detail.

Finally, the role of the SDR as a unit of account was quite separate from the actual financing role, Mr. Rye considered, a view that was reinforced by experience with the ECU. He could cut short his remarks on the ECU because Mr. Polak had made his points. In sum, he had concluded, rightly or wrongly, that experience with the ECU did not seem to offer much help in redefining the role of the SDR. The source of that redefinition would have to be found elsewhere.

Further investigation of impediments to the attractiveness or the usability of SDRs seemed to be required, Mr. Rye stated. In that context, he could support Mr. Polak's suggestion for a reconsideration of reconstitution.

Mr. Zecchini considered that the most appropriate opportunity that had presented itself for expressing a comprehensive set of ideas on the role of the SDR had been the discussion in the Board on January 31 (EBM/86/17, and EBM/86/18) and February 3 (EBM/86/19). In economics, as in all other social disciplines, proposals had to be framed in an historical perspective in order to be justifiable. The Fund had to build on the lessons of the past to be able to create a more viable international monetary system for the future. On the occasion of that previous discussion, it had been made clear that his chair favored a strengthening of the role of the SDR in the system, both from a quantitative and a qualitative point of view. Specifically, a process for the gradual creation of SDRs should be established so as to raise the SDR share in the portfolios of monetary authorities and contribute to a better working of the present liquidity-creating process as well as of the adjustment process. At the same time, the SDRs' characteristics should be improved to make them more desirable to central banks and private financial institutions.

Having briefly restated the general position of his chair, Mr. Zecchini went on, he could discuss some of the considerations behind it: the contribution of the SDR to a more appropriate pattern of the supply of reserves and consequently of the adjustment of external balances; the possibility of using SDRs to finance the Fund's lending; the SDR as a unit of account and a numeraire; and the improvement of the SDR's characteristics.

The floating exchange rate system clearly had not lessened the need for countries to accumulate reserves, Mr. Zecchini observed. However, that need had been increasingly satisfied through resort to credit markets. As a result, private financial institutions, by varying the supply of reserves, had had a major impact on the international adjustment process. At times, that process had been unduly delayed or accelerated on the basis of less than accurate perceptions by banks of a debtor country's creditworthiness and its adjustment efforts. Sometimes, the decision to limit additional credit had been guided merely by considerations of profitability and risk. As the staff had rightly pointed out, the imperfections of the system lay basically in the inability of the present market-denominated mechanism for reserve creation to determine an appropriate level of reserves for the system and the satisfactory distribution among countries of those reserves.

To those imperfections, he would add the difficulties--if not the inability--of the present system to induce an appropriate mix of owned and borrowed reserves, Mr. Zecchini said. Once again, it had to be recognized that the two types of reserves could not be considered perfect substitutes in assessing the adequacy of international liquidity and the pressure that its distribution exerted toward external adjustment for individual countries as well as for the world economy as a whole. As long as the market played the leading role in regulating the accretion to reserves and in managing international liquidity, the economic and monetary system was bound to be unstable and to be more vulnerable to exogenous shocks. Evidence of that inherent source of instability could be found in the present pattern of commercial financing flows to developing countries: in 1984, new net lending increased by only 3 percent and in 1985 and 1986, it was expected to be close to zero.

There was therefore a widely felt need to regain a greater measure of international control over the process of reserve and liquidity creation and distribution, Mr. Zecchini added. Although that could be achieved through the strengthening of international surveillance, that alone was insufficient since only the deficiencies on the demand side of a system that was guided by the market would be dealt with, whereas it was necessary to deal explicitly with the systemic aspects relating to shortcomings on the supply side.

Separate consideration should be given to another source of instability in the reserve system that was related to the interplay of the floating exchange rate regime with the multicurrency structure of reserves, Mr. Zecchini noted. He was referring to sudden shifts in reserve holders' preferences with respect to the currency composition of their reserves. There were some benefits to be had from preventing such shifts from adding to the pressure on key currencies that had developed already in the marketplace.

He did not believe that the SDR mechanism in either its present or an improved form could provide the sole remedy for such deficiencies, Mr. Zecchini remarked. However, the SDR might be part of a coherent package of remedies to which it would make an important contribution. In order to deal with the scale and the distributional aspects of the liquidity problem, a double criterion for expanding the supply of SDRs could be considered. On the one hand, a rule could be established to ensure a steady allocation of SDRs aimed at gradually raising the relative share of SDRs in world official reserves to a minimum percentage. On the other hand, room could be left for supplemental allocations of a temporary nature, which would be enacted and canceled in predetermined circumstances.

As for the use of the SDR as a means of financing loans by the Fund either to a limited set of countries or to the generality of the membership in cases of reserve shortage, two options could be envisaged, Mr. Zecchini went on. The first option would imply creating SDRs when the Fund financed the program of a country having a relatively small quota, with the latter condition avoiding distortions of the periodic quota increases, and SDRs being canceled at the time of the loan's reimbursement. Alternatively, SDRs could be transferred temporarily from surplus countries to those members undertaking strong adjustment efforts and in need of reducing their relative exposure vis-à-vis financial markets. The second option would consist of a safety net for the purpose of tackling major disruptions in the supply of reserves through the market mechanism. The conditions that should trigger the deployment of the safety net could be specified at a later stage, once the principle of its establishment had been accepted. A safety net could also be provided in the form of a substitution account. At times of sudden shifts in the reserve currency preferences of official institutions, the substitution of SDRs for less appreciated reserve currencies would avoid adding pressure to those currencies in the market.

Another relevant aspect of the SDR in the context of economic stability concerned its functions as a unit of account and numeraire, Mr. Zecchini stated. The benefits of the SDR as an accounting unit were evident since they were linked to the SDR basket structure. While there was no need to develop the latter point, it might be appropriate to study further the role of the SDR as a numeraire of both the reserve and the monetary system. The staff paper dealt mainly with the implications of the numeraire for reserve diversification and currency substitution in the portfolios of central banks. Very little had been said in that paper, or in other staff papers, on the role of the SDR in providing a benchmark for the exchange rate system. Even the advocates of the proposal for target zones had failed to mention the relationship between targets for exchange rates and the numeraire. After all, in the European Monetary System (EMS) the parity grid and the related target ranges for component currencies coexisted with the ECU parities. The ECU was also considered an indicator for assessing the relative stability of the exchange rates in the EMS. Perhaps the staff could shed some light on a similar relationship between the SDR as a numeraire and target zone mechanism, while at the same time clarifying its relevance to the present exercise on the role of the SDR in the system.

The last aspect for consideration pertained to the improvement of the characteristics of the SDR, Mr. Zecchini remarked. If the reserve asset was to maintain an appropriate place in reserve portfolios, it would be desirable to promote the demand for it by placing it on an equal footing with other reserve assets. That could be achieved, in particular, by increasing its liquidity, specifically, by introducing improvements into the transfer mechanism, the mechanism for pricing SDR assets, and in the use of SDRs for exchange market intervention. From the Fund's point of view, the development of the private market for SDRs should also be seen as instrumental to the development of a market on which official SDRs could be exchanged on a wider scale than at present and at an appropriate price. There was no other compelling reason--or advantage to the Fund--for promoting the private SDR. He would be willing to consider a technical proposal for establishing a bridge between the official circuit and the private market. For instance, one such bridge could be provided by allowing a financial institution, like the Bank for International Settlements, to act as an intermediary between the central banks and the private banks for transactions in SDRs. In such a system, the monetary authorities would have the opportunity to mobilize their SDR asset holdings in the private market. That and other technical improvements of the operational characteristics of the SDR could be better analyzed in a paper by the staff, for Board consideration in the months ahead.

On the comparative analysis of the SDR and the ECU, Mr. Zecchini made the technical point that the staff had not presented a parametric analysis of the comparative advantages inherent in investing in the two currency units. He would have expected to find a reference to parametric analyses to test the importance of various factors in explaining the relative success of the private ECU. Recent studies showed that both SDR- and ECU-denominated assets were efficient portfolios for the private investor. However, the same studies showed that the SDR portfolio performed better than the ECU portfolio in reducing the exchange rate risk. Specifically, the covariance between exchange rate movements of currencies included in the SDR basket had been lower than that for the ECU basket, indicating that other factors might have played a more important role in supporting the expansion of the ECU.

Finally, Mr. Zecchini said that he had doubts about the appropriateness and usefulness of a link between SDR allocations and development assistance for the purpose of enhancing the role of the SDR and strengthening the international monetary system. It seemed more appropriate to keep the two issues separate if progress on both of them were to be achieved.

Mr. Foot said that he had found nothing in SM/86/17 to change his view that thorough discussion of exchange rate reform and related issues of surveillance should precede consideration of any initiatives in the area of liquidity creation. However, there were a number of propositions in the main paper with which he was in some measure of agreement.

First, he agreed with the staff that the current system of liquidity creation was not perfect and could contribute to instability in the system generally, Mr. Foot continued. That being said, he noted that the staff had been a little disingenuous in setting up the text book model of the gold standard as a comparator for measuring the performance of the current system. Little of the empirical work on the gold standard--particularly that on the United Kingdom in the nineteenth century--had shown that that model had any basis in reality.

He could also agree with the staff that an adequate supply of reserves was important for the preservation of an open trade and payments system, Mr. Foot said, adding however that his authorities saw little evidence that the global total of reserves had been insufficient for that purpose in recent years. He also added that the relationship between the level of reserves and the level of world activity or trade was not simple nor did the causation run mechanistically from reserves to trade. At times, he had wondered whether that was also the staff view.

The third point he would endorse was that floating exchange rates clearly did not eliminate the desire to hold reserves, Mr. Foot continued. Nevertheless, if a change in the management of exchange rates were agreed, the global demand for reserves could be affected and probably increased. That was the key reason for his view that the discussion of exchange rates should logically have priority on the Board's agenda.

Again, for a number of reasons listed in both the staff paper and in the earlier statement by Mr. Polak, there was a good deal in the argument that owned reserves were superior to borrowed ones, Mr. Foot noted. It was certainly reasonable, therefore, to wonder whether it was satisfactory to place reliance on the banking system for the determination of the global level of reserves.

All that being said, Mr. Foot commented, it was hard to see how a vigorous case could be made for envisaging that the SDR would necessarily make a major contribution to economic stability. He had used the word "necessarily" advisedly because the possible range of future economic circumstances was enormous, and the value of the SDR safety net outlined in the staff paper was obvious. However, he shared Mr. Polak's view that it was of little value to discuss that particular aspect further at the present stage because the contingency against which it would be used could not be envisaged in advance.

Should it be decided that greater central control over international liquidity was desirable, the SDR could be well placed to act as a regulator through the allocation mechanism and, what was as important, cancellation as necessary, Mr. Foot observed. Such a role would require a greater critical mass of SDRs in members' reserves than at present; that in turn, as several other Directors had already noted, would probably require an enhancement of its technical features--to ensure willing holders--and also, for quick results, a means of ensuring that SDR allocations were substitutes for existing borrowed reserves rather than merely additions to them. Finally, a plausible cancellation mechanism would be needed. The staff paper had pointed readily to the frailties of private sector institutions in reaching desirable decisions on reserve creation; but it mentioned only implicitly that bodies such as the Fund itself might have different but equally important weaknesses in their decision-making processes. The weakness to which he made particular reference was of course the tendency to ignore or at least to underrate the risk of overliquidity in the financial system. One intriguing aspect of Mr. Nimatallah's third option was the attempt to pull together the best of the decision-making processes of the public sector and the banking sector. Although he had considerable reservations about Mr. Sengupta's views on the value of indicators to trigger cancellation, he would be interested in knowing in due course what indicators might play that role.

The SDR could make some contribution toward improving the composition of reserves, Mr. Foot went on. Such a role would include raising the proportion of owned reserves; reducing pressure on exchange rates that would otherwise result from currency switching; and assisting smaller or less sophisticated countries that did not want to construct their own currency reserve baskets. But he saw that overall contribution as modest at best.

On the question of distribution, his chair agreed strongly with Mr. Polak's statement at EBM/86/17 that attempts to link the SDR to development finance confused the issue and--for his authorities--would be a major step backward for the SDR, Mr. Foot stated. Commenting on the Belgian and other proposals that had been mentioned during the discussion, he made the technical point that, so far as the United Kingdom was concerned, any such arrangement would have to be structured so that it did not involve direct lending to other countries, which was not possible under the U.K. Exchange Equalization Account.

He had concluded, from the staff's comparative analysis of the functioning of the SDR and the ECU and in light of his earlier remarks, that it would be premature for the Fund actively to promote private use of the SDR, Mr. Foot said. First, the official ECU had at present an even more limited usefulness than the SDR and had a long way to go before it developed into a reserve asset. Second, the private ECU market had grown for a number of reasons, not least of which was that it could be used as a means of taking a position against the U.S. dollar, a factor that was not relevant in the use of the SDR. Third, both the official and the private ECU had benefited from a degree of discrimination in their favor from some sources that needed to be remembered in assessing its true rate of growth. Fourth, there were more currencies in the ECU than the SDR--making it less easy to replicate in market transactions to create one's own basket--and those currencies had strong trading links in the European Communities; one strongly aired view was that a private sector SDR not only contained currencies in which potential private holders could trade easily enough to construct their own basket but that it was also overdominated by the U.S. dollar for many private sector holders to be particularly interested. Fifth, and finally, the private ECU market was still narrowly based and was predominantly an interbank market.

In sum, Mr. Foot concluded, changes to the SDR should follow from a wider consideration of its role in the international monetary system, with consideration being focused on exchange rates for at least one stage preceding the discussion on the SDR.

Mr. Kafka remarked that while he agreed with the comment in the staff paper that official interest in the ECU in Europe had contributed to the development of the asset, whereas a growing cloud seemed to be hanging over the SDR, the distinction between those two assets seemed to have been overdrawn. For instance, the staff had described the ECU as serving as the numeraire of the EMS whereas the SDR was merely the unit of account for Fund transactions; and it had mentioned the ECU as being used in EMS settlements but had not listed the SDR as having a similar function even though it was used in settlements among participants and also between participants and the Fund. It seemed to him that the SDR could make a major contribution to stability beyond the ways in which it already served that purpose and that were partially summarized in Section III of SM/86/17. The main contribution of the SDR would be to provide owned reserves as compared to borrowed ones, although the issue was somewhat more complicated, as the staff had suggested, if more implicitly than explicitly. If a country owned SDRs and owed much larger amounts of short-term debt, the stability of its reserves was only marginally better than if it owned no SDRs. But it would make sense to find out whether countries were prepared, as he believed they would be, to substitute allocated SDRs for borrowed reserves rather than spending either. For that reason a reconstitution provision would be helpful and it could be for a much higher percentage of SDR holdings than in the past.

The question whether the SDR could be mobilized more rapidly than either the General Arrangements to Borrow or, more likely, the Federal Reserve swap network, had always puzzled him, Mr. Kafka added. The SDRs' main contribution to stability might therefore be through a steady increase in allocations rather than in the more dramatic form of the safety net. That did not of course mean that the SDRs' function as a safety net was a negligible one. It was the problem of reserve distribution which private markets could not resolve and that the SDR could help to alleviate in two ways: by a voluntary or a statutory redistribution formula or, without it, by means of a relatively heavy reconstitution provision so that those having adequate reserves would not be induced to spend additional SDR allocations. Those countries without large reserves would be discouraged in any case from spending them.

It was clear that no use could be made of the SDR unless its existing miserly volume were increased, Mr. Kafka stated. Without going into that subject at the present meeting, he expressed the hope that pending a decision on future SDR allocations the staff would supply additional exploratory ideas for improving the SDR.

Mr. Sugita said that his authorities considered that the primary role of the SDR under present circumstances 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," as stated in the report of the Group of Ten. He had already explained in the previous discussion the major reasons for his authorities' view of the role of the SDR. Therefore, his comments on some of the issues taken up in the two additional staff papers under discussion would be brief.

He had three points to make on the staff paper on the potential contribution of the SDR to economic stability, Mr. Sugita went on. First, the paper argued that since the global supply of reserves depended mainly on decentralized private decision making, there had been some overshooting in reserve supply with periods of excessive expansion being followed by periods of inadequate expansion or even contraction. It went on to argue that since that was a problem of the overall scale on which reserves were supplied, it could be dealt with effectively through the mechanism of SDR allocation and cancellation. He hesitated to support that view because the fluctuation in the supply of reserves was closely connected with the creditworthiness of individual borrowing countries, and it was legitimate to question whether such fluctuation was a matter of global reserve scale. Overshooting or undershooting might come about as a result of an abrupt change in the perception of financial institutions regarding the creditworthiness of certain borrowing countries. Such fluctuations had to be distinguished from fluctuations on a global scale. It seemed difficult to deal with that problem of particular borrowing countries through the SDR allocation and cancellation mechanism.

Second, the staff paper pointed to several imperfections of the present reserve supply mechanism in respect of the phenomenon of the loss of creditworthiness, which, it argued, signaled the need for adjustment, Mr. Sugita remarked. Those imperfections included, according to the staff paper, a sudden loss of creditworthiness and the imposition of harsh adjustment measures; an often inaccurate evaluation of creditworthiness by lenders, made in terms of a country's geographical location rather than on a case-by-case basis; and difficulties in restoring creditworthiness after the implementation of needed adjustment. While he did not deny the existence of some of those problems, the question was whether the SDR was the appropriate instrument to deal with them: they were obviously not problems on a global scale but of individual borrowing countries or what was called in the staff paper "distributional shortcomings of reserves." The staff itself had admitted that the SDR was not an adequate instrument for remedying problems of that kind. It had also argued that extension of credit through the Fund's General Department would be a more appropriate instrument for that purpose. He fully endorsed that argument, and he believed that particular importance should be attached to securing adequate financial resources for the General Department.

Third, it was possible to make a case that even though SDR allocations could not directly resolve some of the imperfections of the present reserve supply mechanism, periodic allocations of SDRs could indirectly alleviate those problems by gradually increasing the share of owned reserves, Mr. Sugita said. His authorities had two major reservations about that argument, as he had mentioned in the previous discussion of the role of the SDR. First, although the SDR was said to be a form of "owned" reserve, it did not possess the quality of normal owned reserves in terms of its liquidity. Second, since a large proportion of the SDRs allocated to non-oil developing countries had been spent and transferred to some other countries with strong external positions, the SDR had been used virtually as an instrument for the transfer of resources rather than as a reserve asset.

As for the staff paper on the comparison of the SDR and the ECU, Mr. Sugita observed that as he agreed with the points made by Mr. Polak and Mr. Hodgson, he had only two brief observations. First, several reasons were given in the staff paper for the rapid growth of the private ECU as distinct from the SDR. One reason was the ECU's regional currency composition and its link to the exchange arrangements of the EMS. The other important reason mentioned was that EC institutions and member countries had extended a variety of supportive measures to promote both official and private use of the ECU because they considered that an increased role for the ECU was an essential precondition for financial integration in the European Communities. There had been no such impetus to develop private use of the SDR so far, and his authorities saw no significant merit under present circumstances in adopting measures to promote increased private use of the SDR, which they did not believe would contribute to international financial stability.

Official use of the SDR had been relatively large compared with official use of the ECU, and had been on an increasing trend, according to the staff paper, Mr. Sugita noted. However, a major share of official SDR transactions had been related to operations and transactions in the Fund's General Department, including purchases, repurchases, and the payment of charges; the share of transactions by designation or by agreement had been relatively small. Therefore, a large volume of official SDR transactions should not be interpreted in itself as an indication of active use of the SDR as a reserve asset. On the other hand, transactions by agreement had increased somewhat recently, a development that could be viewed as an improvement in the functioning of the SDR as a reserve asset.

Mr. Nimatallah said that he would be interested in learning more about the possibility mentioned by Mr. Zecchini of a connection between the role of the SDR as a numeraire, as a unit of account, and the proposal for target zones.

The Treasurer remarked that the Articles made provision for the SDR to be used as the numeraire. The Articles also envisaged the possibility, which was very remote at present, of the SDR functioning as the peg for all currencies. Whatever the definition of target zones, they were not pegs. His initial reaction was thus that the way to use the SDR as a numeraire of exchange rates would depend on the nature of the target zone proposals: the looser those proposals, the less of a role there would be for the SDR as a numeraire; the tighter those proposals, the greater the consideration that could be given to certain aspects of the SDR in that respect. Without wishing to mention the divergence indicator in the European Monetary System, because of doubts about the EMS as a proper basis for comparisons with the SDR, it was perhaps as part of the indicator mechanism--if there were to be indicators in a target zone mechanism--that Mr. Zecchini might wish the staff to explore the issue further.

Mr. Zecchini commented, on a purely technical and personal basis, that although it was undoubtedly true that there was a relationship between the strictness of the target for monetary fluctuations and the need for a numeraire, he was not sure whether general agreement could be reached on the appropriateness of an inverse correlationship of the type mentioned by the Treasurer. For instance, even in the case of soft target zones, there was a need for an outside point of reference in order to assess the relative stability of the monetary system. Thus, a technical point could be made in favor of using the SDR as that outside benchmark instead of, for instance, another currency like the Swiss franc.

Referring to the Treasurer's point about the function that a numeraire could play as an indicator of the source of divergence, Mr. Zecchini observed that that was one of the prerogatives of the ECU that had not worked in the way intended, for a series of technical reasons inherent in the European Monetary System that were not present in the SDR system. Therefore, he considered that it would be useful for the staff to explore the theoretical and technical implications of a system of either hard or soft target zones in which the SDR as a numeraire would be used as an indicator. Such a study would not detract from official positions, including that of his own authorities, on target zones.

The Executive Directors agreed to resume their discussion in the afternoon.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/86/34 (2/24/86) and EBM/86/35 (2/26/85).

2. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/86/42 (2/21/86) and EBAP/86/43 (2/24/86), and by Advisors to Executive Directors as set forth in EBAP/86/42 (2/21/86) and EBAP/86/43 (2/24/86) is approved.

APPROVED: October 24, 1986

LEO VAN HOUTVEN
Secretary