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To: Members of the Executive Board

From: The Acting Secretary

Subject: Implications of Changes in the International Monetary System  
for the Role of the SDR

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Attached for consideration by the Executive Directors is a paper on the implications of changes in the international monetary system for the role of the SDR which has been scheduled for discussion on Friday, January 31, 1986.

Mr. Rhomberg (ext. 8976) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

Implications of Changes in the International  
Monetary System for the Role of the SDR

Prepared by the Research Department

Approved by Wm. C. Hood

December 24, 1985

At its meeting in Seoul, Korea, on October 6-7, 1985, the Interim Committee "urged the Executive Board to pursue its planned review on the role of the SDR, in all its aspects, in the international monetary system as a matter of priority, and to submit to the Committee a progress report for consideration by the Committee at its next meeting." <sup>1/</sup> On the same occasion, the Committee requested the Executive Board to study the issues raised in the reports by the Group of Ten and the Group of Twenty-Four on the international monetary system, both of which also contain a discussion of the role of the SDR. <sup>2/</sup> This paper is the first on this subject to be provided to the Executive Board for consideration in its work pursuant to these requests by the Interim Committee. A second paper, dealing with the potential contribution of the SDR to the stability of the international monetary system will follow shortly.

In the years since the SDR was created, the international monetary system has experienced a number of profound changes. The present paper sketches the effects of these changes on perceptions of the role that the SDR can and should play in that system. It first briefly reviews the problems of international liquidity inherent in the Bretton Woods gold exchange standard and summarizes the views that were held when the SDR was established regarding the potential contributions of the new asset to the solution of these problems (Section I). It then considers how a number of structural changes in the international monetary system, in particular the suspension of gold convertibility of the U.S. dollar, the switch from a fixed to a more flexible exchange rate system, and the evolution of international capital markets, have affected the mechanisms through which international liquidity is provided (Section II). This discussion leads to a review of changes in perceptions of the role of the SDR brought about by changes in the economic setting in which the facility must function (Section III). Concluding remarks identify the main issues raised in this review (Section IV).

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<sup>1/</sup> Communique of the Interim Committee of the Board of Governors of the International Monetary Fund, October 7, 1985, Joint Press Release No. 85/33, para. 8.

<sup>2/</sup> Ibid., para. 10.

## I. Shortcomings of the Gold Exchange Standard and the Contributions of the SDR

This section briefly reviews the shortcomings of the gold exchange standard that motivated the establishment of the SDR system. It then discusses to what extent SDR allocations were viewed as a means of alleviating these shortcomings.

### Insufficient liquidity

A major shortcoming of the reserve system of the period after the second world war was its inability to ensure adequate growth of international liquidity. This inadequacy was demonstrated both by a priori reasoning about the structure of the reserve system and by reference to empirical manifestations of incipient reserve shortages in the second half of the 1960s.

At the end of 1969, just before the first allocation of SDRs, gold was still the principal component of reserves. Officially held gold stocks accounted for 49 percent of total international reserves of \$79 billion, while foreign exchange reserves (denominated for the most part in U.S. dollars) and gold tranche positions in the Fund accounted for 42 percent and 9 percent, respectively. In addition, credit tranche drawing facilities in the Fund and other official credit facilities provided access to liquidity under specified conditions.

Increases in reserves showed a composition that was different from that of reserve stocks. The volume of gold reserves had been augmented through new production until 1964; but it subsequently declined as official gold sales in the private market, intended to keep market prices from rising unduly above the official price of \$35 per ounce, more than offset accretions from new gold production. Reserve positions in the Fund fluctuated around a moderately rising trend in accordance with variations in the volume of outstanding Fund credit. The fastest-growing component of official reserves was that of foreign exchange holdings, which provided more than three fourths of the increase in total reserve holdings from 1960 to 1969.

None of the three major reserve components could respond in a flexible manner to increases in the demand for reserves. The supply of gold was limited by conditions of production and by the unfavorable evolution of production costs relative to the fixed price of gold, which was the linchpin of the Bretton Woods par value system. The supply of reserve positions in the Fund (beyond the amount corresponding to quota payments in other reserve assets) was a by-product of the extension of Fund credit and could not respond beyond narrow limits to changing world liquidity needs. The reserve element that was most responsive to changes in reserve

needs was the foreign exchange component, most of which consisted of claims on the U.S. Treasury. In the 1950s and 1960s, the growth of this component was limited by the size of U.S. balance of payments deficits. <sup>1/</sup> To be sure, these deficits could, up to a point, respond to an increase in the demand for foreign exchange reserves in the world economy: they could be increased through the effects of devaluation of currencies against the U.S. dollar and through official borrowing in the U.S. capital market. Nevertheless, there were rather narrow limits set to this response by the restraints on exchange rate action under the par value system and by the relatively small volume of U.S. bank lending to monetary authorities abroad.

In view of these limits to the responsiveness of the supply of reserves, the gold exchange standard--just as the gold standard--was perceived as having a deflationary bias because reserve supplies were unlikely, under ordinary circumstances, to keep pace with growing demands for reserves as long as the price of gold in terms of the U.S. dollar, the principal reserve currency, was to be kept constant. However, what had been called a deflationary bias in the context of the gold standard was identified as a tendency toward reserve shortages in a setting in which economic policies were primarily used for the achievement of national objectives and were not necessarily adjusted to variations in the supply of reserves.

Empirical evidence examined in the second half of the 1960s seemed to confirm the expected inadequacy of reserve growth. An incipient reserve shortage was viewed as being evident in a slowing tendency in the growth of reserves, a declining ratio of reserves to imports, an increasing number of restrictions on international transactions, and growing recourse to official credit arrangements.

The growth rate of the stock of reserves held by all countries fell from 4 percent per annum during the period 1959-64 to 2.5 percent per annum during the period 1964-69. The slowing in the growth of the stock of reserves in the decade of the 1960s resulted largely from a reduction of the deficit in the U.S. official settlements account and a decline in countries' official gold holdings. <sup>2/</sup>

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<sup>1/</sup> More precisely, it was limited by a deficit in the U.S. official settlements account, which is the counterpart to a net increase in U.S. liabilities to foreign official holders plus any net reduction of reserve assets held by the United States.

<sup>2/</sup> It should be noted that the U.S. current account surplus was also shrinking over most of this period.

Because of the unprecedented growth of world trade and payments during this period, the ratio of reserves to imports for all countries fell from 48 percent in 1959 to 28 percent in 1969. For the United States, this ratio fell from 122 percent in 1959 to 41 percent in 1969, reflecting a redistribution of reserves from the United States to other industrial countries. It was widely believed that the demand for reserves tended to grow with the value of imports--though not necessarily in precise proportion to it--and that a severe decline in the ratio of reserves to imports could be interpreted as a symptom of a reserve shortage.

An increase in restrictions on current and capital account transactions was also interpreted as evidence of a shortage of international reserves. A number of policies were introduced in an attempt to limit the growing volume of short-term private capital movements and to increase the reserves available to offset such flows. In response to an outflow of capital, for example, the United States introduced the Interest Equalization Tax in the first half of 1963, which was designed to lower the after-tax return accruing to U.S. residents purchasing non-U.S. dollar-denominated foreign assets. In this regard, the Fund's 1964 Annual Report concluded that "measures indirectly restricting or distorting international trade ... have been retained or imposed by many countries. Measures to control capital flows have been applied or intensified in recent years by a growing number of industrial countries."

A further relevant development was the increased recourse to bilateral official credit arrangements. In 1961, the central banks of a group of countries reached an agreement to provide reciprocal lines of credit. This swap network grew from less than \$2 billion at the end of 1961 to almost \$20 billion at the end of 1968. <sup>1/</sup> Net drawings outstanding at the end of 1968 were \$6.7 billion. These reserve credits came to play an important role in reserve developments of the years 1964-68. Although they provided needed resources, reliance on them was generally not considered to be an adequate substitute for reserves from more traditional sources. Many observers felt that "ad hoc bilateral borrowing arrangements ... threaten the continued existence of the present system [and] provide no solid or dependable foundation for adjusting the overall supply of reserves to the long-term requirements of an expanding world economy." <sup>2/</sup> In this sense, the spreading and increased use of these arrangements was taken as evidence of an inadequate supply of reserves in other forms.

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<sup>1/</sup> Total reserves of industrial countries amounted to SDR 60 billion at the end of 1968.

<sup>2/</sup> Machlup, F. and Malkiel, B., eds., International Monetary Arrangements: The Problem of Choice. Report on the Deliberations of an International Study Group of 32 Economists (the so-called Bellagio Group), International Finance Section, Princeton University, Princeton, 1964, p. 54.

Failing confidence in the gold convertibility  
of the principal reserve currency

The gold exchange standard evolved in the period between the two world wars in response to the inadequate growth in the supply of gold relative to the reserve needs of a growing world economy. Since the supply of gold was subject to rising cost of mining, as well as ultimately to limited physical availability, it was a natural idea to attempt to supplement gold by creating balances in a currency that could itself be converted into gold. The role of this reserve currency was first assumed by the pound sterling but was taken over by the U.S. dollar after the second world war.

While gold reserves could be "stretched" with claims on a reserve-currency country, it was clear that there was a limit to this dilution: growing claims on the reserve center would at some point become so large relative to the center's gold holdings as to raise doubts about the continued convertibility of these claims into gold at a fixed price. 1/

In the event, the point at which gold convertibility of the U.S. dollar became doubtful to holders of dollar balances arrived rather quickly. Although the United States entered the postwar period with huge gold reserves--valued at nearly \$25 billion in 1949 and accounting at that time for three fourths of the world's gold stock and well over half of the world's total reserves--total private and official claims on the United States came to equal the rapidly reduced U.S. gold stock in 1959 and official dollar holdings alone matched that stock in 1964. By 1968 the U.S. gold stock covered only two thirds of U.S. liabilities to foreign official holders and little more than one fourth of all U.S. liabilities to foreign holders.

As long as a fixed gold price was to be maintained, the reserve center faced the necessity to sell gold in the private market to counter upward pressures on the prices at which private gold transactions were undertaken. In 1961, the central banks of the major European countries and the United States formed the Gold Pool for the purpose of intervening in the London gold market so as to keep the price of gold at or near the official level of \$35 an ounce. After substantial gold sales in the years 1966-68, the Gold Pool was terminated in March 1968, and it was agreed that gold transactions among monetary authorities would be carried out at the official price, while other transactions could be effected at free market prices, thus establishing a two-tier gold market. The suspension of gold sales in support of the private market price of gold,

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1/ This general argument was first formulated in the early 1960s. See Triffin, R., Gold and the Dollar Crisis, Yale, 1961.

however, did not eliminate pressure on the U.S. gold stock. An increase in the rate of inflation in the United States toward the end of the 1960s tended to undermine the purchasing power of reserve assets denominated in U.S. dollars. This development, combined with the fixed U.S. dollar price of gold, provided a growing incentive to convert such reserve assets into gold. Extensive efforts on the part of the United States, largely in the form of moral suasion, were necessary to prevent large conversions of U.S. dollar-denominated reserve assets into gold. Nevertheless, by August 1971 it became necessary to suspend convertibility of official dollar holdings into gold.

The possibility of increasing the officially fixed U.S. dollar price of gold was raised in the discussions of the liquidity and convertibility issues. It was argued that such an increase in the dollar price of gold would alleviate the liquidity problem by increasing the dollar value of total reserves, while confidence in convertibility would be strengthened by the fact that the dollar value of the U.S. gold stock, relative to the value of official claims on the United States, would increase. However, it was recognized early that such an action "would involve great inequities" and give "strong encouragement to speculative factors." <sup>1/</sup> In this light, it was concluded that "The international monetary system has a vital stake in maintaining the value of gold in existing monetary reserves at \$35 an ounce--neither less nor more." <sup>2/</sup>

A number of proposals that were brought forward in the course of the debate over the advisability of supplementing reserves through international action contained elements that were responsive to the problem of confidence, which they sought to solve through centralization of reserves. <sup>3/</sup> For instance, a suggestion was made that there could be provision for the exchange of a fraction of foreign exchange balances for specially denominated deposits at the Fund to avoid the conversion of these balances into gold. It was even proposed that countries be obliged to hold a fixed minimum of their total reserves in the form of deposits at the Fund. <sup>4/</sup> These suggestions also foreshadow responses

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<sup>1/</sup> Speech by the Managing Director at the Institut d'Etudes Bancaires et Financieres, Paris, June 11, 1965, reproduced in Supplement to International Financial News Survey, Vol. 17 (1965), p. 215.

<sup>2/</sup> Statement by the Governor of the Fund for the United States, Henry H. Fowler, Summary Proceedings, Annual Meetings 1968, p. 53.

<sup>3/</sup> For a discussion of these proposals, see Machlup, F., Plans for Reform of the International Monetary System, International Finance Section, Princeton University, Princeton, 1964.

<sup>4/</sup> See Triffin, R., "Tomorrow's Convertibility: Aims and Means of International Policy," Banco Nazionale del Lavoro Quarterly Review, No. 49 (June 1959).



that were sought at a later date to a different type of confidence problem arising in the context of currency switching in a multiple-currency reserve system. The most elaborate effort of alleviating this problem was the proposal to establish a substitution account in the Fund.

#### Asymmetries in reserve creation

Apart from the problems of an inadequate supply of international liquidity and loss of confidence in the gold convertibility of the U.S. dollar, the principal reserve currency, the reserve system of the 1960s was also alleged to contain asymmetries in the distribution of benefits and costs of reserve creation. In particular, two of these asymmetries had to do with the position of reserve-currency countries and with the costs and benefits of the reserve system accruing to the developing countries.

The reserve-currency countries were viewed by many observers as being able to finance their payments deficits through the issuance of their liabilities, which might have to be acquired by the authorities of other countries in the course of exchange market intervention necessary to prevent the appreciation of their currencies. Nonreserve-currency countries, by contrast, had to settle any such deficits by the transfer of assets. Under the gold exchange standard, as practiced in the 1950s and early 1960s, the unrestricted convertibility of dollar balances held as international reserves provided some discipline over the balance of payments policies of the reserve-currency country. This discipline was, however, greatly weakened by the suspension of convertibility.

The view that the reserve-currency country derived a special net benefit from its status was not uncontested, however. In the first place, it was pointed out that there were also considerable costs involved in fulfilling the function of a reserve center. Some of these costs arose from a perceived loss of control over monetary policy. It was feared that a reserve center might not always be able to sterilize the effects on domestic monetary aggregates of variations in the external demand for its currency. Indeed, at a later stage this view explained the reluctance with which some countries faced the prospect of assuming some of the privileges and responsibilities of a reserve-currency country. In any case, it is difficult to identify in any given historical period the factors governing the growth in official claims on the United States. In particular, these claims may increase because of autonomous U.S. payments deficits or because of deficits induced by a rise in demand for reserves in the form of liquid claims on the United States.

The alleged asymmetry in favor of a reserve center in the distribution of benefits associated with reserve creation has been particularly criticized because of the implied disadvantage to developing countries.

From the inception of the debate over the creation of an international reserve asset, representatives of developing countries, and many other observers as well, have sought ways to redress, or even to reverse, this asymmetry. Early proposals on reserve supplementation sought to link the creation of reserve assets to the provision of development finance. Newly created reserve assets could be allocated to developing countries in excess of their reserve needs or placed with international development agencies such as the World Bank or IDA through the purchase of securities issued by them. Developing countries would thus be the main beneficiaries of any gains ("seigniorage") resulting from the creation of new reserve assets. Such proposals were generally opposed by those who thought that decisions concerning development finance should be separated from decisions about reserve creation.

The role intended for the SDR at  
the time of its activation

A growing concern about the ability of the Bretton Woods system to generate an adequate supply of international reserves and to sustain confidence in the system led to two studies during 1963 and 1964, one by the G-10 and another by the Fund, of the functioning of the international monetary system. The Fund study <sup>1/</sup> concluded that the need for international liquidity could not be met adequately by the ordinary supply of gold and foreign exchange reserves. Similarly, the Ministers of the G-10 concluded that "this need may be met by an expansion of credit facilities and, in the longer run, may possibly call for some new form of reserve asset." <sup>2/</sup> In 1965, a report of the G-10 on the creation of reserve assets (the Ossola Report) stated the problem as arising "from the considered expectation that the future flow of gold into reserves cannot be prudently relied upon to meet all needs for an expansion of reserves associated with a growing volume of world trade and payments and that the contribution of dollar holdings to the growth of reserves seems unlikely to continue as in the past." <sup>3/</sup> Subsequent discussions were well summarized in the 1968 Annual Report: "... the broad impact of the new facility will be that it will permit the Fund to assure an appropriate level of international reserves in the light of the needs of the world economy, by supplementing the existing reserve assets in the form of gold and

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<sup>1/</sup> The Fund study was published as Chapters 3 and 4 in the Annual Report, 1964.

<sup>2/</sup> See "Statement by Ministers of the Group of Ten and Annex prepared by their Deputies," London 1964, para. 2.

<sup>3/</sup> G-10, "Report of the Study Group on the Creation of Reserve Assets," R. Ossola, Chairman, May 31, 1965, p. 17.

reserve currencies." 1/ The statement by the Governor for the United States at the 1968 Annual Meeting was in the same vein: "The Facility is intended to meet the need, as and when it arises, for a supplement to existing reserve assets ... it should operate to relax appreciably some of the unnecessarily painful strictures on international finance that come from fears of actual or impending reserve shortages." 2/

The main provision with respect to allocation of SDRs in the amendment of the Articles of Agreement establishing the SDR specifies that "the Fund shall seek to meet the long-term global need, as and when it arises, to supplement existing reserve assets in such manner as will promote the attainment of its purposes and will avoid economic stagnation and deflation as well as excess demand and inflation in the world." 3/ This language points to the creation of supplementary reserves in the specified circumstances as the principal purpose of the new facility.

In September 1969 the Executive Directors took up a proposal by the Managing Director to allocate SDRs in the first basic period. The proposal summarized the past developments in the supply of reserves: "Since about 1964 ... growth of reserves flattened markedly, the ratio of reserves to trade declined more rapidly, the transfer of reserves from deficit to surplus countries ceased to act as a force tending to equalize reserve ratios, and there was increasing resort to international credit as a means of relieving the tightness of reserves." 4/ In the light of these general considerations and more specific projections of a deficit of U.S. payments (on the official settlements basis) of \$0.5 billion to \$1.0 billion per annum, the draft proposal adopted the assumption of a reserve growth of \$1 billion to \$1.5 billion per annum in the early 1970s. It then estimated the desired growth in reserves by extrapolating the average ratios of reserves to imports over the period 1954-68 and arrived at an expected growth of required reserves of over 4 percent per annum. These calculations provided a range for reserve increases of approximately \$3.5 billion to \$5 billion per year over the early part of the 1970s. The estimate of required reserve supplementation then led to a proposed allocation of \$9.5 billion over the years 1970-72, which was approved by the Board of Governors in October 1969. This decision "was designed to restore a rate of growth in global reserves consistent with growth in the trend need for reserves." 5/

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1/ International Monetary Fund, Annual Report, 1968, p. 16.

2/ Statement by the Governor of the Fund for the United States, Henry H. Fowler, Summary Proceedings, Annual Meetings, 1967, p. 82.

3/ Article XVIII, Section 1(a) of the Articles of Agreement.

4/ See Summary Proceedings, Annual Meetings, 1969, pp. 278-79.

5/ International Monetary Fund, Annual Report, 1971, pp. 18-19.

The language of the Articles and the stress on the prospective development of total reserves in the first proposal on SDR allocation emphasized the aim of creating unconditional liquidity to avoid or mitigate a possible global reserve shortage when the circumstances described in the Articles warranted such reserve supplementation.

The objective of mitigating an impending reserve shortage was closely linked with the aim of maintaining convertibility of dollar-denominated foreign exchange reserves into gold at the fixed official price. To this end, the value of the SDR was fixed at SDR 0.888671 grams of fine gold. 1/ Hence an allocation of SDRs was expected to be a substitute for an increase in the official gold stock and to reduce the share of foreign exchange reserves in total international reserves. It was hoped thereby to increase confidence in the continued convertibility of dollar-denominated foreign exchange reserves. This view was endorsed by the Governors of the central banks of the seven active members of the Gold Pool, who stated "... as the existing stock of monetary gold is sufficient in view of the prospective establishment of this facility for Special Drawing Rights, they [the monetary authorities] no longer feel it necessary to buy gold from the market." 2/ The SDR's role in strengthening confidence in the convertibility and the stability of the value of currencies in terms of gold was acknowledged by the Governor of the Fund for the United States, who expressed the expectation that the SDR "will permit growth in world reserves and buttress confidence in the stability of the entire system of world finance." 3/

Considerations concerning the use of the SDR to lessen the asymmetry implicit in the role of a reserve-currency country had been very much part of the early deliberations regarding the establishment of the SDR. It was felt that any seigniorage accompanying the creation of international reserves should accrue to all participants in proportion to their quotas in the Fund rather than to the reserve-currency country alone. Toward the end of the 1960s, however, the problems created by the shortage of international reserves had overshadowed any concern about the asymmetry problem, and the argumentation put forward in the proposal

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1/ Article XXI, Section 2 of the Articles of Agreement as amended on May 31, 1968.

2/ Communique issued by the governors of the central banks of Belgium, Germany, Italy, the Netherlands, Switzerland, the United Kingdom, and the United States at the conclusion of their meeting in Washington, D.C. on March 16 and 17, 1968. Published in International Financial News Survey, Vol. 20 (1968), p. 89.

3/ Statement by the Governor of the Fund for the United States, Henry H. Fowler, Summary Proceedings, Annual Meeting, 1967, p. 82.

for the first allocation tended to concentrate on the problem of relieving the reserve shortage rather than on the mitigation of asymmetries as motivating SDR allocation.

Proposals to use SDR allocation to establish a link between the creation of liquidity and the provision of development finance were part of the discussions leading to the establishment of the SDR. <sup>1/</sup> However, it was generally felt that liquidity creation should not lead to an unrequited long-run transfer of resources. Hence, the amendment to the Articles was drafted so as to require allocations to be in proportion to participants' quotas. The role of the SDR in development finance was not part of the argumentation leading to the first allocation.

## II. Changes in the Structure of the International Monetary System

Since the early 1970s, a number of structural changes in the international monetary system have taken place that have raised questions concerning the role of the SDR in the current multiple-currency reserve system. This section reviews the most important of these structural changes and considers their implication for the reserve system.

One major structural change was the suspension of the convertibility of official U.S. dollar balances into gold. The years 1970 and 1971 were marked by large balance of payments deficits of the United States, which resulted in rapid accumulation of official claims on U.S. residents. Although actual conversions of such claims into gold could, for a time, be limited by moral suasion, the United States eventually terminated the convertibility of the dollar into gold in August 1971.

A second, and related, structural change was the break-down of the system of fixed exchange rates and the advent of greater exchange rate flexibility. The multilateral realignment of exchange rates, negotiated in the Smithsonian Agreement of December 1971, only temporarily halted the movement toward more flexibility in exchange rates among the major industrial countries. By March 1973, most of these countries had allowed their currencies to float. Many other countries continued, however, to manage their exchange rates or to fix them relative to another currency or to a basket of currencies. Moreover, most countries with floating exchange rates have continued to intervene in the foreign exchange markets to a greater or lesser extent.

The third major change in the international financial system was the expansion and integration of international credit markets, in particular those involving bank assets and liabilities. Private credit became widely

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<sup>1/</sup> See, for example, Report of the Study Group on the Creation of Reserve Assets, R. Ossola (Chairman); May 31, 1965, paras. 137 and 138.

available to official borrowers. As a result, many governments were able to increase their stock of foreign exchange reserves by borrowing foreign currencies from commercial banks or other private sources and acquiring liquid reserve assets in the form of deposits or securities. The development of "offshore" or "Eurocurrency" markets and the emergence of Euro-bond markets is also important in this context, because it weakened the connection between the accumulation of foreign exchange assets denominated in a particular reserve currency and the evolution of the balance of payments of the country issuing that currency. For example, an increase in the demand by monetary authorities for assets denominated in U.S. dollars can now be met, in part, by an increase in the issue of liabilities denominated in U.S. dollars by non-U.S. residents, with the remaining part being met by an increase in the supply of such liabilities by U.S. residents. In this case, only the transactions between U.S. residents and the foreign monetary authority would be recorded in the capital account of the U.S. balance of payments.

A fourth structural change of significance was the growth in the importance of currencies other than the U.S. dollar in official reserves. The share of U.S. dollar-denominated assets in total foreign exchange reserves fell from 80 percent in 1976 to 65 percent in 1984, while the share of the deutsche mark grew from 7 percent in 1976 to 12 percent in 1984; similarly, the share of the Japanese yen grew from 1 percent in 1976 to 5 percent in 1984.

These changes have significantly altered the mechanisms through which reserves are provided, and they have had far-reaching consequences for the international monetary system as a whole. Broadly speaking, the new features of the reserve system have weakened constraints on countries' policies that characterized the Bretton Woods par value system as it existed at the time when the SDR was established.

For example, the United States no longer had to arrange its policies with a view to maintaining convertibility of the U.S. dollar into gold at a fixed price. In light of the relative magnitudes of the aggregates involved, such an undertaking would in any case not be feasible in present circumstances. In addition, Fund members no longer have to maintain fixed exchange rates and many of the larger member countries in fact allow their currencies to float subject to greater or lesser intervention in the exchange market. Consequently, countries have the option of holding smaller reserves than would be prudent in a par value system, although the evidence points to little diminution in the overall demand for reserves as a result of floating.

Furthermore, creditworthy countries can settle payments deficits or augment their reserves by international borrowing, without undertaking specific adjustment policies to gain command of additional resources. By

financing external deficits or reserve accumulation through the issuance of their own liabilities, all of these countries can partake in some measure of the benefits previously accruing only to a reserve-currency country. All the same, creditworthiness can be lost, especially if the status it conveys is abused. The danger of losing creditworthiness provides for these countries a discipline analogous to that emanating from the obligation of a reserve-currency country to maintain gold convertibility of its currency.

Borrowing in international markets for the purpose of adding the proceeds to the borrower's international reserves has no adverse effect on the perception of the borrowing country's creditworthiness, at least as long as the intention is actually carried out and the reserve accounts give evidence of the availability of amounts corresponding in magnitude to the previous borrowings. For this reason, reserves can generally be acquired through borrowing in international financial markets by countries with the credible intention of augmenting their reserves. Creditworthy countries can now hold the amount of reserves they desire in the light of the (fairly modest) net cost of placing borrowed funds, i.e., the difference between the borrowing cost and the return from the placements. These countries are thus no longer required to pursue policies leading to balance of payments surpluses in order to raise their reserves to the desired level. In this sense the responsiveness of the supply of reserves has increased.

Two important qualifications are necessary, however. First, it is true that countries whose creditworthiness in general has become a matter of doubt, and which therefore encounter difficulty in borrowing for the purpose of financing a balance of payments deficit, may also face a problem of credibility when attempting subsequently to borrow for the purpose of adding to their reserves. In order to achieve their reserve goals, these countries must, therefore, take steps either to restore their creditworthiness or to generate current account surpluses. Second, reserves that are "borrowed" in the sense of the present discussion have to be refinanced periodically at interest rates prevailing at the time when the underlying loans reach maturity. This need for refinancing may be burdensome, especially if the loans are of a short maturity, if the interest rates are subject to strong fluctuations, and if future access to credit markets is uncertain. Uncertainty with regard to future interest rates and credit availability, as well as uncertainty with regard to the exchange rate of the currency in which debt is denominated is carried over to the reserve holdings themselves and impair to a certain extent their reserve character. This in turn makes it advisable to make provisions against the contingency of the borrowed reserves being difficult, costly, or impossible to refinance. This may mean that the proper maintenance of a certain volume of borrowed reserves requires the holding of an associated amount of owned reserves.

Finally, the availability of several reserve currencies makes it possible to exercise portfolio choices in the conduct of reserve policy. In making these choices, countries can attempt to avoid to some extent the exchange risk inherent in the holding of currency reserves. This risk is especially severe when the reserve center whose currency is held is not the main trading partner of the reserve-holding country. Avoidance of the exchange risk in reserve holding was not important at a time when convertibility of a dominant reserve currency into gold seemed assured and when exchange rate changes in the system could typically be expected to be devaluations of member currencies against the reserve currency. In a world in which a reserve currency can depreciate as well as appreciate against the currencies of members of the system, diversification and risk spreading appear to have gained importance.

While a reserve system based on a number of reserve currencies can enable countries to reduce the exchange risk inherent in their holdings of foreign currencies, it also entails the danger of instability through the switching of reserve currencies in response to changing, and perhaps ephemeral, expectations. It is true that the evidence in reports on the currency composition of reserves does not indicate great volatility in this composition. Nevertheless, the combined pattern of interest rates and expected exchange rate changes is in principle an important determinant of countries' reserve policies. As a result, official trading in the currency markets does not necessarily and in all circumstances exercise a stabilizing influence in a multiple-currency reserve system.

By and large, the evolution of the international monetary system has been in the direction of removing some of the constraints and rigidities existing in the Bretton Woods par value system and thus provides greater scope for independent action by individual countries. Greater autonomy in national policymaking has no doubt at times benefited individual countries and the world economy, but it has also been accompanied by problems arising from a weakening, or a delayed incidence, of adjustment pressures and from reduced attention to matters of policy coordination. Decentralization of the international monetary system, while alleviating some existing problems, has thus created new problems of its own. It is in the area of counteracting adverse effects of this decentralization that the existence and use of an internationally created and controlled reserve asset could make a contribution to the objectives of stability, coordination, and adjustment in the world economy. Views on the question of whether or not there is such a potential contribution will be examined in the following section.

### III. Views of the Role of the SDR Today

This section considers the extent to which views about the role of the SDR have been affected by changes in the international monetary system since the first allocation in 1970. It begins with a summary of



those original views. It then considers the current assessment of the functions that the SDR was expected to fulfill. Finally, it raises the question of whether the evolution of the international monetary system may be seen to have brought to the fore any new tasks for which the SDR is suited.

#### Original views of the role of the SDR

At the end of the decade of the 1960s, the principal role envisaged for the SDR was to help alleviate the current and expected shortage of international liquidity. International reserves were widely considered to be inadequate. This inadequacy was seen to be evident in the slowing of the growth of reserves in the second half of the decade and in an absolute decline in official holdings of gold, in declining ratios of reserves to imports, in an increase in restrictions on current and capital account transactions, and in an unprecedented growth in official lines of credit.

A second role envisaged for the SDR was to shore up confidence in the continued convertibility of the reserve currency into gold. If a growing demand for reserves could only be satisfied through the accumulation of claims on reserve-currency countries, it became increasingly likely that convertibility of gold at its officially fixed U.S. dollar price could not be maintained. The sharp decline in the official holdings of gold by the United States in the late 1960s gave added force to this view.

A third role seen for the SDR was to moderate certain asymmetries inherent in the reserve system. Under the gold exchange standard, the reserve-currency country was thought to enjoy an undue advantage. It was held that this advantage derived from the ability of the reserve-currency country to finance its official settlements deficit by issuing claims denominated in its own currency. Since other countries accumulated those liabilities as reserves in the course of exchange market interventions necessary to maintain fixed par values, it was contended that the reserve-currency country could obtain assured financing of its payments imbalances at a lower cost than other countries and would be able for a period of time to avoid the adjustment of its domestic policies to restore external balance. SDR allocations would, it was thought, lessen this asymmetry by providing an alternative to the generation of currency reserves through liability settlement of deficits of the reserve center. In a different vein, the SDR was seen by some participants in the debate as a vehicle for redressing, or indeed reversing, asymmetries affecting especially the developing countries. In this view, which never achieved general acceptance, the SDR system could be used to establish a link between the creation of liquidity and the provision of development assistance by allocating SDRs entirely, or disproportionately, to developing countries.

### Current assessment of the original roles

A current review of the functions that the SDR had been expected to serve at its inception could, in principle, arrive at one of three conclusions, namely, that a particular function is still valid as originally envisaged, or that it has been modified in the course of the evolution of the international monetary system, or that it is obsolete. It is convenient to begin by examining the functions of the SDR to see whether any of them falls into the third category.

It is evident that the role of the SDR as an asset that could strengthen confidence in the convertibility of the U.S. dollar into gold is no longer relevant. Indeed, it ceased to be relevant soon after the SDR was brought into existence, when the United States suspended the convertibility of officially-held dollar balances into gold.

The consequences of the obsolescence of this particular function of the SDR were drawn soon after the event, when the valuation of the SDR was changed from being based on a certain weight of gold to being determined by a basket of currencies and, later, when the SDR interest rate was raised in steps from 1.5 percent per annum--a rate closer to the zero interest rate on gold than to the yield on U.S. Treasury bills--to rates related to yields on financial instruments representative of assets of which foreign exchange holdings are generally composed. <sup>1/</sup>

As regards the two other functions of the SDR identified above--relieving a reserve shortage and correcting certain asymmetries--it would be fair to say that, in the opinion of most observers, these functions have been modified but not eliminated by changes in the international monetary system.

The role of the SDR in providing a supplement to existing reserve assets continues to be relevant. It is, however, seen in a rather different light than it was at the time of the first allocation. International capital markets have developed to such an extent that creditworthy countries can issue debt denominated in reserve currencies. While not all countries are creditworthy all the time, no country is permanently barred from the group of creditworthy countries. The possibility of augmenting world reserves through the international credit mechanism has made it increasingly difficult to determine, at any particular moment, that there is a global need for a deliberate act of reserve creation. This view was recently endorsed by the G-10, who noted in their report on "The Functioning of the International Monetary System" that "during most of [the eighties] the supply of international liquidity has been

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<sup>1/</sup> The popular designation of the SDR in its formative period as "paper gold" also lost currency after the suspension of gold convertibility of the U.S. dollar.

ample, if not excessive," and a number of the G-10 deputies were led to conclude "there is at present no clear evidence of a long-term global need to supplement international reserves." <sup>1/</sup> This assessment is not shared by the G-24, who express the view that "during [the past decade] the supply of international liquidity was uneven and grossly inadequate, especially for developing countries." <sup>2/</sup> Furthermore, it has been argued that the uncoordinated decisions of private creditors are unlikely to provide a reliable source of reserves.

The issue hinges on how the concept of a reserve shortage (or, as the Articles put it, of a need for reserve supplementation) can be defined in circumstances where reserves are more less freely supplied--at a price--to countries regarded by the international credit market as creditworthy. There is clearly neither a shortage nor an excess of reserves for this group of countries. Indeed, it is sometimes argued that there cannot be a global shortage of reserves in these circumstances because countries that do not have access to private credit markets can acquire reserves through payments surpluses. This view--that the world demand for reserves can always be satisfied by existing sources of reserve growth and that no reserve supplementation is ever needed--leaves out of account the possibility that world economic conditions could be improved by a change in the terms on which reserves are being supplied. Reserve supplementation can still be viewed as a valid function of the SDR if it is seen as serving the objective of easing the terms on which reserves are supplied to the world economy in circumstances where such an easing is considered appropriate.

The role of the SDR in reducing asymmetries associated with the processes through which reserves are being supplied has not been diminished by structural changes since the first allocation. Indeed, that role could be said to have been both widened and deepened. It has been widened insofar as the number of reserve currencies has increased and the supply of these currencies plays an even more dominant role than formerly in the provision of new reserves to the system. It has also been deepened in the sense that the importance of creditworthiness in gaining access to new reserves is more fundamental than before the expansion of international capital markets. As a result, the relevant asymmetry of the system through which reserves are provided lies no longer in the difference between reserve centers and other countries but in the distinction between countries that can acquire reserves by borrowing them and those that cannot.

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<sup>1/</sup> Report of the G-10 Deputies on "The Functioning of the International Monetary System," EBD/85/154, para. 63.

<sup>2/</sup> Report of the G-24 Deputies on "The Functioning and Improvement of the International Monetary System," EBD/85/228, para. 17.

These questions have already been addressed by the Executive Board on various occasions. For instance, it was stated in the Annual Report for 1985: "The adjustments in absorption and production required to generate payments surpluses imply that the cost of reserve accumulation for these countries [i.e., countries without market access] is much higher than for countries with access to international capital markets." 1/ Concurring with this view, the G-24 report stresses that: "A number of countries had to run large trade surpluses to service their debt and to build up minimum reserves required for normal transaction and precautionary purposes." 2/ From this viewpoint it has appeared then that SDR allocations could play an important role in helping countries obtain reserves without incurring the costs of generating balance of payments surpluses. In this context, it has also been noted that "despite vigorous adjustment policies pursued by developing countries leading to sizable improvement in their current account position, creditworthiness was not restored; nor was there a reversal of the decline in bank lending." 3/

In contrast to these views, the G-10 report states the view of some Deputies that "the difficulties encountered by a number of countries are primarily an indication of their lack of creditworthiness and are not related to a general shortage of liquidity." These G-10 Deputies contend that "SDR allocations are not the appropriate tool for providing finance to countries whose access to international credit markets has been jeopardized and [suggest] that they might result in delaying necessary adjustment." 4/

The role of the SDR in assisting in the transfer of real resources to developing countries, which was envisaged at the time of the first allocation by some participants in the discussion but was never an agreed function of the SDR system, continues to be advocated. The G-24, in its report, concludes "it will be desirable to link the allocation of SDRs to the development needs of developing countries." 5/

#### Further considerations as to the role of the SDR

Since the first allocation of SDRs, increasing attention has been given to the contribution that the SDR might make to the stability of the international monetary system. Of course, the role foreseen for the SDR

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1/ IMF, Annual Report, 1985, p. 62

2/ Report of the G-24 Deputies on "The Functioning and Improvement of the International Monetary System," EBD/85/228, para. 93.

3/ Ibid., para. 94.

4/ Report of the G-10 Deputies on "The Functioning of the International Monetary System," EBD/85/154, para. 74.

5/ Ibid., para. 23.

in preserving the convertibility of dollars into gold was a stabilizing role, but as the system has evolved, new dimensions of this stabilizing role have been given emphasis. For example, an important argument used in the proposal for the allocation in the third basic period was essentially a stability argument. While at that time the allocation of SDRs was again seen as providing for an increase in the supply of reserves consistent with the long-term global need for reserves, the basis for such an allocation was extended so as to encompass an improvement in the quality of reserves that could be said to enhance the stability of the reserve system. In his proposal for an allocation of special drawing rights for the third basic period, the Managing Director argued:

While it is true that most countries have a means for satisfying their need for reserves when international capital markets are as free as they are today, the decision to allocate special drawing rights does not depend on a finding that the long-term global need cannot be met except by allocation. A characteristic of a system in which countries add to their gross reserves as their international indebtedness increases is that they are faced with the need for periodic refinancing. This difficulty does not arise when additions to net reserves are made through allocation of special drawing rights. 1/

This role for the SDR could be regarded as of even greater significance today than when it was first envisaged, because of the greater proportion of reserve holdings that require refinancing.

Other aspects of the role of the SDR in contributing to the stability of the international monetary system are currently being given increased attention. This topic will be taken up in a separate paper. 2/ Certain aspects of the matter may be alluded to here. For example, the very creditworthiness of countries that enables them to borrow reserves may in certain circumstances be abused and lead to borrowing that is excessive in relation to the capacity for servicing the debts and subsequently to excessive contraction in the supply of reserves provided through the credit markets. The question may be raised whether such excessive borrowing might be avoided or reduced if reserves were regularly supplied through different channels, and in particular through the allocation of SDRs. This view, however, is challenged by those who doubt

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1/ Allocation of Special Drawing Rights for the Third Basic Period: Proposal by the Managing Director of the International Monetary Fund, Annual Report, 1979, pp. 123-27.

2/ A separate paper entitled "The Potential Role of the SDR in Contributing to the Stability of the System" is under preparation.

that borrowing in private credit markets would be stabilized by the availability of a regular alternative source of reserve supply and contend, instead, that the instabilities associated with excessive borrowing could then be even greater. A further illustration of considerations relating to the contribution of the SDR to stability is to be found in the G-10 report, where it is suggested that "the SDR may well have a useful role in meeting the long-term global need for reserves, and in this context in providing a safety net for future contingencies." 1/

The role of the SDR in relation to the stability of the international monetary system is closely related to the role that it might play in relation to the control of the global amount of international liquidity. Presumably, the primary purpose of seeking some control over liquidity is to allay the instabilities that could develop in the absence of adequate control. The notion of control was given some attention in the period when the idea of the SDR was germinating. It was perhaps more in the forefront at the time of the second amendment of the Articles of Agreement, when the objective of "making the Special Drawing Right the principal reserve asset in the international monetary system" was incorporated in the Articles (Article VIII, Section 7). The G-10 report argues, however, that "the preponderance of market-supplied international liquidity has reduced the scope for influencing the process of reserve creation directly. Only a small share of total liquidity, arising from IMF-related reserve assets and credit provided under bilateral and multilateral official credit arrangements is amenable to some form of direct control." 2/ The report does not conclude that the role of the SDR should be enhanced by increasing the proportion of SDRs in the system. It does argue that "these developments have increased the importance of pursuing sound domestic policies in order to safeguard creditworthiness." 3/ The G-24 report argues that "the scope for international liquidity policy is now limited by the willingness of major countries to consider the international impact of their policies. In addition to surveillance over exchange rate and other macroeconomic policies of major industrial countries, the Fund should be enabled to influence the liquidity of the world economy through adequate SDR creation and its more efficient distribution." 4/

Reference may be made in conclusion to an enhanced role for the SDR in the IMF itself and in the system more generally. From its inception, the SDR has served a useful, though limited, role as a unit of account.

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1/ Report of the G-10 Deputies on "The Functioning of the International Monetary System," EBD/85/154, para. 78.

2/ Ibid., para. 61.

3/ Ibid., para. 61.

4/ Report of the G-24 Deputies on "The Functioning and Improvement of the International Monetary System," EBD/85/228, para. 20.

the SDR has served a useful, though limited, role as a unit of account. In the present multiple currency reserve system this function of the SDR has become more important, particularly in the conduct of the Fund's business. To go further and to base the Fund on the SDR in the fundamental sense of financing its acquisition of assets by the issue of SDRs could provide one of the channels by which the Fund might enhance its monetary character and evolve, as might be needed, toward a role as the central monetary institution of the system. This role was alluded to in the G-10 report, and the idea of basing the Fund more fully on the SDR was examined by the G-10 Deputies, but no agreement was reached on these ideas.

#### IV. Concluding Remarks

The role of the SDR in the international monetary system has continued to evolve in response to fundamental structural changes in the system. When the first amendment of the Articles of Agreement brought the SDR into existence, it was primarily envisioned as a means of alleviating a shortage of international reserves, of maintaining confidence in the convertibility of U.S. dollar-denominated foreign exchange assets into gold, and of reducing some of the asymmetries between reserve centers and other countries. The structural changes of the 1970s--including suspension of gold convertibility, elimination of par values, evolution of international credit markets, and increase in the number of reserve currencies--eliminated the role of the SDR in helping to maintain gold convertibility and modified or extended the perceptions of its other functions. Views continue to differ on the extent to which, under current international conditions, the SDR should be used for reserve supplementation and to help reduce the asymmetries inherent in a system in which some countries do not have access to international financial markets. In addition, however, concerns about the growing importance of reserves subject to refinancing have led some observers to perceive that the SDR may have a potential role in increasing the stability of the international monetary system. Finally, the idea that the SDR system could have a role in facilitating some control over international liquidity continues to attract attention.

