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Minutes of Executive Board Meeting 86/36

3:00 p.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	
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	M. Sugita
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J. E. Ismael	
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E. I. M. Mtei	A. Abdallah
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Y. A. Nimatallah	J. E. Suraisry
P. Pérez	
H. Ploix	S. de Forges
J. J. Polak	
C. R. Rye	A. V. Romuáldez
G. Salehkhou	O. Kabbaj
A. K. Sengupta	
S. Zecchini	N. Coumbis

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

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Also Present

European Department: R. A. Feldman. External Relations Department: I. S. McDonald. Legal Department: F. P. Gianviti, Director; A. O. Liuksila, J. M. Ogoola. Research Department: W. C. Hood, Economic Counsellor and Director; R. R. Rhomberg, Deputy Director; J. M. Boughton, M. L. Dooley, D. Folkerts-Landau, A. Lanyi, D. J. Mathieson. Treasurer's Department: W. O. Habermeier, Treasurer; T. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer; W. L. Coats, Jr., E. Decarli, J. A. Gons. 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, J. Hospedales, G. Nguyen, A. Ouanes, P. Pêterfalvy, I. Puro, D. C. Templeman, N. Toê, A. Vasudevan. 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, K. Murakami, A. H. Mustafa, J. Reddy, B. Tamami, 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 resumed from the previous meeting (EBM/86/35, 2/26/86) their consideration of a staff paper on the potential contribution of the SDR to economic stability (SM/86/17, 1/29/86), together with a staff paper on 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. de Groote said that the historical review that the Board had completed on January 31 at EBM/86/17 and EBM/86/18 and on February 3 at EBM/86/19 had shown how over time the SDR had taken on three roles: supplementing existing sources of reserve supply to meet the long-term global need for reserves required for the smooth expansion of world trade and payments; improving the composition of the reserve assets of members in such a way as to make the reserve system and the international monetary system more stable; and finally, serving as a unit of account for the Fund's own operations. He would submit, first, that the function of supplementing the existing stock of reserves in a lasting way was no longer of great relevance in present circumstances, although temporary situations might require offsetting variations in the stock of international reserves--whether upward or downward--which could take place through SDR allocations or cancellations; and second, that the principal function of the SDR in meeting long-term reserve needs consisted at present in improving the composition of the stock of international reserves by making it more stable.

The long-term need to supplement existing reserve assets had become much less pressing than it might have been when the SDR was conceived, Mr. de Groote continued, when it had been possible to envisage a need to compensate for the destruction of reserves that might have resulted from a large U.S. current account surplus. But since then, the United States had played continuously its role of a reserve creation center, a role that had been enhanced by the suspension of convertibility. The emergence and rapid expansion of a multicurrency reserve system that created and distributed reserves through the international capital markets had created a mechanism for adapting over time the supply of reserves to demand, making it doubtful that a case could be made in the foreseeable future for a permanent addition to the existing stock of reserves. The possibility of temporary disturbances in the supply and distribution of reserves under the present mechanism of decentralized decision making could not however be excluded. Such disturbances did indeed occur, and they had been summarized convincingly on pages 7-12 of SM/86/17. One contingency that had not been included in the staff's summary was the present system's failure to respond to a possible demand for reserves for purposes of intervention to stabilize exchange rate movements between major currencies. Particular consideration must be given to the possibility of a demand on the part of the reserve center itself for reserves for exchange market intervention. Reserve currency countries of course could exert unlimited downward pressure on their exchange rates by selling their own currencies in the market. A different situation would occur if, faced with a current account deficit and loss of market confidence, a reserve center wished to intervene in the market in order to counter a sharp drop in its exchange rate. The possibility of such a situation was not to be excluded. In any case, the Fund's legal obligation to promote exchange rate stability justified considering mechanisms to meet such a demand for reserves.

It was difficult to reconcile the idea of a safety net, which was designed to deal with temporary disturbances in the present reserve system, with the stipulation that only a long-term and global need for reserves justified an SDR allocation, Mr. de Groote continued. That difficulty might be lessened if the interpretation were centered on the global need, which, as the staff had noted, could be presumed to exist if it had systemic implications affecting the proper functioning of the international financing system itself. However, the reference to the long-term need created problems of interpretation because the disturbances to which he had referred were temporary in nature. Allocations to offset temporary disturbances, permitting the SDR to serve a safety net function, would require the present mechanism for creating SDRs to be modified, either by interpretation or amendment of the Articles. One possible way suggested by the staff would be to build into decisions on SDR allocation a safeguard clause calling for subsequent cancellation when the conditions justifying the original allocation had improved. Such an allocation/cancellation method had the great virtue of probably being feasible under the existing Articles. The staff could perhaps prepare a legal paper on that point in due course. The technique could also conceivably be activated on a preventive basis to send periodic signals to the markets, thereby guiding their perception of the desirability of accelerating or moderating the expansion of international liquidity.

Another more innovative method would be to create a permanent short-term credit mechanism within the Fund similar to the one already set up within the European Communities (EC) to supply SDRs to help members cope with various short-term liquidity needs, Mr. de Groote went on. Such a mechanism, which would of course require a significant amendment of the Articles, would make it possible to respond flexibly to the needs of individual members or groups of members without the constraints of the quota-related pattern of distribution that was characteristic of a normal allocation.

Other methods providing the same kind of flexibility without requiring amendment of the Articles could be constructed on the lines of the Belgian proposal for the conditional use of SDR allocations or Mr. Sengupta's proposal for what might be termed a reserve link, Mr. de Groote stated. The basic thrust of both those proposals, as well as of the French variant, was to provide a better distribution of allocated SDRs by creating a mechanism to permit countries that did not immediately need the SDRs newly allocated to them to make part or all of their allocation available for temporary use by countries that had a reserve need. To correct certain misunderstandings that the Belgian proposal had engendered, it should be noted, as Mr. Polak had observed, that an error had slipped into SM/86/17, where it was suggested on page 19 that the issuance of SDRs under the Belgian proposal would be made conditional on the implementation of an adjustment program, similar to a stand-by arrangement. SDRs would continue to be allocated in the normal way, but with the additional proviso that countries not needing their allocations, or needing them less than other members, would be free to transfer them to the Fund under the mechanism discussed in the framework of the proposal and described in his statement at EBM/84/45 (3/26/84) and in the staff memorandum on that proposal (EBS/84/191, 9/5/84). The Fund would then on-lend those SDRs to other countries on condition that they commit themselves to use the SDRs obtained in conjunction with an adjustment program. Under Mr. Sengupta's reserve link proposal, the SDRs would be onlended unconditionally to increase temporarily the stock of reserves of a group of countries. Both those approaches were very different from stipulating that the disbursement of SDRs would be fully governed by the same rules that applied to the disbursement of the ordinary resources of the Fund. In any case, the redistribution mechanism contemplated by the Belgian proposal could very well be adapted to deal with a variety of situations in which a specific group of countries experienced a temporary need for reserves.

The second main role proposed for the SDR--to improve the composition of the reserve stock of member countries in order to increase the overall stability of the reserve system--had been present from the time of the original creation of the SDR, as he and others had recalled during the recent historical review of the role of the SDR, Mr. de Groote continued. It had been expected at that time that an SDR allocation would serve as a substitute for an increase in the official gold stock, thereby reducing the share of dollar reserves in total international reserves. That role of the SDR had become even more prominent during the 1970s with the decision to allocate SDRs in the third basic period. Gradually, it had become better understood that in the present reserve system, in which the supply of reserves was adapted over time to demand, the compositional role of the SDR was the only one that continued to have validity over the long term. An allocation of SDRs influenced the composition of reserve assets only when the total stock of reserves adapted itself to demand through a relatively smaller use of other sources of reserve supply. SDR allocations responded to a long-term reserve need that was in effect a need for a more stable component in a total that could not be influenced by centralized decisions; obversely, it was a need for a more stable total volume of reserves which could over time be satisfied through increasing the share of the more stable component.

Since the SDR's main contribution was to influence the composition of the reserve stock, it had to be shown how the SDR improved the quality of reserve assets, Mr. de Groote added. The improvement took place in several ways. As an owned reserve asset, the SDR formed a valuable buffer for the present system, which was based excessively on borrowed reserves, and thereby buttressed confidence in the system as a whole. That argument was also valid for individual countries whose SDRs gave them some protection against the vicissitudes of international capital markets. Another considerable advantage of the SDR over other reserve assets derived from its currency basket nature, which made it more stable than any single currency in the basket with respect to both interest and exchange rate fluctuations. Furthermore, as Mr. Polak had pointed out, its basket nature gave the SDR a systemic advantage over other reserve assets: it reduced the likelihood of major currency shifts by central banks because it offered them a stable, long-term investment opportunity and in that way promoted exchange rate stability.

The unanswered question was why that overwhelming evidence of the compositional qualities of the SDR had not yet attracted the necessary support for a new allocation of SDRs, Mr. de Groote stated. Somewhere along the line the mistaken assumption must have been made that an ad hoc justification was required every time the question of an SDR allocation came up. The aim of improving the composition of reserve assets through SDR allocations had been present from the outset, and that potential role had been enhanced by the way the reserve system had evolved. Thus, it would have been quite logical to accept the principle of regular periodic allocations enabling the SDR to play its legitimate compositional role. The discussions could then have focused on the amount of SDRs to be allocated and the modalities of allocation instead of bogging down over the first principles of the allocation itself. On that point, he fully agreed with Mr. Nimatallah that the first and essential step toward allowing the SDR to play its role as a reserve asset was to make the political decision in favor of a meaningful allocation. Furthermore, in order to convince those who still had doubts about the quality of the SDR as a reserve asset, efforts to make it a more complete asset, capable of serving a variety of purposes, should be redoubled. More should be done to enhance the attractiveness of the SDR as an asset to hold by broadening opportunities for its investment and by promoting its private uses. Another desirable course of action would be to find ways of making the SDR suitable for intervention purposes. In those respects, he would welcome any further comments that the Treasurer could make on the staff comparison between the SDR and the ECU in those respects.

Another general consideration bearing on the more integrated use of the SDR as a reserve asset was related to its suitability for balance of payments financing, Mr. de Groote remarked. Why should the normal practice of surplus countries in acquiring reserve assets for investment in the international capital markets and on lending to deficit countries not be extended to the SDR? If that recycling or redistribution process were to be partly taken over by the SDR, with the Fund acting as a central agent--along the lines of the Belgian proposal--the international recycling and adjustment process would be considerably strengthened. The Fund's lending operations were already partly financed with SDRs paid in by members in connection with quota increases. The further development of that embryonic function through the more flexible use of SDR-denominated reserve assets would provide considerable systemic advantages. First, the various roles of the SDR could be integrated since SDRs allocated to meet the long-term need for a better reserve composition could in the course of their existence be invested with the Fund to help cope with the various contingencies he had mentioned at the beginning of his intervention. Second, the further incorporation of the SDR into the Fund's lending operations would prepare the way for the ultimate integration of the Fund's monetary and financing roles and for the emergence of the Fund as a full-fledged monetary institution. Third, that part of future quota increases to be paid in reserve assets could be covered through an allocation of SDRs, thereby considerably strengthening the role of the SDR and of the Fund as well.

To conclude, Mr. de Groote put forward the following proposals for further action on the SDR issue. Within the framework of the present Articles, the role of the SDR should be understood and promoted as a way of improving the composition of the stock of reserves held by members; that was precisely the interpretation that had to be given to the notion of long-term global need. The promotion of that role would require further perfection of the reserve asset qualities of the SDR and political commitment to the principle of periodic allocations of SDRs. Given the risk of periodic deficiencies in the supply and distribution of reserves in the present decentralized decision-making process, the SDR also had a useful role to play as a safety net; the various proposals submitted for that purpose merited further examination and comparison. Finally, further work on the SDR should also be seen in a longer-term perspective in order to prepare the way for an integrated approach to the various functions of the SDR and the ultimate incorporation of the SDR mechanism into the Fund's general lending operations.

Mr. Grosche observed that there could be no doubt that the present system of providing international liquidity had not been working entirely satisfactorily and that improvements were called for. In correctly pointing out the various shortcomings of the present system of supplying and distributing international liquidity, the staff had made a particularly welcome point when it stated on page 4 of SM/86/17 that an open-ended supply of free reserves could invite destabilizing policies. Almost all the actual or potential roles that the SDR could assume in order to contribute to economic stability had been dealt with in the staff paper. However, he would have preferred separate treatment of those roles requiring an amendment of the Articles.

Organizing his statement according to Mr. Polak's four helpful points, Mr. Grosche observed first that he fully agreed with Mr. Polak that SDRs should be allocated in the event that the current reserve system did not provide an adequate amount of liquidity for conducting an acceptable level of international trade and financial transactions. That event was unlikely to occur in the foreseeable future but it was certainly helpful to have the instrument at hand in case a legitimate and global need could not be satisfied through current account surpluses or through lending. Such a global need could conceivably arise suddenly, and the SDR could provide a useful safety net in order to overcome an acute liquidity crisis. Again, he fully agreed with Mr. Polak that it would be difficult to envisage the precise contingencies in which the safety net would be used. Therefore, he would not advocate developing hypothetical criteria for determining a temporary liquidity shortage or ways to deal with it in precise terms. Like Mr. Polak, he believed that it would not take much time to work out the mechanics, if and when the need for contingency measures presented itself.

In that connection, he had found some merit in the staff's idea that decisions to allocate might be taken with less hesitation if they contained a safeguard clause to the effect that cancellations would take place without the need for a new decision, Mr. Grosche noted. But in practice, such a proposal would probably encounter a number of difficulties. It would be difficult to reach a consensus on an adequate rate of growth of liquidity and on the amount to be cancelled, and he doubted whether the system of indicators mentioned by Mr. Sengupta at the previous meeting would be helpful in that respect. In addition, it appeared doubtful that all countries would be able to pay back the SDRs at the time of cancellation since, as past experience showed, many countries would have spent the allocated SDRs.

Under present circumstances, he believed, with the staff, that international surveillance was the only practical and feasible way to control international liquidity, Mr. Grosche went on. Although he tended to share Mr. Polak's skepticism with respect to that statement, he detected no alternative that would be both appropriate and feasible. Efforts to make the SDR the principal reserve asset by regular, substantial SDR allocations, without a parallel and controlled contraction of traditional reserve assets, would have inflationary and destabilizing effects and should therefore not be considered further.

On the question whether the SDR could make a useful contribution to improving the quality and stability of reserve holdings, Mr. Grosche commented that that idea also was not new but had been touched upon in earlier discussions. He had detected no new arguments in SM/86/17 in support of the idea that an increase of the stock of SDRs by allocation would in itself improve the overall quality of reserves. He remained to be convinced that a shift from borrowed to owned reserves would result from steady SDR allocations. He doubted that owned reserves would replace borrowed reserves, even in the medium to longer term. Without a parallel restriction of the lending capacity of capital markets, additional allocated SDRs were more likely to supplement than substitute for borrowed reserves.

He could fully subscribe to the statement by the staff and Mr. Polak that the SDR played an important role as a unit of account in the Fund's operations and that it had also added an element of stability to the reserve system, Mr. Grosche said.

The proposal to make use of the SDR as a means of financing the Fund was a completely new departure, as Mr. Polak had pointed out, Mr. Grosche continued. Referring first to the use of the SDR as a means for resource transfer to developing countries, he was grateful to the staff for having outlined on page 20 of SM/86/17 some arguments against the establishment of an SDR link scheme. His authorities continued to oppose such a scheme, which raised a number of serious risks, in addition to the arguments made by the staff. First, the adjustment process could be weakened. Second, an apparently easily financeable transfer of resources could be inflationary and thus destabilizing. Third, the SDRs issued under such a scheme would primarily flow back to--and remain with--countries with a strong balance of payments and reserve position. The result would be not only a disproportionately high burden for those countries in the provision of real resources but would also imply an unwelcome change in the structure of their foreign reserves since such a scheme could only work if the acceptance limit for SDRs were substantially extended. That however was clearly a high price to pay in exchange for the advantage perceived by the Group of Twenty-Four--namely, that the link "would not only meet the unfilled absorptive capacity of developing countries, but also reduce the pressures on the industrial countries to accommodate an improvement in the current account balances of developing countries." He continued to believe that the necessary transfer of real resources to developing countries had to be financed by ordinary and not by monetary means, despite the political problems involved in generating the budgetary appropriations.

His authorities also had reservations about the proposal for conditional SDRs, another idea that had been discussed on previous occasions as well as in the G-10 report, Mr. Grosche said. Without repeating the arguments voiced against that proposal, he noted that balance of payments assistance by the Fund in support of adjustment programs was more appropriate. As for Mr. Sengupta's proposal, it was certainly necessary to bolster confidence in the ability of many developing countries to service new foreign debt, and additional reserves could serve that purpose. But he doubted whether the limitations that Mr. Sengupta sought to place on the reallocated SDRs would have the desired effect; there were surely better ways to demonstrate to the markets that particular countries would remain on a path of stability.

In sum, the issue of reserve shortage in problem countries was only at first glance a liquidity problem, Mr. Grosche remarked. On a second look, it turned out to be a problem of appropriate policies for adjustment and growth. Allocating SDRs in order to substitute for reserves lost as a result of inappropriate economic policies would come close to a transfer of resources by monetary means, which should be avoided.

Finally, Mr. Grosche considered that the staff's comparative analysis of the functioning of the SDR and the ECU showed clearly that there were important systemic differences between the two units with respect to their objectives, functions, characteristics, and the environment in which they operated. Those differences, particularly the composition of the basket, explained why the ECU had been more successful on the private markets than the SDR. A further essential difference was related to the fact that the ECU was designed to support the exchange rate arrangement of the European Monetary System (EMS) and not to supplement reserves.

The SDR added to reserves; the ECU simply expressed them in other terms. Moreover, the role of the ECU was indeed being determined to a large degree by Euro-political factors, whereas the SDR's role had to take into account global economic and monetary considerations in accordance with the Articles of Agreement. For all those reasons, the ECU could not serve as an ideal model for the further development of the SDR.

Mr. Huang said that he hoped that the continuing deliberations on the role of the SDR in the international monetary system would lead to some positive results. As he perceived the current situation, the SDR had not yet played a significant role in the system, accounting as it did for only a small part of the world's reserves in spite of the stipulation in the Articles of Agreement that the SDR should be made "the principal reserve asset in the international monetary system." The key currency countries had not been moving toward the fulfillment of that intention, for two main reasons, in his view. First, those countries were satisfied with the existing reserve system in which they could obtain reserves easily through borrowing in the international capital markets. Second, they feared that the increasing availability of SDRs might induce the developing countries to postpone needed adjustment.

The staff had made an in-depth analysis of the inadequacy of international capital markets that he did not need to repeat, Mr. Huang said, although he did wish to point to similar experience with the exchange markets. Not long ago, some free market advocates had been complacent about the performance of the exchange market and had rejected market intervention. Since the agreement reached by the Group of Five in September 1985, there had been no more remarks about the ideal operation of the market. He wondered whether the same analogy did not apply to the workings of the international capital markets, whose functioning was still being highly praised, even though a major government initiative--the Baker plan--had been required in an attempt to provoke the market to resume private lending to the needy countries. The malfunctioning of international capital markets had been so evident that he failed to understand how it could continue to be claimed that that market provided international liquidity in the most efficient way.

A second objection to an enlargement of the SDR's role was concern that further SDR allocations might undermine the incentives of developing countries to take the necessary adjustment measures to correct imbalances in their economies, Mr. Huang remarked. In his view, it would make no sense for any country to abandon a well-tailored adjustment program on account of a modest allocation of SDRs. The existence of an adjustment program must mean that the country was engaged in borrowing so that its overall policies would be subject to the conditionality imposed by lenders such as the Fund or the private market. That conditionality would apply also to policies and activities sustained by unconditional financing, such as the allocation of SDRs. Admittedly, an increased issue of SDRs was likely to reduce countries' borrowing from the Fund or the private market, or both. But it could be argued that as long as countries continued to borrow to some extent, the degree of conditionality would not be altered so that the intensity of the adjustment effort would not be affected.

Having made those counterarguments to the objections to enlarging the role of the SDR, Mr. Huang said that he had little to add to what had been said already by the staff and other Directors about the potential contribution of the SDR to economic stability. It was apparent that greater availability of SDRs, permitting the substitution of owned for borrowed reserves, would lessen the vulnerability of the current reserve system and increase its stability. Central banks would also be assisted through the mitigation of the exposure of their reserve portfolios to the instability of exchange rates among major currencies, and the quality of international reserves could thereby be improved. A larger share of SDRs in international reserves would also help to bring the reserve-generating process under international control and overcome the volatility of the process.

In its paper on the comparison between the SDR and the ECU, the staff had shown a feasible way of reinforcing the strength of the SDR, Mr. Huang considered. The Board's deliberations on the SDR's role should benefit greatly from that analytical study.

As for the various proposals for extending the role of the SDR, Mr. Sengupta's interesting idea of an overdraft facility was worth further exploration, Mr. Huang concluded. Mr. Polak's proposal on the SDR as a means of financing the Fund also had great value. In general, he had an open mind and would be glad to participate in the further discussion of the various proposals.

Mr. Ismael said that his chair was in full agreement with the staff's identification and analysis of the limitations and shortcomings that were deeply rooted in the existing multicurrency reserve system. As evidenced by the reports of the Deputies of the Group of Ten and the Group of Twenty-Four, concerns over the less than satisfactory functioning of international monetary arrangements were real and widely shared among developed and developing countries alike. Those concerns had led to continuous discussions, centering on the four fundamental factors underlying the ever increasing instability in the international economic system--namely, the appropriateness of exchange rate arrangements; the effectiveness of surveillance over exchange rate policies; the consistency of macroeconomic policies undertaken by the major industrial countries; and the deficiency of the reserve-generating mechanism.

The first three of those issues had been discussed intensively on a number of occasions, but largely because of divergent views on the choice of specific measures required to address the problems, a solution satisfactory to all parties had not been reached, Mr. Ismael noted. As to the fourth issue relating to the creation of reserves under the present multicurrency reserve system, several important shortcomings required immediate attention. They were the uneven distribution of global reserves or liquidity; the instability and unreliability of its supply, particularly for that part of reserves provided by a broad spectrum of private financial institutions; the misleading signals that reliance on creditworthiness gave for policy adjustment, and the imperfect perception of borrowing countries' situations on the part of private suppliers of borrowed reserves; and finally, the inability of the system to control effectively the process of reserve creation. While those problems were extremely difficult to tackle, there was a consensus in the international community on the need for longer-term structural remedies and a coordinated effort.

He had been somewhat disappointed that the staff had not made a greater effort to explore possible avenues for employing the SDR to rectify what to him was the most serious shortcoming of the multicurrency reserve system, the uneven distribution of reserves, Mr. Ismael stated. The staff had done no more than mention that "possibilities for remedying this asymmetry with the help of the SDR are limited." In the same paragraph, the staff had stated that "the only possible remedy--not a very practical one in present circumstances--for the uneven incidence of balance of payments discipline would be the replacement of the reserve-currency system by an SDR standard with 'asset settlement' instead of 'liability settlement' for all countries...." Therefore, he would be interested in having in due course a further elaboration of Mr. Sengupta's proposal, following the discussion at the previous meeting.

On the issue of the controllability of the volume of liquidity in the international monetary system, he had not yet been convinced that the adoption of an SDR allocation/cancellation mechanism would work as effectively as intended unless certain preconditions were met, Mr. Ismael said. Those preconditions included steady allocations of SDRs until the stage was reached at which the SDR became a significant component of member countries' reserves, so that the distributional problem was rectified to some degree. At that point, if sufficient progress was being made to tackle those two issues, his chair would be willing to defer consideration of a proposal to introduce the allocation/cancellation mechanism as a general regulator of global international liquidity and reserves. The allocation/cancellation mechanism inherent in a safety net scheme was more practical and attractive for dealing with acute and temporary shortages of liquidity.

As for fluctuations in the value of foreign exchange reserves arising from the erratic behavior of reserve currencies, the benefits of the substitution account, as it had been proposed during the period 1973-74 and 1979-80, were even more apparent than they had been in the past, in light of the instability of exchange rate movements in recent years, Mr. Ismael considered. In the process of searching for ways and means to reduce global financial instability, he would particularly welcome the re-examination of the substitution account by the Executive Board.

Finally, Mr. Ismael noted that according to the analysis in SM/86/20, the most striking difference between the SDR and the ECU lay in the concerted promotion effort of the countries in the EMS that had resulted in more widespread use of the ECU and ECU-denominated financial instruments in the private market. Although it had not been foreseen that the Fund would need to borrow in the private markets in the near future, the issue of broadening the private use of SDR and SDR-denominated financial instruments needed to be further explored. In particular, it would be of considerable help if the staff could make a comprehensive study of the implications of the increasing use of SDRs in the private market on global financial stability, and offer further thoughts on possible measures to encourage the private holding of SDRs.

Mr. Mtei said that he had noted from the staff analysis that the existing multicurrency reserve system could not guarantee world economic stability because of its various shortcomings, including reliance on private financial markets as the principal source of reserves, dependence on borrowed as against owned reserves, and distributional weaknesses. Because the system relied on private capital markets for the bulk of international reserves, there were wide fluctuations in the availability of international liquidity which, in turn, generated instability in the world economy. Since he was in agreement with the main thrust of the staff analysis of the systemic weakness of the international liquidity system, he would limit his intervention to the central issue--namely, the contribution that the SDR could make to alleviating the shortcomings of the system and enhancing its stability.

SDRs could provide the current multicurrency system, in which the supply of international liquidity was dependent on the deficits of a few countries, with the ability to adjust that supply to the growing needs of individual countries and the world economy as a whole, Mr. Mtei stated. The staff envisaged that in certain circumstances the current reserve system might "fail to provide even the minimum amount of liquidity necessary for conducting international trade and financial transactions at an acceptable level." There was no guarantee that the market system could automatically create the necessary international liquidity to deal with a real shortage. The SDR allocation mechanism, if it was allowed to operate effectively, could make up for that deficiency. In that connection, he shared the staff view that the SDR mechanism should be used as a control device to ensure "stable growth at an appropriate rate in the supply of international reserves." He could also support a procedure for reaching prior agreement, at the time of allocation, on indicators that could trigger the cancellation of SDRs. The SDR had an important advantage over the ECU--namely, its ability to affect the total of international reserves through allocation, whereas the ECU was created by means of a swap mechanism that involved only the substitution of alternative forms of reserve assets.

As a reserve asset, the SDR could play an important stabilizing role because its value was more balanced and stable than that of any other reserve currency, Mr. Mtei commented. In addition, the availability of

SDRs was not subject to change based on the perception of the international banking system of the creditworthiness of members, as borrowed reserves were. For those reasons, as well as the SDR's ability to minimize the impact of fluctuations in exchange rates, interest rates, and inflation, the SDR had great potential to promote world economic and financial stability and as an instrument for diversifying the composition of official reserves.

The SDR also performed an important function as an international unit of account, Mr. Mtei stated. Because the SDR basket was composed of the currencies that were most important for international trading and financial transactions and that were held by Fund members in their reserves, the SDR provided a relatively stable unit of denomination. As the staff noted on page 21 of SM/86/17, "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."

The use of SDRs as a means of payment had made little headway, other than in Fund and official transactions, Mr. Mtei remarked. In its comparative analysis of official and private uses of the ECU and the SDR, the staff had noted that the various activities of the entities and members of the European Communities had provided the impetus for the promotion of both the official and private use of the ECU. Unfortunately, the SDR had so far lacked the necessary political support. In his view, mechanisms that would enable private banks and other entities to use SDRs should be considered. Increased use of the SDR, both private and official, could contribute to international financial stability. He would support further studies by the staff aimed at promoting the use of the SDR.

The basic reason why the SDR was not performing well was that its share in world reserves had been too small and that it had not been given the opportunity to play effectively its originally intended role, Mr. Mtei said. The provision of reserves through a steady and regular allocation of SDRs could be a very important means of supplementing members' reserve needs. Such allocations would enhance members' ability to stem the adverse impact of external short-term disturbances on their own economic policies and investment planning, thereby helping to promote world economic stability. As he had already mentioned, one cause of the existing instability in the world economy was the shift to a system based on borrowed rather than on owned reserves. Since the market could not be relied upon to provide the needed international liquidity, particularly for low-income countries with no access to commercial credit, the accumulation of owned reserves became an acute problem. In that connection, two purposes could be served by SDR allocations: members that, for a number of reasons, could not borrow reserves would acquire the reserves they needed; and the share of SDRs in total reserves would be increased.

The proposal of the Group of Twenty-Four for a link between SDR allocations and development finance remained relevant, Mr. Mtei considered. Apart from dealing with what the staff had referred to as the "distributional shortcomings of the current reserve system," a direct link between

SDR allocations and development financing would improve both the reserve position of developing countries and their ability to pursue more stable economic policies. It would be worthwhile if the staff could prepare a paper on that specific issue.

In referring to the proposal for issuing conditional SDRs, the staff had suggested that that could be done "by tying the issuance of SDRs to the implementation of adjustment programs," Mr. Mtei noted. He would be interested in knowing whether the allocation of SDRs to the Fund and their conditional use would not contravene the letter and spirit of the Articles of Agreement. He supported the position taken by the Deputies of the Group of Twenty-Four that "only an unconditional SDR allocation could provide the required reserve strength...." However, if SDRs already allocated to countries in surplus could be made available to developing countries in need of reserves, either directly or through the Fund by way of conditional credits, he would raise no objection. The various schemes proposed by Executive Directors, including Mr. Sengupta and Mr. de Groote, could be further studied and their technical implications analyzed.

Mr. Mawakani said that the views that his chair had expressed during the Executive Board's discussion at EBM/86/18 (1/31/86) on the role of the SDR remained valid and were indeed relevant to the issue at hand--namely, the various ways in which the SDR, as an integral part of the system, had contributed and could further contribute to the stability of the world economy in the present international reserve system. The heavy reliance of the present system on international credit markets for reserve creation and distribution entailed some asymmetries to the disadvantage of most developing countries. On page 9 of SM/86/17, the staff had referred to the inability of the multicurrency reserve system to exert the automatic surveillance of the balance of payments adjustment of countries inherent in the gold standard system. While that assertion was valid for creditworthy countries that could pursue expansionary monetary and fiscal policies without incurring unsustainable external payment deficits, it was questionable in the case of noncreditworthy countries. Indeed, in pursuing expansionary economic policies, those countries rapidly incurred large external payments deficits and faced the necessity of adjusting. That was another aspect of the asymmetry in the present system.

Economic stability in such a system, to paraphrase a passage of the G-10 report, depended primarily on the pursuit of sound policies to achieve sustainable noninflationary growth by creditworthy countries, Mr. Mawakani remarked, because noncreditworthy countries would be confronted in any event with pressure to adjust and could not pursue destabilizing monetary and fiscal policies for long. For those countries, the abrupt application of pressure to undertake balance of payments adjustment gave no room for a smooth adjustment process and therefore did not contribute to economic stability. On the whole, because of the sudden change in the availability of liquidity in the system, countries were forced to reduce their rates of economic growth and to restrict external trade. Although he recognized that it would not be very practical under present circumstances, he wondered whether serious consideration should not be given to the idea put forward by the Committee of Twenty in the early 1970s calling for the establishment of an SDR standard, with asset settlement for all countries as a way to correct the asymmetry in the system.

On a related matter, the staff had referred on page 10 of SM/86/17 to shifts in market perceptions of creditworthiness that were based on inappropriate or irrational considerations and the difficulties of restoring creditworthiness even after vigorous adjustment had taken place in countries perceived as noncreditworthy, Mr. Mawakani said. Those problems reinforced the argument for the Fund not to let the decisions of private creditors govern the creation and distribution of reserves. Indeed, as the staff had pointed out, "the global supply of reserves depends mainly on decentralized decision making of numerous private financial institutions in several countries, generally acting in the interest of their shareholders."

As his chair had stated at EBM/86/18, the new valuation of the SDR, by ensuring a closer relationship between the behavior of that instrument and the evolution of underlying economic conditions in the five major industrial countries, could bring some stability to the world economy, Mr. Mawakani continued. The SDR, being a basket of the five major currencies that were generally held as reserve currencies, could also help to solve the compositional problem inherent in a multicurrency system of floating exchange rates. If the SDR were to become prominent in the system as a unit of account, the destabilizing effects on exchange markets of currency substitution by reserve holders would be minimal, thereby contributing to further stability of the system. In that connection, it might be useful to resume the discussions on the establishment of a substitution account. As suggested by the staff, a gradual process of substitution facilitated by steady allocations of SDRs could help to overcome the difficulties encountered in the course of the discussions on that issue during the periods 1973-74 and 1979-80.

The unreliable availability of reserves when they were most needed had been mentioned by the staff as the most serious deficiency of the present system, Mr. Mawakani noted. Even for countries with access to international capital markets, that unreliability and the uncertainties pertaining to the terms and conditions on which borrowed reserves were acquired had prompted a shift toward owned reserves, irrespective of the cost. The high real cost of acquiring reserves through the generation of current account surpluses could not be overemphasized; in many instances, it had entailed a sharp curtailment of imports. Such a process, if generalized, could become a serious drag on the growth of international trade and of the world economy. Therefore, SDR allocations of the magnitude mentioned by Mr. Nimatallah under his Option 1 could provide countries with a useful supplement to the level of reserves they wished to hold in relation to their international transactions, and thus could enhance the stabilizing role of the SDR in the system.

The Deputies of both the Group of Twenty-Four and the Group of Ten had recognized that the performance of the present system had not been satisfactory and had stressed the need for greater stability to ensure smooth adjustment toward steady noninflationary growth of the world economy, Mr. Mawakani noted. The staff had reviewed extensively the various techniques by which the SDR had contributed and could further contribute to economic stability. While some of those techniques would be difficult to implement at the present time, many of them were within reach because they could be put in place under existing provisions of the Articles of Agreement. For instance, Article XVIII directed the Fund to allocate and cancel SDRs under certain circumstances, and Article XXII called upon participants in the SDR Department to collaborate with the Fund and with other participants in order to facilitate the effective functioning of that department and achieve the objective of making the SDR the principal reserve asset in the international monetary system.

The staff had made references in SM/86/17 to the concepts of a safety net and conditional SDRs as possible alternatives for consideration, Mr. Mawakani observed. Although the objective of a safety net might be appealing--namely, to deal promptly with an acute liquidity shortage in the system--he would have some difficulty if the intention was to relegate the SDR to a minor role in the international monetary system. In that connection, he agreed with Mr. Polak that the mechanics to counter the type of contingency that the safety net was supposed to tackle could be put in place at any time "provided always that the Fund had a functioning SDR allocation mechanism in place."

The search for ways in which the SDR could contribute effectively to economic stability should be conducted against the general background of the supply of SDRs and the promotion of the SDR, Mr. Mawakani considered. Unfortunately, the allocation issue was no longer in the realm of technicality but had become a political issue. With more political will on the part of all Fund members, the asset would go a long way in contributing to greater economic stability. In that respect, the comparative analysis of the functioning of the SDR and the ECU undertaken by the staff was revealing. Indeed, despite the fact that the SDR had been created ten years before the ECU, the latter had outperformed the former in many respects. For instance, the ECU had accompanied a growing degree of exchange rate stability within the EMS; its use had induced greater economic stability in the European Communities than the SDR had in the world economy. Moreover, private ECUs had gained credibility in international financial markets while private SDRs, apart from their short-lived success toward the end of 1981, had not been greatly used in private financial transactions. As explained by the staff, the reasons for such differences in the behavior of the two currency units, which nevertheless had much in common, lay in the attitude of the respective "parents," the differences in some of their characteristics, and to some extent, the peculiarities of the situation of some EC members. Perhaps the foremost contributory factor had been the attitude of the "parents." EC members had shown a strong political commitment to making the ECU the principal asset within the community and the numeraire for expressing central rates used in the exchange rate mechanism of the EMS. It was such strong political commitment from the membership of the Fund that was required to promote the SDR but that so far had been lacking.

To summarize, the lessons to be drawn from the EMS experience were that with strong political will translated into efforts to ensure convergence of national economic policies, substantial progress could be achieved toward making the SDR the principal reserve asset in the international monetary system, Mr. Mawakani concluded.

Mr. Nebbia observed that the exchange rate and international reserve systems were undergoing dramatic change while at the same time the world's leaders were showing increasing political will to introduce substantial reforms in the international monetary and financial systems. The Fund should respond appropriately to the demands of that new situation and, rather than discussing the role of the SDR in the present system, should envisage its potential contribution in the transition to the new system that was currently evolving. In particular, the specific proposals relating to the SDR should be consistent with new policies on intervention in exchange markets, the new proposals to deal with the debt problem, and the role envisaged for the Fund in the new system.

The present system for supplying international reserves was based on weak and unstable mechanisms, Mr. Nebbia noted. To gain access to reserves, countries had to be deemed creditworthy by private financial markets. Yet it had been shown that many systemic and subjective factors beyond the control of countries affected expectations and therefore creditworthiness. Political, strategic, and geographical factors, as well as a country's stage of development, were key elements used by private markets to assess creditworthiness. Those elements, together with systemic factors--such as external prices and international interest rates--could not be controlled by countries themselves. It was necessary to move toward a system based on more robust pillars.

SDRs had not been created to play a countercyclical role, Mr. Nebbia stated. But reliance could not continue to be placed on current arrangements for the supply of international liquidity because those arrangements were reinforcing the deflationary and inflationary pressures in the world economy. In times of economic growth, expectations rose too high, and excessive lending and inflationary pressures emerged. When the cycle turned down, private markets became reluctant to lend, and the scarcity of liquidity deepened the decline in world output and trade.

Substantive allocations of SDRs at a steady rate could change the current imbalance between borrowed and nonborrowed reserves, Mr. Nebbia added, thereby counteracting the current fragility in the international financial system. Since the availability of borrowed reserves depended on access to private capital markets, the major problem of the present system was the distribution of international liquidity. Many developing countries that had adopted strong adjustment policies during the past few years had not recovered their creditworthiness; therefore, they could not obtain the minimum reserves they needed to finance a pace of adjustment that was compatible with their urgent need for economic growth. He agreed with Mr. Sengupta's statement during the earlier discussion of the role of the SDR at EBM/86/17 that while the SDR's unconditional character should be retained, new procedures should be devised to enable the Fund to change the distribution mechanism so as to take into account the particular needs of different countries at the time of allocations. In that respect, it would be useful if the staff could prepare a document on all the alternative procedures mentioned during the previous meeting--namely, those of Mr. de Groote and Mr. de Maulde--particularly in connection with Mr. Sengupta's proposal, which implied unconditional lending of SDRs when countries had a need for international reserves. That specific proposal might meet the concern not only of those industrial countries that opposed SDR allocations for fear that adjustment efforts would be relaxed but also of the developing countries that had stressed the need to maintain the unconditional character of SDRs. Such a paper could help to clarify and formalize many of the issues on which comments had been expressed during the exchange of views at EBM/86/35 (2/26/86).

The problem of reserve distribution raised once again the validity of the proposal for a link between allocations of SDRs and development finance, Mr. Nebbia remarked. Under present circumstances, a link would allocate SDRs more efficiently because it would meet the urgent need of developing countries for reserves, while at the same time those countries not suffering from a reserve shortage--because they already had access to private capital markets--would not need to be supplied with reserves.

The greatest difference between the ECU and the SDR lay in the vastly different experience with the two units in the private sector, Mr. Nebbia stated. Therefore, it would be productive to explore, first, whether the development of the private SDR could enhance the functioning of the SDR as an official reserve asset and, second, what improvements should be made to the SDR in order to promote its use in private markets. In discussing the SDR's role as a stabilizer in the world's monetary arrangements, and taking into account recent developments in the exchange rate field, it was important to evaluate experience with the ECU as the unit in which EMS intervention credits were denominated and in supporting other exchange rate arrangements of the EMS.

Mr. Lundstrom thanked the staff for the two very helpful papers and Mr. Polak, Mr. Nimatallah, and Mr. Sengupta for their constructive statements. He remarked that most of the views expressed by his chair during the previous discussion of the role of the SDR were relevant to the present discussion. In supplementing those views briefly, there were many points he did not need to cover because he agreed with Mr. Zecchini.

SDR allocations should retain their function as a complement to other forms of reserve creation, Mr. Lundstrom stated. It was desirable to continue to have an instrument for the creation of reserves through carefully considered international decisions. A larger share of the SDR in international reserves would improve the quality of reserves and the stability of the reserve system. In that context, he was interested in the idea of allocating SDRs at a steady rate in order to increase gradually the share of SDRs in reserves. That method should be analyzed in further in-depth studies on how to modify the allocation mechanism, and those studies should include measures to promote the use of SDRs.

As for the suggestions that aimed at extending the stabilizing tasks of the SDR--and that might require amendment to the Articles of Agreement--such changes must not infringe on the long-term role of the SDR as a complementary reserve asset, Mr. Lundstrom emphasized. In other words, the result must not be to relegate the SDR system in the future solely to, for example, a safety net function. Therefore, it was essential to remove existing obstructions to decisions on regular allocations before additional functions for the SDR were given serious consideration.

Making the allocation mechanism more flexible in order to cope with short- and medium-term liquidity needs might of course have a certain stabilizing influence, inter alia, through the signal effect, and should therefore be considered further, Mr. Lundstrom said. However, some problems should be noted. To begin with, it was difficult to assess, in each particular instance, the need for a general infusion of liquidity. Moreover, increased flexibility might reduce confidence in the SDR's long-term role. For instance, decisions on cancellation--even when there were good economic grounds--could contribute to a loss of confidence and partially reduce the principal advantage of the SDR over borrowed reserves. Yet the very possibility of subsequent cancellation might facilitate agreement on allocations. Perhaps one cautious step forward might be to stretch somewhat the criterion of long-term need to include medium-term needs that, with a certain degree of probability, could be expected to become long term.

The safety net function for the SDR raised problems, some of which were similar to those he had just mentioned, but its exceptional character suggested that it should be considered as a somewhat separate issue, Mr. Lundstrom commented. The idea as such was interesting since the allocation mechanism was in place and could be used quickly. At the same time, one of the many questions that arose concerned the general criteria for making such allocations and the guarantees that might become necessary to safeguard confidence in the SDR in a crisis situation. Of course, once a crisis had arisen, the guidelines would have to be adapted to the situation.

His view on the link issue was negative, Mr. Lundstrom stated. With respect to conditional SDRs, he confirmed his support for further studies, which had undoubtedly been given additional impetus by the exchange of views at the previous meeting. He was particularly grateful for Mr. de Groote's interventions, and he looked forward to a staff paper setting out the various options.

The staff's comparative analysis of the SDR and the ECU demonstrated clearly that even if there were many extrinsic similarities between their official functions, the fundamental settings and circumstances of their use differed considerably. The ECU was largely conditioned by its role in European economic cooperation whereas the SDR lacked a corresponding foundation. It was therefore difficult to extract proposals for strengthening the SDR from a comparison with the ECU. The development of the private SDR should take place in prevailing market conditions. Accordingly, it was important that authorities not discriminate in favor of either the SDR or the ECU in order to avoid distortions in the markets.

It was in any event necessary to adopt measures to increase the attractiveness of the SDR, Mr. Lundstrom observed. Obviously, such measures had to emanate primarily from the Fund but also from the ministries of finance and central banks of member countries. A sufficiently attractive SDR was a precondition for increased use of the asset, both official and private. In favoring the introduction of measures to those ends, his authorities believed that any possible changes should be directed primarily toward the official SDR.

Ms. Bush said that in assessing the potential contribution of the SDR to future economic stability, the staff paper made a legitimate point in noting that international reserve balances did provide a degree of policy flexibility for member countries that helped them to pursue sound economic policies in a steady fashion. Reserves acted as a shock absorber in the face of unexpected external and internal events. To the extent that such events were temporary, reserves helped to avoid abrupt shifts in policy; if they were more permanent, authorities were able to respond in a measured manner by taking the required new adjustment measures. Since SDRs were a component of international reserve holdings, they could play a role in permitting reserves to cushion policies to deal with those shocks.

However, the staff had also correctly pointed out that the cushion provided by reserve holdings might tend to influence member countries to delay taking the necessary adjustment measures, with the result that later corrective measures had to be stronger, more abrupt, and potentially destabilizing to the economy and to the monetary system, Ms. Bush continued. Thus, the key question was whether or not the SDR, as a supplemental source of liquidity, could play a role that encouraged sound economic policies and thus led to greater economic stability. The importance of sound economic policies, close international economic cooperation, and convergent economic performance had also been the principal theme of Mr. Dallara's comments on surveillance at EBM/86/29 and EBM/86/30 (2/19/86).

As her chair had noted during the earlier discussion of the impact of changes in the international monetary system on the role of the SDR, it was essential for the Board to accept some common view of the world liquidity environment within which the SDR would operate if it was to reach a consensus on the future role of the SDR, Ms. Bush commented. In that connection, it seemed evident that for the foreseeable future the main source of international liquidity would continue to be private capital markets and that the international liquidity system would continue to be characterized by widespread use of a number of reserve currencies. The only quick alternatives would involve some form of substitution account or the imposition of exchange controls to limit or control the creation of liquidity by private markets, neither of which were realistic or desired. The best way to achieve a greater degree of economic stability, at least for the foreseeable future, therefore seemed to be build upon the current international monetary system, through the instruments of the exchange rate, surveillance, or international liquidity.

With respect to the stability of the present system, she had not been persuaded by the argument that the current multiple currency cum private financing system was inherently asymmetrical or unstable, Ms. Bush went on. That was different from saying that it had not at times shown some signs of instability. It could be argued that the present system possessed certain intrinsic advantages, and that if anything, it might well be more symmetrical than its predecessor. A number of major currencies, although their relative roles clearly differed greatly, were acting as reserve currencies, and many countries had access to international credit markets. The presumed benefits to reserve currency countries might be offset by the fact that their monetary and exchange rate policies were somewhat circumscribed by the system. Furthermore, the United States--and other reserve currency countries as well--must follow sound economic policies if they were to retain access to international credit markets.

More open capital markets also afforded portfolio managers better opportunities to hedge and diversify risks, Ms. Bush remarked, and, more broadly, offered financing opportunities in support of sound investments and sound policies on a scale that dwarfed capital flows under the Bretton Woods system. Thus, creditworthy countries currently had more freedom than ever before in terms of policy options with respect to the domestic economy, exchange rate flexibility, and the management of foreign liquidity. Whether that greater freedom of economic management had been or would be used well or badly would largely determine whether or not the international monetary system was stable. To be sure, large-scale portfolio shifts could occur, with some adverse consequences for international monetary stability. But that was basically true of any system, particularly of any realistic alternative to the current system. Such shifts also largely reflected responses to fundamental changes in economic policies and unexpected economic events rather than systemic imperfections.

The rapid growth of private markets as a source of international liquidity was a major change of recent years, Ms. Bush added. On the whole, private markets had basically served the system well, particularly since it had been neither realistic nor desirable for official sources of liquidity to perform the role played by private markets in the 1970s. The supply of liquidity under current arrangements was potentially very responsive to demand. Countries able to maintain confidence in their underlying creditworthiness typically could obtain adequate financing, reflecting the efficiency of the private markets. The lack of access of some countries to international capital markets primarily pointed to an inadequacy of economic adjustment efforts in those nations. That being said, private markets had not always functioned optimally from the standpoint of generating an appropriate amount of global liquidity. At times, liquidity had seemed excessive, at least in retrospect, and at other times too restrictive. For instance, although it was generally considered with the benefit of hindsight that liquidity creation in the 1970s and early 1980s had been excessive, particularly for some countries, it had seemed important at the time to recycle large amounts of petrodollars. Moreover, the use to which such capital flows had been put and the economic policies they had sustained had received too little attention. Contrarily, it was no secret that her authorities had been concerned about the recent sharp contraction in bank lending.

Referring to the presumed shortcomings of the current international reserve system as presented in the staff paper, Ms. Bush recalled that the SDR had been created to address problems concerning the scale of international liquidity. As she had suggested earlier, she was skeptical about the possibility of agreeing on the appropriate amount of global liquidity, particularly because it was not so much the quantity of reserves that was crucial but the influence that reserves could have on a country's management of its economy. As indicated in the staff paper, reserves could act as cushions when economic conditions changed or they could help authorities to delay needed responses to changing economic conditions.

As for what were called distributional shortcomings of the current reserve system, she had mentioned at both the present and previous meeting the strong skepticism of her authorities about supposed asymmetries in favor of reserve currency countries, Ms. Bush continued. The second type of asymmetry--in terms of countries' differential access to and the cost of international private credit--could not be tackled with the SDR, which was an inadequate instrument for the purpose, as the staff itself had pointed out, because of the implied need to aim the remedy at specific countries.

Furthermore, the SDR, being an owned reserve, did not need to be refinanced periodically, Ms. Bush added. The other side of the coin was that it constituted unconditional financing, which in a systemic sense could be viewed as making SDRs less attractive than borrowed reserves because they did not provide a useful discipline over economic policies, together with a corresponding contribution to economic stability. Thus, greater quantities of SDRs, or their allocation to countries with immediate financing gaps, might not improve overall stability.

As for supposed compositional shortcomings, the SDR as a unit of account did offer a degree of convenience but, again as the staff pointed out, it was not essential to portfolio diversification because with little additional effort, reserve holders could diversify their portfolios in such a way as basically to replicate the SDR, Ms. Bush remarked.

The fact that SDR-denominated assets had not increased greatly in volume on private markets suggested that on balance the SDR had not been found to have important comparative advantages as a global asset over dollar-denominated or other reserve currency-denominated assets. Nevertheless, the SDR did have an attraction for some who, for various reasons, preferred an alternative to major reserve currency portfolios.

Further criticisms of the current system, Ms. Bush observed, were that financial institutions had difficulty in assessing country risk; that instructions issued by bank regulatory agencies worsened market perceptions of countries' creditworthiness, and that official export credit agencies were too quick to cut off cover. If financial institutions did fall short in their ability to assess country risk, then it was incumbent upon the Fund and member governments to encourage financial institutions to further develop their skills and expertise in assessing country risks. That was important, as private financial institutions were the major source of liquidity in the current system. Moreover, she challenged the suggestion that bank regulatory bodies took a view of a country's adjustment effort and creditworthiness that was frequently and significantly different from that of the banks themselves. In fact, banks frequently made provisions for loan losses before they were ordered to do so by regulators. In the United States, certainly, regulators were well informed of developments in major debtor countries, including the status of their economic adjustment efforts. If commercial banks did not have regulatory or oversight bodies to look to for a second view, they might conceivably be more prone to take the most conservative action in terms of loan loss provisions at an earlier stage in order to protect their financial positions. That could be inferred from the quickness with which public securities or bond markets responded to economic and financial problems of sovereign nations, credit in those markets tending to be restrained rather quickly when problems began to surface. In sum, the bank regulatory bodies performed a useful function in the overall management and stability of the international monetary system. Finally, official export credit agencies had generally become more flexible in their approach to cover for countries that had encountered debt problems, although some further evolution of that approach was possible.

As she had suggested, the best contribution that the SDR could make to enhancing the stability of the system would be by improving the quality of economic management, economic coordination, and economic performance, especially among major countries yet it was hard to see how the SDR could play more than a marginal role. She would be interested in the further reflections by the staff and members of the Board, but she had doubts about the extent to which specific proposals made so far could realistically be expected significantly to improve monetary stability. In addition, she wondered how accurately governments and international institutions could assess systemic liquidity needs in response to changed economic conditions and whether a greater role for the SDR in providing liquidity would make a substantially positive contribution.

In that connection, certain questions came to mind, Ms. Bush remarked. For instance, could the Fund effectively control the stock of global liquidity through the SDR, even if what was a proper stock was known? Use of the SDR creation process would appear to be particularly cumbersome in cases of temporary liquidity need because a political decision would be required to cancel an SDR allocation. If countries did not have access to capital markets because of inadequate adjustment efforts, should allocations of SDRs be made to ease their access to financing? Would conditional financing by the Fund of adjustment programs not be a superior response?

Referring to some specific ideas explored in the staff paper, Ms. Bush said that she wondered whether periodic but reversible SDR allocations and cancellations to meet temporary liquidity needs were feasible. For instance, how could cyclical effects be disentangled from secular effects in determining the need for reserves? In addition, an allocation/cancellation process might not be politically realistic.

Her authorities continued to oppose strongly any role for the SDR as a mechanism to transfer real resources, either as a basic source of liquidity or as a means of subsidizing the cost of borrowing reserves, Ms. Bush added. Such an SDR role would clearly be inconsistent with the Articles, and would undermine the monetary nature of the SDR. It could also undermine creditor countries' willingness to contribute to the financing of the institution and perhaps adversely affect other forms of official aid flows.

The idea of a conditional allocation of SDRs might be interesting in theory, Ms. Bush remarked, but it could raise difficult legislative questions in a number of countries and could be viewed as a means of substituting for quota increases. In addition, strong opposition had been expressed in the Executive Board to such an element of conditionality, raising doubts about the possibility of reaching a consensus.

Her authorities did not reject the concept of a safety net, which might be usefully explored in connection with contingency planning, Ms. Bush considered. However, it was not at all clear that there was a practical role for the SDR in that respect.

She had reviewed with interest the paper comparing the functioning of the SDR and the ECU, which had clearly evolved in rather different ways, Ms. Bush observed. An active promotional effort in support of the SDR was not likely to have made a great deal of difference. The crucial distinction between the two units reflected the very different regional versus global roles that they played. Certainly, there was no counterpart among the entire Fund membership to the special economic integration efforts which had given birth to the ECU. However, she was hardly an expert on the EMS and the ECU, and she had been interested in the views of her European colleagues.

In conclusion, Ms. Bush remarked that although her comments about the potential future role of the SDR in adding to the stability of the international monetary system might have sounded rather negative, she continued to be persuaded that sound economic policies in all member countries and good international cooperation remained the key to such stability. Furthermore, she was convinced that such policies and stability could be further encouraged by strengthened international surveillance. Possibly the SDR could, in some fashion, enhance stability by influencing economic policy responses in a favorable manner. But it was still difficult for her to see just how that could be done any better than under the present system.

Mr. Finaish said that he continued to think that the SDR remained useful under present international monetary arrangements and that it had the potential of becoming more useful if its role was enhanced through making steady periodic allocations of significant amounts and improving its attractiveness to make it competitive with other reserve assets. Besides the use of the SDR as a unit of account, the original roles envisaged for the SDR--as a supplement to existing reserve assets and as a means of reducing asymmetries associated with the reserve supply mechanism--remained relevant under the existing international monetary system. Moreover, the SDR had the potential of playing other roles that could contribute further to the stability of the world economy.

The major change affecting the reserve system since the move from the Bretton Woods gold exchange standard to the current regime had undoubtedly been the emergence of international capital markets as the major generator of reserves, Mr. Finaish continued. Given certain assumptions, markets led to efficient solutions but not necessarily optimal solutions as long as they could be improved upon in some desirable sense. For example, market solutions might lead to a distribution of income and wealth that might be considered inequitable. In addition, the assumptions required for market efficiency did not always hold, for instance, in cases of deficiencies in information and the existence of monopolistic or oligopolistic elements in the market. Consequently, a case could be made, in principle, for the SDR to supplement or modify the supply of liquidity generated by the free international capital markets.

The principal role envisaged for the SDR had been reserve supplementation to help alleviate existing or expected shortages of international liquidity, Mr. Finaish noted. The evolution of more developed, freer international capital markets had made it difficult to determine the existence of a reserve shortage in the sense of demand for reserves exceeding available supply at some particular price. By borrowing in the international credit markets, creditworthy countries could satisfy their demand for reserves at all times, and thus a global need for reserve supplementation to bring demand and supply into equilibrium seemed unlikely. However, such a view ignored the impact of various market imperfections and the problems faced by countries perceived as noncreditworthy. More important, it ignored the significance of the terms on which reserves were supplied. The level of reserves at which the demand for and supply of reserves were equal was adequate only in that narrow technical sense but not necessarily in the optimal sense of being the most conducive to international economic prosperity. In the latter sense of optimality, equality of the demand for and supply of reserves did not preclude the advisability of deliberate reserve creation in order to improve the terms on which reserves were supplied or the manner in which they were distributed.

The staff had identified three problems of stability--of scale, composition, and distribution--and had examined the possible contribution of the SDR in alleviating each of them, Mr. Finaish noted. While the scale and compositional inadequacies of the present reserve and liquidity generating process were not insignificant, those of a distributional nature were by far the most serious. An important distributional problem was the asymmetry associated with creditworthiness. The cost of augmenting reserves for creditworthy countries was the relatively small difference between the rate at which reserves were borrowed and the rate at which reserves were invested. The similar cost incurred in augmenting reserves in countries without access to international credit markets was the high real cost associated with the need to generate external payments surpluses. Other aspects of that asymmetry related to the manner in which the market evaluated creditworthiness. For instance, present arrangements appeared to penalize countries that were small in size, at a low stage of development, in a certain region, and/or having once lost their creditworthiness.

Another asymmetry, which had been reduced but not completely eliminated under the current multiple currency reserve system, was that between reserve centers and other countries, Mr. Finaish commented. Not only was the demand for reserves by reserve centers less in relative terms than that of other countries, but reserve centers could also finance external deficits or augment their reserves through the issuance of liabilities denominated in their own currency. Other creditworthy countries, including some industrial countries, did not have that privilege.

The staff's belief that the SDR could make only a limited contribution toward remedying the aforesaid asymmetries was largely correct, within the context of the present institutional setting, Mr. Finaish remarked. The reasons underlying the staff view included the need to direct distributional remedies at specific countries or developing countries as a group, whereas the SDR mechanism, as set out in the Articles of Agreement, focused on the scale of reserves and made no allowance for remedying distributional shortcomings. At the time of the negotiations leading to the establishment of the SDR, the need for deliberate reserve creation had been emphasized, and the judgment had been made that the needs of developing countries for development aid fell outside the framework of a mechanism focused on reserve creation. It could still be argued, of course, that developing countries' share of SDR allocations should be increased, based on their greater demand for reserves in relative terms compared with developed countries, but that argument seemed futile at a time when no agreement had been reached on making even modest allocations to prevent the SDR from becoming rather insignificant.

At any rate, the liquidity problems experienced by most developing countries under the present reserve and liquidity generation process was serious enough to warrant devising an effective solution for them, Mr. Finaish added. The systemic dimension of developing countries' inadequate access to liquidity flows and reserves strengthened the case for searching for such a solution. The SDR had the potential of providing a framework for meeting at least part of the liquidity needs of developing countries, and at no, or limited, cost to creditors. The use of SDRs generally conferred an element of concessionality on developing countries in terms of a lower rate of interest, whose burden creditors acquiring SDRs did not necessarily assume. In effect, the risk premium of the free market was alleviated: the SDR rate of interest was a market rate from the perspective of creditors while developing countries could not borrow at such a rate in private markets. In addition, the certainty with which the SDR was available was a quality that access to the free market did not provide.

At the previous meeting, an interesting and largely impromptu discussion had taken place on some specific proposals seeking to address the question of how to direct the allocation of SDRs toward countries that needed them most, Mr. Finaish recalled. Those proposals differed in some significant respects. He had noted the useful clarification by Mr. Sengupta of his proposal as a mechanism not for channeling SDR allocations to developing countries as long-term development assistance--the familiar link concept--but rather as a mechanism for channeling needed reserves to those countries. The mechanics of the various proposals needed to be fleshed out and analyzed more fully by the staff as a basis for a fuller round of discussion. However, while deliberations on such proposals might continue in the future, that task should not stand in the way of consideration of the question of an SDR allocation under existing arrangements.

Finally, for the SDR to be effectively used in the performance of its role in the international monetary system, changes needed to be instituted to make the SDR attractive enough to acquire and hold as a matter of free choice, Mr. Finaish concluded. The need for designation, coupled with the feeling of being taxed when designated, reflected the inferiority of the SDR relative to other reserve assets. One possibility for exploration, in order to increase the attractiveness of SDRs, was the elimination of the understanding that participants must have a balance of payments need to use SDRs. Of course, there were other ways to increase demand for the SDR, as other Directors had already mentioned.

Mr. Salehkhou stated that it was encouraging to note at the outset that the need for greater stability and improved performance of the international monetary system had been recognized in the reports of the Deputies of both the Group of Ten and the Group of Twenty-Four. However, in spite of the increasing number of deficiencies of the current international reserve system and their adverse impact on world economic stability, consensus on international action to establish a more stable framework within which to alleviate the instability of the system was still lacking. Although recent actions by major reserve currency members had had some positive results, the purposes of the Fund, which according to the Articles were to promote international cooperation and to promote exchange stability, had been undermined for lack of the participation of the full membership in the decision-making process.

The developing countries, whose economies had been severely affected by the mismanagement of international liquidity, had also been unable to make an effective contribution to that decision-making process, Mr. Salehkhou added. Therefore, he strongly supported the recommendation of the Group of Twenty-Four Deputies that "a suitable institutional mechanism should be evolved for an in-depth and joint examination of the two reports." Only in that way could it be proved that there was meaningful international cooperation among members at large.

The staff had skillfully explored and elaborated the shortcomings of the present system and he need not repeat them, Mr. Salehkhou continued. However, he wished to emphasize that the brunt of the burden of such weaknesses had been borne largely by developing countries. The adequacy of international reserves played a crucial part in stabilizing the external sector of an economy, yet while most developed countries had ample access to international reserves, other countries found their ability to acquire reserves constrained. The latter countries therefore had had to create the reserves they needed through the generation of balance of payments surpluses which, considering the limited prospects for increasing exports, had called for a considerable contraction in imports.

Conversely, the adverse effects of unlimited access to international reserves, permitting a country to pursue destabilizing policies by spending acquired reserves to finance a balance of payments deficit, were clearly matters for concern, Mr. Salehkhou went on. The shortcomings of the present system, which provided no global, automatic constraints on the policies of any country, could be attributed mainly to those developed countries that were in a position to continue such destabilizing policies without undertaking necessary adjustment measures.

The supply of reserves in the present system was also a matter of serious concern, Mr. Salehkhou stated. Private financial institutions, which had increasingly become the main source of reserves, were heavily influenced by nonmarket forces. Their evaluation of individual countries' creditworthiness relied largely on the political attitudes of the official agencies in major currency countries, as indicated also on page 11 of SM/86/17. Changes in the conditions on private financial markets as a result of economic policies designed or pursued by key currency members harmed the developing countries, including those whose creditworthiness had been restored. The very limited access of some groups of countries to market borrowing had been acknowledged in both the G-10 report and the U.S. initiative to seek debt relief for developing countries that called, inter alia, for increased lending by the private banks. However, while the prospects of that initiative were still not very clear, it would at best mitigate only temporarily the existing deficiencies of the current reserve system.

Exchange rate fluctuations, which appeared in some circumstances to favor a country or group of countries while at the same time harming others, also had destabilizing effects on the world economy, Mr. Salehkhou observed. That happened when confidence in a reserve currency was lost, and countries holding such currency in their reserves collectively decided to change the composition of their reserve assets.

The possible contribution of the SDR to enhanced economic stability by countering the effects of shortcomings with respect to the scale, composition and distribution of reserves in the present system had been well presented by the staff, Mr. Salehkhou considered. While SDRs, in addition to being a reserve supplement, could also be considered as a safety net to deal with the liquidity crisis of the present system--which lacked an automatic governor--it was discouraging to note their declining share in total reserve assets. SDRs could also alleviate the compositional problem of the multicurrency reserve system by protecting reserve holders against wide fluctuations in the value of their reserve holdings.

While he strongly supported the view of the G-24 Deputies that "only an unconditional SDR allocation could provide the required reserve strength," and while he was not in agreement with the view that SDR allocations would weaken adjustment efforts, Mr. Salehkhou considered that an SDR contribution to the extension of Fund credit to individual countries--an issue that should be discussed separately--would alleviate part of the distributional shortcomings of the system. However, it would be necessary for such credit not to become conditional or to be linked in any way to the implementation of adjustment programs.

Despite all the advantages that could be envisaged for the SDR in contributing to economic stability, and despite sufficient technical data and objective analysis by the staff, the necessary allocation of SDRs unfortunately continued to be opposed by a few industrial member countries, Mr. Salehkhou stated. Since the existing requirements for SDR allocation had been questioned by some major members, a more precise definition of the requirement of long-term global need, as set forth in Article XVIII and in other related Articles of Agreement, could help to overcome that problem.

To conclude, Mr. Salehkhou said that because direct control over the liquidity-creating process was not feasible and because SDR allocations could only alleviate--not control--the deficiencies of scale of the system, international surveillance over the policies of members, with emphasis on reserve currency countries, remained the principal mechanism for control of world liquidity.

The Director of the Research Department said that he could agree with the three points that Mr. Polak had added to his opening statement--namely, that the central banks were the main force supplying credit to the world; that even if that force were kept under control, the distribution of the credit might be inappropriate; and that in any event, the proportion of that credit flowing into reserves depended upon the decisions of governments or central banks. If those points were absent from the staff paper under discussion, they had not been absent from other staff papers, in particular, an earlier paper on the control of international liquidity.

The points had been worthwhile emphasizing because they were pertinent to some of Mr. Nimatallah's remarks, the Director continued. The concept advanced by Mr. Nimatallah was a large, far-reaching one, given present attitudes, especially in respect of his first and second options. One feature of Mr. Nimatallah's approach--particularly in the second option and reflected also in the third--was the search for ways in which commercial banks might be induced to conform more closely to the system's needs for liquidity, and to accept guidance in that respect. As Mr. Polak had mentioned, the size of the balance sheets of the commercial banks was determined by the central banks; equally, the extent to which the inflow of capital to a country was channeled to official reserves was again a matter for central bank decision, perhaps in consultation with governments. Therefore, he would have thought that Mr. Nimatallah might have had in mind exploring the nature of the Fund's contacts with central banks and the shaping of its surveillance activities rather than looking for ways to bring the Fund's influence to bear more directly on the commercial banking systems of members.

In response to Mr. Sengupta's question about the feasibility of simultaneous decisions on SDR allocation and cancellation, the Director explained that the staff had considered that such decisions would most likely be taken in connection with the use of the SDR for safety net purposes under the existing provisions of the Articles of Agreement. As the staff had acknowledged, there would need to be criteria for cancellation. Of equal or perhaps greater interest to Mr. Sengupta was the idea of criteria for allocation as well. Although he would defer to the position taken by the Legal Department, it should be possible, in principle, for the Executive Board to reach a decision about the global need for reserve supplementation--and thus on a decision to allocate SDRs--by consulting prespecified criteria. Of course, it remained to be seen whether the membership would care to formalize its decisions for judging the global need for reserves in that way.

Referring to Mr. Zecchini's idea that the SDR might be used as a numeraire for the definition of target zones, the Director went on, any of a number of possible techniques could be used to convert the relationship of each of the five currencies to the SDR into the zone limits. It might be convenient to make that definition, using the SDR numeraire, if the zone limits were mutually consistent in width for all currencies. However, there might be reasons for defining zonal limits that were not of uniform percentage width, in which case, the relationship to the SDR would not be as close although the SDR could still be a useful comparative unit of account. The matter warranted further study. However, it should be noted that the practice of specifying zonal limits in terms of currency rates against the SDR would enhance only marginally the role of the SDR in the system, and it would probably contribute nothing at all to the stability of the system.

In speaking of the distributional shortcomings of the current system, Mr. Ismael had referred to the staff's reference on page 14 of SM/86/17 to the replacement of the reserve currency system by an SDR standard with asset settlement instead of liability settlement for all countries as the only possible but not very practical remedy in present circumstances for the uneven incidence of balance of payments discipline, the Director of the Research Department recalled. In those remarks, the staff had been referring to one of the two distributional shortcomings of the present reserve system--namely, to what had been called the asymmetry between the reserve currency country and all other countries. Other forms of distributional shortcomings had been dealt with at considerable length in the staff paper. Certainly, he agreed with Mr. Ismael that it would be desirable to study further the earlier proposals by Mr. de Maulde, Mr. de Groote, and the latest proposal by Mr. Sengupta.

The Treasurer commented that the staff should not be understood as having reached the conclusion that the attractiveness of the ECU rested on its promotion by the institutions of the European Communities. Admittedly, official support had played some role, with certain members of the EC having discriminated in favor of the ECU. But the main attraction of the ECU, especially in the private market, was its actual or perceived stability in terms of the exchange rates of the component currencies. It was particularly convenient for small enterprises, traders, and investors, to have a simple way of diversifying their exchange risk without engaging in costly forward exchange operations. Thus, there had been a natural, private market for ECUs in a stable system; the staff had not taken a view in its paper on how large the potential for that market was or on how long it would last.

It was not as easy as some Directors had suggested to replicate the SDR simply by composing a basket of the same currencies, the Treasurer added. The technical difficulties were not that great but there were several impediments. First, most references to diversification were to assets and not to liabilities, which were extremely important, given the existing world debt problem. As countries' efforts to borrow had shown, it was not easy to diversify liabilities; the market seemed to leave them with little choice but to borrow predominantly in dollars. The Fund, when it had entertained the idea of borrowing in the market, had found that it would not be such an easy matter to replicate the SDR currency basket. The basic problems were first, that the markets for the five currencies in the basket were not all equally open in an uninterrupted way to make it possible to find a good matching bundle of SDR currencies. Second, even if those markets were open, some of them were not large enough or sufficiently developed in terms of instruments, maturities, and the like to make a precise SDR replication. However, it was not a matter of looking for an exact SDR replication, but rather that there was simply no market for some currencies at given points in time or, if there was, it would be at the cost of considerable fluctuations in exchange rates and interest rates. Even with a less precise replication of the SDR, encompassing some but not necessarily all of the five currencies, the management and operational costs could be considerable.

The Managing Director made the following summing up:

> First, a few notes on the characteristics of the current reserve system. It was generally agreed that the functioning of the present reserve creation system had shown some shortcomings over past years. It was recognized, of course, that at present the level of international reserves depends mainly on the decisions made by private financial institutions. While this system can be and has been quite flexible in meeting liquidity needs, in the view of a very large majority of Directors, but not all, there have been systemic weaknesses in the working of the system. Periods of what were, with hindsight, excessive expansion were followed by periods of excessive contraction, producing an uneven pattern of reserve expansion; in particular, I think all were agreed that the private market system had shown some deficiencies in assessing correctly and in a timely fashion the creditworthiness of borrowing countries. At the present time, in fact, a lag can be observed in the reaction of banks to the adjustment policies followed by a number of borrowing countries after a period of overexpansion which is now being followed by a period of what could be called overcontraction. This phenomenon compounds the distributional problems or flaws of the market system, a point to which I will come back later.
>
> For countries without access to private markets, reserves by definition can only be accumulated--if there are no other sources of reserve creation--through current account surpluses. A number of Directors considered that this phenomenon, which we are currently observing, is creating a recessionary trend in the system that has global liquidity implications; this was not the view of all Directors.
>
> The role of surveillance in overseeing the monetary policies of the key currency countries--policies that eventually govern the conditions of reserve creation, as Mr. Polak has reminded us--was considered by all as an essential condition for the smooth functioning of the reserve system. But a number of Directors stated that reliance could not be placed on international surveillance--either on conceptual grounds or because of the uncertainties and limited efficiency of the surveillance process--in regulating international liquidity.

Second, on the role of the SDR in contributing to the stability of the system, the following potential contributions were discussed, although not agreed by all.

First, the use of SDR allocations to increase the proportion of owned reserves in a system that is very heavily dependent on borrowed reserves was seen by a large number of Directors as a systemic improvement in the present system.

Second, the SDR constitutes a basket of currencies and thus, in the view of a number of Directors, presents central banks with what Mr. Polak aptly called a balanced reserve asset whose value is more stable than that of any alternative individual currencies. The possible use of the SDR by members to modify the currency composition of their reserves without undertaking exchange market transactions was seen as a possible way of enhancing the stability of the system and helping to avoid potential shifts in currencies. That point was underlined by a number of Directors. The idea of a substitution account was touched upon in this respect but not considered as practical for the time being.

Third, the use of the SDR as a unit of account--both for Fund transactions and potentially as the numeraire for a system of target zones, if that is possible--was stressed by several Directors.

Fourth, the role of the SDR in helping to regulate total international liquidity was touched upon with very different connotations by a number of Directors. Most of those who held the view that the SDR could help to regulate total international liquidity considered that in order for the SDR to become a "swing" source of international reserves--as Mr. Nimatallah put it in a very graphic way--a significant increase in the ratio of SDRs to owned reserves would have to take place. Alternatively, as he suggested, a smaller increase in the proportion of SDRs in non-gold reserves would have to be combined with what he called some exertion of official influence on the decision-making process of private capital markets.

Fifth, the use of the SDR as a safety net for use in contingencies, for instance, when private markets might be unable to meet the global need for reserves, was discussed. Most Directors thought that the idea was worth exploring but that it would be difficult to determine in advance the precise criteria for its activation and the possible modalities of such a contingency mechanism.

Sixth, in discussing proposals for improving the contribution of the SDR to stability, considerable attention was directed to earlier proposals by Mr. de Groote and Mr. de Maulde, and the recent proposal of Mr. Sengupta. A study of these proposals, more especially of Mr. Sengupta's proposal, which has not yet been explored, and of its technical implications and possible modalities, will be carried out by the staff.

As for the relative expansion of use of the SDR and the ECU, first, the growing private use of the ECU reflects, in the view of Directors, both the attractiveness of ECU-denominated assets to private investors and also some degree of official support. The currency composition and the stability of the exchange rate of the currencies in the European unit were seen by several Directors as an important factor behind the success of the ECU on the private markets.

In the view of many Directors, the ECU is not a model for the SDR because of differing characteristics in the two systems, differing circumstances, and various technical factors. A number of Directors--I would say probably a majority of Directors--were not convinced that the Fund should support the private use of the SDR.

I shall now make a few concluding remarks, which are perhaps more personal than a precise reflection of the discussion. In theory, a floating exchange rate system does not require members to hold reserves, but experience has shown that there is a legitimate--and I want to underline that word--demand for reserves. As has been said by many of you, reserves can cushion external shocks, extend the policy options of member countries, and thus foster better optimal economic policies to address external circumstances. One property of the SDR that has not been contested is that it can provide owned reserves in the present system.

Several Directors continue to have great doubts about the analysis and conclusions in the staff paper about the contribution to stability that could be made by enhancing the SDR. They are not convinced that the system is incurring a long-term global liquidity need; they do not believe that increasing the amount of SDRs would be the appropriate way to address the distributional problems of the present system. They see the answers as lying more in the field of improved country assessment by lending institutions, improved adjustment, and, if necessary, the provision of conditional credit. They would not wish to minimize either the possible inflationary impact of infusions of liquidity into the system, or the impact on weakening the adjustment process. SDR allocations could, in their view, delay adjustment actions. More generally, they do not see how the SDR could play more than a marginal role in the system. They would, however, as I understood them today, be willing to explore the role of the SDR as a possible safety net in emergency situations.

However, most Directors, while they are interested also in the idea of a safety net, think that the matter of the SDR's contribution to the system should be examined in a more positive and systemic way than through an emergency or contingency mechanism. They hold the view that allocations of SDRs at a steady rate, consistent with the stability of the world economy and with the growth of world trade, would alleviate the distributional shortcomings of the present system and contribute to building a stock of assets, which would form a substantial part over time of total reserves without discarding the major role of the private institutions in providing liquidity. The building up of a more substantial stock of SDRs could, in turn, in their view, improve the quality of individual countries' reserve composition and the stability of the system at large. It would, indeed, in their mind, increase the possibility of influencing the supply of international liquidity through the interplay of allocations and cancellations, and would thus help to some extent to regulate the system. I must admit, however, that a number of Directors who are in favor of steady allocations have some doubts on the practicality of taking decisions in principle to cancel SDRs at the same time as decisions are taken to allocate SDRs.

I have found the discussion very interesting, not in leading to any practical conclusions, but in revealing various threads, which I would like to stress. I do not think there is any desire in the membership for fundamental changes in the system. For instance, there is no general call for major substitution or asset settlement. But there is a general view that the shortcomings of the system should be remedied. Of course, not everyone sees the answer in the form of SDR allocations. But I would just leave with you two or three personal ideas:

First of all, I think we would probably tend to agree that in cases of very sharp contraction of liquidity, in the context of the present system, something more is needed on the official side, for instance, the safety net idea, and also Mr. Nimatallah's reference to finding some way of influencing the private system.

In addition, if one wanted to resume SDR allocations, a way should be found to assuage the fears of those who look at SDR allocations as a possible agent for retarding adjustment. In that vein, we should look at ideas for reconstitution, of which Mr. Sengupta's proposal--although it is couched in different terms--is one interesting manifestation. The cancellation idea is also some form of answer to those who feel that allocation is not a systemic way of handling what has been excessive liquidity creation.

Finally, I would say that whatever we do there must obviously be a political will to act. Technical arguments will convince no one in the absence of political willingness to move ahead.

The Deputy Managing Director then assumed the chair.

Mr. Zecchini remarked that although some countries in the European Communities might discriminate in favor of the ECU, it should be noted that other large member countries of the EC were not in favor of the ECU and discriminated against it. If experience with the ECU was considered relevant to the discussion on the SDR, it would be necessary to undertake a much more formal, parametric analysis of the demand and supply for private ECUs in order to shed additional light on the reasons for the greatly expanded use of the private ECU.

It was highly questionable, on both theoretical and factual grounds--especially from experience with some target zone mechanisms--to conclude that there was no relevant role for a numeraire in stabilizing the system, Mr. Zecchini considered. He preferred to await the results of further studies before reaching any such conclusion.

While there was no doubt that more effective surveillance could be an efficient means of countering the problem of instability in the international monetary system, Mr. Zecchini remarked, he would not go so far as to say that better control over the monetary policies of a number of countries would suffice to ensure appropriate management of international liquidity. To be more specific, in the 1970s, financial innovation on a large scale, the explosion of Euromarkets, and the significant expansion of offshore banking centers, had all, in some way or another, hampered the ability of monetary authorities to control the monetary system. He could not subscribe to the technical view that surveillance of monetary policy would ensure, by itself, the stability of the system, unless a series of factors that had escaped the control of monetary authorities could be brought under control. Those factors were related not only to monetary measures but to institutional and structural elements that went beyond the simple, cyclical management of money.

The Executive Directors concluded for the time being their discussion of the potential contribution of the SDR to economic stability and the comparative functioning of the SDR and the ECU.

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Secretary