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March 7, 1985

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

Attached for consideration by the Executive Directors is a paper on the level of the Fund's SDR holdings. A draft decision appears on pages 6 and 7.

This subject has been tentatively scheduled for discussion on Friday, March 29, 1985.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. W. L. Coats, Jr., ext. 8249.

Att: (1)

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INTERNATIONAL MONETARY FUND

Review of the Level of the Fund's SDR Holdings

Prepared by the Treasurer's Department

(In consultation with the Legal Department)

Approved by W. O. Habermeier

March 7, 1985

1. Introduction

The Executive Board has reviewed the policy on sales of SDRs through the operational budgets in each of the last four years: in March 1981, May 1982, May 1983 and February 1984. 1/ As a result of these reviews, transfers of SDRs in purchases under the operational budgets were guided initially--following the coming into effect of the Seventh General Review of Quotas in November 1980--by the aim of progressively reducing the Fund's SDR holdings from SDR 5.6 billion--the level in early 1981--to approximately SDR 1.5 billion by the end of 1983. In the last review in February 1984, which followed the coming into effect of the quota increase under the Eighth General Review, it was agreed that the Fund would aim at reducing the level of its SDR holdings from about SDR 7 billion to a level of SDR 4 billion by May 31, 1985, which is expected to be achieved, and that the Fund would review the question again prior to April 30, 1985. 2/

This memorandum reviews the factors which have been taken into account by the Executive Board in its deliberations on the appropriate target holdings of SDRs by the Fund. In light of these considerations and the circumstances explained below, it is proposed that the Fund should aim to reduce its holdings of SDRs to about SDR 2.5 billion by end-May 1986. The amount of SDRs proposed for sale by the Fund under the quarterly operational budgets during the intervening period would be determined in the light of this aim.

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

2/ Executive Board Decision No. 7626-(84/23)S, adopted February 13, 1984.

2. General Background

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

As noted above, the Executive Board last reviewed the level of the Fund's holdings of SDRs in February 1984, and decided that holdings should be reduced from SDR 7.0 billion to about SDR 4.0 billion by end-May 1985. Inflows and outflows of SDRs in the period since the beginning of 1984 to end-February 1985 are shown in Table 1. Inflows, mainly charges, repurchases and interest on the Fund's holdings, amounted to about SDR 5.4 billion during the last fourteen months. These have been more than offset by outflows totaling about SDR 7.6 billion, in the form of sales to members making purchases, payments of remuneration and of interest on Fund borrowing, and sales to members needing to acquire SDRs for the payment of charges. As a result, the Fund's SDR holdings have been reduced overall by about SDR 2.2 billion, to about SDR 4.8 billion as of end-February 1985. In the light of expected inflows and outflows of SDRs, including proposed transfers of

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

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

Table 1. Transfers of SDRs
to and from the General Resources Account

(In millions of SDRs)

Fund's SDR holdings :	Jan. 1, 1984 <u>1/</u>	6,998.8
<u>A. Inflows of SDRs</u>		
Repurchases	742.0	
Charges	3,816.1	
Interest	690.8	
Quota payments	161.4	
Assessment	3.0	(+) 5,413.3
<u>B. Outflows of SDRs</u>		
Purchases	3,686.0	
Remuneration	2,279.3	
Repayment of Fund borrowing	114.3	
Interest on Fund borrowing	510.9	
Acquisitions	1,031.0	
Refunds and adjustments	21.0	(-) <u>7,642.5</u>
Fund's SDR holdings :	Feb. 28, 1985	4,769.6

(cont. from p. 2)
September 14, 1979:

Transfers of SDRs Under Article V, Section 3(f)

Pursuant to Article V, Section 3(f), the Fund shall provide SDRs instead of the currencies of other members to a participant making a purchase in accordance with decisions on the operational budgets taken under Rule 0-10. For this purpose, the Executive Board shall keep under review the amount of the Fund's holdings of SDRs in the General Resources Account in the light of all relevant considerations, including the relationship of SDR holdings to its other assets, and will determine from time to time the approximate range within which the Fund will aim to maintain these holdings.

1/ The Fund's holdings as shown in Table 1 of SM/84/24 were SDR 6,972.3 million as of January 13, 1984.

SDRs in purchases under the next operational budget, it is expected that the Fund's SDR holdings will continue to fall and will reach approximately the target figure of SDR 4.0 billion for end-May 1985.

3. Considerations Bearing on the Future Level of the Fund's SDR Holdings

In earlier reviews, the following factors were considered in determining the target range of the Fund's holdings of SDRs:

(i) the Fund's actual and prospective holdings of SDRs in relation to total allocations of SDRs; (ii) the Fund's liquidity; (iii) the Fund's operational need to hold SDRs; and (iv) the Fund's financial position.

(i) A general consideration is the relation between the Fund's SDR holdings and the total of SDR allocations. In the past, most Executive Directors have felt that it was in general preferable for SDRs to be held in members' reserves rather than in the Fund. At the present target of SDR 4.0 billion, the Fund's holdings will be about 19 percent of total allocations of SDR 21.4 billion by May 1985; this is still high compared to the level of November 1983, which was 7 percent of total allocations but, of course, lower than the proportions reached in early 1981 and again in early 1984, following quota payments under the Seventh and Eighth Reviews, respectively. An appropriate level for the Fund's SDR holdings in proportion to the total allocations of SDRs is largely a matter of judgement, though the Fund's holdings should not represent an unduly large proportion of the total of SDR allocations. There is certainly no reason, however, for the Fund to hold a higher proportion of total SDRs than may be justified in light of its liquidity, operational needs, and net income.

(ii) SDRs held by the Fund are highly liquid assets because they can be readily used to finance members' purchases and to replenish needed currencies. As most SDRs transferred by the Fund to members making purchases are exchanged for currencies through the designation system, these transfers are subject to the capacity of members in "sufficiently strong" balance of payments and reserve positions to absorb SDRs within their legal acceptance limits. This scope is normally large. ^{1/} The Fund can also, subject to the SDR acceptance limit of the member concerned, replenish its holdings of a needed currency by requiring the member concerned to sell its currency to the Fund against SDRs. The adequacy of the Fund's liquid assets, of which SDRs holdings are a portion, must be seen also in relation to the size of its liquid liabilities. The Fund's liquid liabilities total

^{1/} At mid-February, 1985, for example, the legal obligations of members judged "sufficiently strong" to accept SDRs within their acceptance limits were in excess of SDR 20 billion, compared with the Fund's SDR holdings of SDR 4.8 billion.

SDR 42.6 billion at end-January, 1985, of which reserve tranche positions amount to SDR 28.6 billion and loan claims are SDR 14.0 billion. Not including gold, the Fund's total of currently usable assets amounts to SDR 40.8 million at end-January 1985. ^{1/} The ratio of currently usable assets to liquid liabilities has improved slightly since end-1983 in spite of SDR holdings declining from SDR 7 billion to SDR 4.8 billion during the last fourteen months. The relatively high level of usable currencies tends to reduce the need to hold SDRs for liquidity purposes, because the potential need to replenish a member's currency is likely to be less.

(iii) As regards operational requirements, the Fund needs working balances to be able to provide SDRs to members that need them to meet obligations payable in SDRs. These obligations are (i) charges on the use of Fund resources, and (ii) quarterly payments of net charges in the SDR Department. In addition, the Fund also offers to pay remuneration in SDRs, and for this purpose adequate SDR holdings should be maintained. The magnitudes and timing of the prospective inflows and outflows of SDRs are such that, in the view of the staff, the operational needs of the Fund to hold SDRs do not stand in the way of a further substantial reduction of the Fund's SDR holdings.

(iv) As long as the SDR interest rate is higher than the rate of remuneration, a higher (lower) level of SDR holdings results in a somewhat higher (lower) level of net income to the Fund. Following increases in the remuneration coefficient in relation to the SDR interest rate, the financial effects of a reduction in the Fund's SDR holdings on its income and expenses have diminished. Using the present SDR interest rate, and taking into account the present remuneration coefficient (i.e., 90 percent of the SDR interest rate) a difference of SDR 1 billion in the Fund's average holdings of SDRs would affect net income for FY 1986 by about SDR 8.5 million. ^{2/}

4. Proposal on the Future Level of the Fund's SDR Holdings

As a result of three successive reviews which started in 1981, it was decided by the Executive Board to reduce the level of the Fund's SDR holdings to about SDR 1.5 billion by the end of 1983. This target was reached in November 1983, prior to the large increase at year-end associated with quota payments under the Eighth General Review. On the occasion of the last review of the Fund's SDR holdings in February

^{1/} See EBS/85/56, "The Fund's Liquidity and Financing Needs," March 7, 1985.

^{2/} The SDR interest rate in the week beginning February 18, 1985 was 8.45 percent per annum. Based on a remuneration coefficient of 90.0 percent, the rate of remuneration is therefore 7.61 percent and the differential is 0.84 percentage point.

1984, the question arose whether the aim should again be to reduce the Fund's holdings to about SDR 1.5 billion over a similar period of 2 1/2 to 3 years, i.e. by early 1987. Indeed, the Board's decision to reduce the level of holdings to about SDR 4 billion by end-May 1985 was based on the view that it would be appropriate to aim at the level agreed in the earlier reviews, within a similar time span and subject to a further review by April 1985. In the staff's view, this objective and timing continue to be generally reasonable, in light of the various considerations reviewed above. This timetable would call for a reduction of the Fund's SDR holdings to a level of about SDR 2.5 billion by end-May 1986 which would have the effect of maintaining over the next year, and, subject to review, over the subsequent year, about the same percentage rate of reduction that is being aimed at during the present period ending May 1985. It is, then, proposed that the Fund's SDR holdings should be reduced to a level of SDR 2.5 billion by end-May 1986, and, that, prior to April 30, 1986, another review be conducted to determine whether the Fund's SDR holdings should be further reduced, say, to about SDR 1.5 billion as is implied by the present rate of reduction in holdings.

Taking account of likely net inflows (see Table 2), a reduction in the Fund's SDR holdings to about SDR 2.5 billion over the period would imply total transfers of SDRs in purchases and payments to lenders under the four operational budgets of about SDR 3.8 billion, or an average of the order of SDR 0.9 - 1.0 billion in each of the next four budgets. According to the latest half-yearly assessment of the Fund's liquidity, ^{1/} purchases of the Fund's ordinary resources, including possible encashments of reserve tranche positions, are projected to total SDR 4.5 billion over the next four quarters. In addition, projected transfers to lenders in loan repayments and interest payments amount to some SDR 2.5 billion. These transfers total about SDR 7 billion, averaging SDR 1.75 billion per quarter. The proposed transfer of SDRs would result in maintaining the proportion of SDRs in total transfers at approximately one-half.

5. Recommended Decision

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

"In determining the amounts of SDRs to be transferred in purchases under the operational budgets, the Fund will be guided by the aim of reducing the Fund's SDR holdings to a level of approximately SDR 2.5 billion by May 31, 1986.

^{1/} EBS/85/56.

Prior to April 30, 1986, the Fund will review the level of its SDR holdings to determine whether and to what extent they should be reduced further."

Table 2. Estimates of Receipts and Transfers of SDRs by the
General Resources Account through end-May 1986

(In millions of SDRs)

Projected Fund SDR holdings end-May 1985		4,000
A. <u>Inflows of SDRs</u>		
Repurchases	950	
Charges	3,240	
Interest and assessment	280	(+) 4,470
B. <u>Outflows of SDRs</u>		
Remuneration	1,720	
Acquisition for charges	450	(-) 2,170
C. <u>Transfers of SDRs in Purchases and Payments to Lenders 1/</u>		(-) 3,800
Projected Fund SDR holdings:		2,500

1/ The amount of SDR 3.8 billion represents transfers in purchases and payments to lenders that would be necessary in the light of the present estimates of other inflows and outflows of SDRs in order for the Fund's holdings to be reduced to about SDR 2.5 billion by May 31, 1986. Total transfers in purchases of ordinary resources and payments to lenders are estimated to amount to SDR 7 billion.