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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/42

10:00 a.m., March 15, 1985

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	
C. H. Dallara	M. K. Bush
J. de Groote	H. G. Schneider
B. de Maulde	X. Blandin
M. Finaish	
H. Fujino	M. Sugita
G. Grosche	
J. E. Ismael	Jaafar A.
	L. Leonard
A. Kafka	H. A. Arias
H. Lundstrom	
E. I. M. Mtei	A. Abdallah
	B. Jensen
Y. A. Nimatallah	J. E. Suraisry
	J. E. Rodríguez, Temporary
	J. de Beaufort Wijnholds
	A. V. Romuáldez
G. Salehkhou	O. Kabbaj
	A. S. Jayawardena
	T. A. Clark
	N. Coumbis
Zhang Z.	Wang E.

L. Van Houtven, Secretary
L. Collier, Assistant

Also Present

African Department: A. D. Ouattara, Director; E. R. Borensztein, S. E. Cronquist, M. Dairi, B. R. H. S. Rajcoomar, M. Sidibé. Asian Department: D. M. Ripley. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director. External Relations Department: J. L. Carter. IMF Institute: O. B. Makalou. Legal Department: G. P. Nicoletopoulos, Director; J. G. Evans, Jr., Deputy General Counsel; Ph. Lachman, A. O. Liuksila, J. K. Oh. Middle Eastern Department: B. A. Karamali. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director; D. J. Mathieson. Treasurer's Department: D. Williams, Deputy Treasurer; J. E. Blalock, W. J. Byrne, W. L. Coats, Jr., J. A. Gons, D. Gupta, T. B. C. Leddy, A. F. Moustapha. Bureau of Statistics: S. H. Hahn. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: D. Hammann, G. E. L. Nguyen, J.-C. Obame, P. Péterfalvy, G. W. K. Pickering, T. Sirivedhin, N. Toé, A. Vasudevan, M. A. Weitz. Assistants to Executive Directors: I. Angeloni, J. Bulloch, M. B. Chatah, J. de la Herrán, J. J. Dreizzen, G. Ercel, C. Flamant, V. Govindarajan, N. Haque, G. D. Hodgson, Z. b. Ismail, A. K. Juusela, H. Kobayashi, R. Msadek, J. A. K. Munthali, E. Olsen, J. Reddy, D. J. Robinson, A. A. Scholten, L. Tornetta, A. J. Tregilgas, E. L. Walker.

1. DESIGNATION PLAN AND OPERATIONAL BUDGET FOR MARCH-MAY 1985

The Executive Directors considered the proposed designation plan (EBS/85/52, 3/4/85) and operational budget (EBS/85/53, 3/4/85) for the quarterly period March-May 1985.

The staff representative from the Treasurer's Department informed Executive Directors that further transactions had taken place since the papers had been issued. There were changes, therefore, in the table on the execution of the designation plan and in the table on the use of currencies and SDRs in transfers and receipts under the operational budget, amounting to only about SDR 15 million in the designation plan and less than SDR 10 million in the budget; the tables would be reissued. 1/

Mr. de Maulde, Mr. Grosche, and Mr. Pickering said that they had no difficulty with the proposed designation plan and operational budget.

The Executive Board then took the following decisions:

a. SDR Department - Designation Plan for March-May 1985

The Executive Board approves the designation plan for the quarterly period beginning March 15, 1985 as set out in EBS/85/52 (3/4/85).

Decision No. 7932-(85/42) S, adopted
March 15, 1985

b. Operational Budget for March-May 1985

The Executive Board approves the list of members considered sufficiently strong as set out in EBS/85/53, page 3, footnote 1, and the operational budget for the quarterly period beginning March 15, 1985, as set out in EBS/85/53 (3/4/85).

Decision No. 7933-(85/42), adopted
March 15, 1985

2. GABON - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Gabon, together with a proposed decision concluding the 1984 Article XIV consultation (SM/85/52, 2/12/85). They also had before them a paper on recent economic developments in Gabon (SM/85/69, 3/1/85).

1/ See Supplement 1 to EBS/85/52 and Supplement 1 to EBS/85/53, issued on March 15, 1985.

Mr. Alfidja made the following statement:

As reported by the staff, the Gabonese economy performed better in 1984 than in 1983, when the stagnation of oil output and the easing of the world prices for petroleum had significant impact on overall economic activity. In contrast, the 13 percent increase in oil output in 1984, combined with the effects of the depreciation of the CFA franc and an improved performance by part of the non-oil sector contributed to an increase in real GDP of about 5 percent, as against 2 percent in 1983. Regarding inflation, an improvement was noted in 1984 when the consumer price index for high-income households rose by 8 percent, down from 14 percent in 1983.

Regarding public finance, the overall position of central government operations, which deteriorated sharply in 1983, evolved favorably in 1984. The overall balance of these operations, on a commitment basis, shifted from a deficit of CFAF 43 billion--3.3 percent of GDP--in 1983 to a small surplus of CFAF 5 billion--0.4 percent--in 1984, owing mainly to oil revenue expansion. For 1985, the Gabonese authorities intend to pursue a cautious fiscal policy. In this regard, they share the view of Fund staff that the effort to moderate public spending must go hand in hand with a more systematic selection and control of such expenditure. To reduce the burden on the central government budget arising from transfers to some public enterprises, the Government intends to speed up the conclusion of contractual agreements calling for the observance of specified performance targets with these public enterprises. Two such contrats-programmes have already been signed, with Air Gabon and the Société Nationale des Bois du Gabon; negotiations with other companies are under way.

With regard to monetary and credit matters, the policy implemented in 1984 reflects the authorities' objective of ensuring noninflationary financing of economic activity. The rate of expansion of domestic credit slowed from about 41 percent in 1983 to 14 precent in 1984. As a reflection of the relative improvement of public finance in 1984, the Central Government's position vis-à-vis the banking system also improved, and the Treasury was able to increase its deposits with the central bank. In 1985, the Government intends to continue to exercise restraint and limit its recourse to the banking system, assuming that revenue grows as expected.

In the external sector, the balance of payments, which in 1983 posted its first deficit since 1979--CFAF 24 billion--has once again registerd a surplus--CFAF 19 billion--in 1984. This improvement came about as a result of the increase in the CFA franc value of petroleum exports in 1984 and higher inflows of long-term public capital.

The policy followed in 1984 with regard to external indebtedness was consistent with the principle of moderation and caution adhered to by the authorities since 1980. Accordingly, outstanding external public debt in terms of SDRs has continued to decline, decreasing from 25 percent of GDP in 1982 to 23 percent in 1983 and 22 percent in 1984. At the same time, the ratio of debt service to exports of goods and nonfactor services dropped from 12.5 percent to 11 percent in 1984.

The Gabonese authorities are aware of the country's great dependence on petroleum and of the risks that such dependence entails. To alleviate the effects of this phenomenon, the Government has been implementing a development plan for 1984-88 that places emphasis on building the economic infrastructure, notably transportation facilities, necessary to induce a diversification of economic activity. My authorities look upon the Fifth Economic and Social Development Plan, which has been favorably reviewed by the World Bank, as a way to effect the transition from an economy dominated by petroleum to one solidly oriented toward developing the other areas of Gabon's economic potential. They share the staff view on the need to intensify relations with international development institutions, in particular the World Bank. They intend to further the technical assistance ties established with this institution to identify projects and carry out feasibility studies.

The Gabonese authorities are also aware of the constraints associated with plan financing, owing to the uncertainties about the outlook for the production and sales prices of petroleum, and with exchange rate fluctuations, particularly of the dollar. They wish to stress, however, that the Plan is not to be considered a static instrument. As circumstances arise, it will be adjusted in accordance with the resources available.

The Gabonese authorities have taken note of the remarks and recommendations set forth in the consultation reports, in particular those pertaining to the assumptions underlying Scenarios I and II appearing in SM/85/52. They do not share the somewhat pessimistic view of the staff about the possibility of achieving certain targets of the Five-Year Plan. As indicated above, they intend to continue to show flexibility in the execution of the Plan.

In sum, I would like to reiterate the resolve of the Gabonese Government to pursue disciplined economic and financial policies. The authorities request the support of the international financial community as well as of frienly countries for the realization of their objectives, especially the implementation of their economic development plan.

Mr. de Maulde commented that he appreciated the scenarios provided by the staff in SM/85/52 on the possible evolution of Gabon's public finances and balance of payments to 1988. Budget developments were the main factor affecting the balance of payments. However, the assumptions underlying the scenarios appeared to have been contradicted by the course of events, especially for two main variables that heavily influenced projections--the price of oil and the exchange rate. At present, the price of oil was about $27 a barrel--lower, by 7 percent, than the $29 price used by the staff in the first scenario, and lower than the 5 percent annual increase over $29 that was the basis for the second scenario. Moreover, the exchange rate for the CFA franc against the dollar was about 17 percent above the staff's assumption of CFAF 435, which more than offset the reduction in the dollar price of oil. Two main conclusions could be drawn from those facts: first, economic uncertainty was similar to meteorological uncertainty in the sense that it was not possible to assign probability coefficients beyond a very short time span, and, second, the Gabonese economy was vulnerable to external factors.

The economy's vulnerability should be an important element in the design of financial policies, Mr. de Maulde continued. A security margin able to accommodate a possible reversal of the trends that to date had had a favorable impact on public finance should be incorporated. After the relaxation of fiscal policy in 1983, bringing about an overall deficit of CFAF 43 billion on a commitment basis, the budgetary situation had improved markedly in 1984 with a corresponding surplus of CFAF 5 billion. But areas of concern remained. First, extrabudgetary expenditure had been sizable in 1984, although mainly because of "exceptional circumstances" that were expected not to recur. Second, progress was needed in controlling budgetary expenditure. Procedures should be tightened to avoid the accumulation of arrears; although mostly technical, arrears made the monitoring of the budgetary situation difficult. Third, the rapid increase in the wage bill, which had averaged 18 percent a year between 1980 and 1984, was worrisome. Clearly, such a rate was unsustainable in the long run. He welcomed the authorities' decision to limit the growth of the wage bill to 12 percent in 1985, which went in the right direction; nevertheless, more should be done. To tighten recruitment policies, the authorities might consider further adapting the qualitative output of the educational system to the needs of the economy.

With regard to the real economy, the main challenge was undoubtedly the need to prepare Gabon for the post-oil era, Mr. de Maulde remarked, and consequently to devise an investment strategy aimed at diversifying the economy away from petroleum production. Fortunately, production seemed to be declining less quickly than envisaged, owing to new fields coming on stream in 1982-83. The best allocation of resources generated by oil production must be sought, but in view of the major constraints facing Gabon--a small internal market, the lack of skilled labor, high wages, and extreme communications difficulties--that was not an easy task. He was pleased that the World Bank regarded the Five-Year Development Plan for 1984-88 as broadly appropriate, and that the Bank was associated with the selection of investment projects through the provision of technical assistance to the Ministry of Planning. Some promising areas included fisheries, although traditionally the Gabonese were not fishermen; mining, including a project for producing barium oxide; and timber, where production so far had been hampered by difficult and costly transportation.

The completion of the second leg of the Trans-Gabon Railway would prove helpful in developing the timber industry and could have a favorable impact on a number of other activities, Mr. de Maulde remarked. The construction of the railway was fully justified. The main problem was that the railway's benefits were mainly "externalities," whereas heavy recurrent expenditures would have to be met by the railway company and indirectly by the government budget. In fact, recurrent expenditures merely to maintain infrastructural projects were not limited to the railway; they were the cause of most of the difficulties experienced by a number of public enterprises, resulting in a sizable increase in government subsidies to the public sector. Solutions to those difficulties lay in improved cost recovery, increased tariffs, better management, as well as more stringent programming of recurrent expenditures through a closer connection between the investment and recurrent budgets. In any case, foreseeable developments should encourage the authorities to err on the side of caution in devising fiscal policies in the years to come.

As infrastructural projects had already been developed, the relative scarcity of sound, productive projects in the short run offered Gabon an opportunity to reduce external debt and to build up foreign exchange reserves in case of adverse external developments, such as a further reduction in the price of oil and a sudden drop in the value of the U.S. dollar, Mr. de Maulde commented. Over the past few years, Gabon, with the assistance of the Fund in 1980-82, had pursued economic policies that had avoided major imbalances and had put the economy back on track toward sustainable development. The Gabonese authorities should be commended for those results, which were rare in sub-Saharan Africa; he was confident that such policies would be pursued in the years to come.

Mr. Mtei commented that the Gabonese economy continued to be dominated by the oil sector, which in 1984 had contributed about 40 percent to GDP and had accounted for 65 percent of government revenue and 85 percent of exports. Thus, despite the recent softening of the oil market, real output had picked up strongly in 1984, mainly because of the coming on stream of a new oil field that had raised crude oil production by 12.6 percent. The rise in oil production and exports had occurred while the CFA franc had been depreciating against the dollar. In the event, government revenue had benefited further and, with the apparent slowdown in expenditure, the overall budgetary position had improved, recording a surplus equivalent to 0.4 percent of GDP. The balance of payments had remained strong, supported mainly by the boost in earnings from the new oil field. It was therefore not surprising that Gabon had been able to build its external reserves to the equivalent of almost three months' imports.

Over the years, oil revenue had provided resources to the Government of Gabon to accelerate the investment program, primarily designed to expand the country's productive capacity, particularly in the non-oil sector, Mr. Mtei remarked. In 1983, investment outlays had been intended to be countercyclical in order to avert a recession. However, that fiscal stimulation had proved excessive, leading to a weakening of the country's financial and economic situation. Both the Government's budgetary position and the balance of payments had deteriorated significantly, as shown in Charts 1 and 2 of the staff report. Developments in 1983 had prompted the authorities to take corrective action, for which they should be commended.

The stated objective of the investment program for 1984-88, recently approved by the Government, reaffirmed the need to diversify the economic base, particularly in agriculture and industry, Mr. Mtei noted. However, actual resource allocations continued to be heavily skewed in favor of the development of physical infrastructure, taking about 50 percent of the total over the plan period. In fact, the development of the railway system alone had been allocated an amount equivalent to 29 percent of total resources. On the other hand, agriculture and industry, which offered better prospects for diversification, had been allocated proportionately small amounts. Although he was aware of the low absorptive capacity in those sectors and the importance of developing infrastructure as a prerequisite to economic growth, he joined the staff in calling for a better balance between outlays for infrastructural projects and those in directly productive sectors.

Apart from the problem implied by the allocation of resources in the investment program, there was one associated with financing, Mr. Mtei continued. Alternative scenarios under different oil price assumptions had been developed by the staff to demonstrate the impact on the Government's financial position and the balance of payments. The staff concluded that even under the more optimistic scenario, the medium-term objective of maintaining stable financial conditions, particularly in the government sector, might be out of reach. The staff also indicated that the balance of payments would come under pressure by 1987. While the situation was far from being desperate, the authorities were well advised to keep a close watch on developments and to ensure that prompt corrective action be taken whenever necessary.

Domestic industry had been hampered by the lack of competitiveness that had resulted in part from higher wage costs in Gabon and the acute shortage of domestic skilled manpower, Mr. Mtei concluded. He supported the staff in urging the authorities to embark upon a more vigorous training program for Gabonese nationals. However, wage restraint might prove difficult to implement, given the higher per capita income deriving from oil revenues, which also induced higher expectations among the Gabonese people.

Ms. Bush observed that, following problems in several sectors during 1983, Gabon's economic and financial performance had shown some improvement in 1984. A less expansionary fiscal policy, as called for during the

1983 Article IV consultation with Gabon (EBM/84/47, 3/28/84), combined with an increase in oil output, due mainly to the coming on stream of a new oil field, had resulted in a small overall budgetary surplus and an increase in real GDP growth from 2 percent in 1983 to 5 percent in 1984. In addition, Gabon's overall external position had improved during 1984, again most notably because of a substantial increase in oil export volume and exchange receipts. While imports and net services had remained close to 1983 levels, causing the external current account surplus to decline modestly, the capital account had improved substantially, resulting in an overall balance of payments surplus of 1.3 percent of GDP, compared with a deficit of 1.8 percent of GDP in 1983. A return to the cautious external borrowing policy of 1980-83 had somewhat eased the debt burden as well.

The staff's two scenarios on the medium-term outlook for Gabon were helpful in analyzing Gabon's economic prospects based on its Five-Year Development Plan, Ms. Bush commented. She noted, however, that those scenarios were sensitive to fluctuations in world market prices for oil and exchange market developments. It would be difficult, even under the more optimistic scenario, to meet the goals listed under the Development Plan without further action in key areas. In that connection, she welcomed the authorities' intention to show flexibility in executing the Development Plan.

To reach the Plan's objective of economic diversification of the non-oil sector, the Gabonese authorities should follow through with their stated intention to direct investment toward productive projects, Ms. Bush said. Increased assistance from the World Bank would help them to make sound project evaluations, conduct investment budget programming, and reach an appropriate balance between infrastructure and productive project investment. Improvement in the competitiveness of domestic industry was also needed to promote increased exports in the non-oil sector. She welcomed the authorities' plan to promote small and medium-sized enterprises mainly oriented toward the domestic market, and she wondered whether efforts would also be made to promote industries and investment in the private sector.

In the light of the projected decline in oil revenue, the Government must take fiscal measures beyond those currently planned in order to meet the goals of the Five-Year Plan, Ms. Bush noted. Improvements in the budgetary process, the tightening of financial controls, and further restraint on current spending, including public sector wages, would be necessary to secure a sound public sector fiscal position. The Gabonese representatives were seriously concerned about the recent increase in government spending, and they intended to take firm action to prevent further problems; measures to improve the financial position of the public sector enterprises were particularly welcome. The linkage between performance targets and government subsidies was helpful, and she hoped that the Government would soon enact more contracts that emphasized performance. As the performance and efficiency of such enterprises improved, the need for government subsidies should subside.

On credit policy, Ms. Bush continued, the improvement in the position of the Government vis-à-vis the central bank had been mainly offset by recourse to more expensive commercial bank credit. She was pleased to learn from Mr. Alfidja that the authorities intended to exercise restraint in that area. That rapid expansion of commercial bank credit could give cause for concern; the authorities should seriously consider the staff's recommendations for reserve ratios and perhaps a more active interest rate policy. Careful demand management could help to build up the necessary reserves to provide a cushion against adverse external developments and to aid the authorities in maintaining their cautious debt policy.

Finally, it appeared that the Gabonese authorities were aware of the critical need to diversify the economy into the non-oil sector and to address the deteriorating fiscal situation, Ms. Bush remarked. With continued uncertainties in the world oil market and with an expected decline in output from currently producing oil fields, the Gabonese authorities would, she hoped, address those issues as soon as possible to enable Gabon to regain its financial strength and the positive real growth of previous years. She supported the proposed decision.

The staff representative from the African Department, commenting on the Gabonese authorities' efforts to improve investment in the private sector, said that the staff's understanding was that the authorities, as stated in their investment plan, intended to keep the economy liberal and, in that connection, to make an effort to promote the development of the private sector in the economy.

Mr. Alfidja reassured Ms. Bush that the Gabonese authorities were open-minded about the use of more active interest rate policies and would not hesitate to use new monetary instruments should the need arise.

The Chairman made the following summing up:

> Executive Directors were in general agreement with the thrust of the views expressed in the staff appraisal in the report for the 1984 Article IV consultation with Gabon. They noted that the implementation in 1984 of a relatively restrained fiscal policy, coupled with a significant increase in oil production, had led to an improvement in the performance of the Gabonese economy, which, as clearly shown in the staff report, remained vulnerable to external factors. In that context, Directors stressed that sustained economic growth required vigorous actions to develop the non-oil sector of the economy. In the recently approved Five-Year Development Plan (1984-88) priority was to be accorded to agriculture, forestry, fishing, and manufacturing. It was noted that the World Bank regarded the Plan's priorities as being generally appropriate. Directors observed, however, that infrastructure would continue to absorb a very large share of financial resources and that technical assistance from the World Bank could be valuable in making project evaluations and in determining sectoral priorities in a balanced manner.

Given the relatively high level of production costs and prices in Gabon, Directors endorsed the authorities' intention to place greater emphasis on improving the economy's competitiveness. This would require restraint in the area of wage policy, as well as improved domestic supply of skilled labor. The medium-term scenarios put forward by the staff with regard to government finance and the balance of payments were welcomed; they showed the vulnerability of the balance of payments situation after 1987. Directors emphasized the need for more prudent demand management policies and, in particular, for restraint in government spending. Expenditure policies in the areas of personnel, other current outlays, and nonpriority investments should bear the brunt of such adjustment. The need to improve fiscal management by bringing all government spending within the budget, and by tightening existing budgetary controls and procedures, was also stressed. Moreover, corrective actions in the area of public enterprises should be implemented urgently; in that respect, the arrangements recently concluded with two important public enterprises were welcomed. To help to maintain relative price stability, fiscal restraint should be complemented by an appropriate credit policy, which could be enhanced through the introduction of reserve requirements and a more active interest rate policy.

Finally, Directors commended the Gabonese authorities on their cautious external borrowing policy, which, together with a buildup of reserves, would help to increase the resilience of the economy to external shocks.

It is expected that the next Article IV consultation with Gabon will be held on the standard 12-month cycle.

The Executive Board then took the following decision:

1. The Fund takes this decision in concluding the 1984 Article XIV consultation with Gabon, in the light of the 1984 Article IV consultation with Gabon conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Gabon continues to maintain an exchange system that is free of restrictions on payments and transfers for current international transactions.

Decision No. 7934-(85/42), adopted
March 15, 1985

3. SDRS - ALLOCATION

The Executive Directors discussed a paper on renewed consideration of an allocation of SDRs in the fourth basic period (SM/85/50, 2/11/85).

Mr. de Maulde remarked that, in previous discussions, most members of the Board had concluded that the requirements of the Fund's Articles of Agreement had been fully met for the resumption of SDR allocations. A few Directors were not yet fully convinced however. Thus, he wished to underline once again that on both technical and political grounds there was a strong case for an SDR allocation.

Three technical aspects supported his position, Mr. de Maulde continued. First, the increase in non-gold reserve holdings of all countries from the beginning of 1982 to November 1984 had been limited--18 percent in three years or less than 6 percent per annum. More specifically, the higher increase in non-gold reserves of non-oil developing countries--30 percent during the same period--had been more illusory than real. It had not corresponded to a real improvement in the net assets of those countries, as it had found its counterpart in the nonrepayment of part of the external debt, as a result of rescheduling operations. There had been an increase in gross reserves, but not in the net asset position of those countries.

Second, Mr. de Maulde went on, although it might seem that the U.S. current account deficit had supplied the rest of the world with international liquidity, that premise was questionable. As shown in the World Economic Outlook documents, the United States, to supplement the deficiency in its domestic savings, had borrowed back from the rest of the world the dollars sent abroad because of the current account deficit.

Third, the amount of reserves needed was clearly related to a country's access to financial markets, Mr. de Maulde remarked. As illustrated in Chart 1 of the staff paper, industrial countries normally maintained a lower ratio of non-gold reserves to imports than did developing countries, which had more difficulty in gaining access to external credits. In current circumstances, access to credit by developing countries continued to be more restricted than in the past, as stressed by the staff. In view of those technical points, he continued to consider that the long-term global need for reserves was established. That need could not be met in a better way technically than through an SDR allocation, as SDRs represented assets that were not generated through borrowing.

In addition to the technical aspects, other considerations should be taken into account, Mr. de Maulde said, including the general economic situation. To facilitate the transition between adjustment and recovery, especially in the larger debtor countries, the surplus released by exports should not be entirely sterilized to reconstitute reserves but should be used to reinforce the supply side of the economy through needed investment and imports of equipment goods. That action would also contribute to maintaining activity in industrial countries.

Another consideration was the need to be prepared to cope with the unavoidable shocks and difficulties that the international monetary system would face in the future, Mr. de Maulde commented. The present balance of payments and exchange rate situation was unsustainable over the medium term; readjustments would have to take place, and the longer they were delayed the more traumatic they would be. It was important for the international community to have at its disposal the necessary tools to deal with conditions of stress. From that perspective, it would be prudent to keep the SDR alive and well. However, the Fund could not accomplish that goal by allowing the share of SDRs in total non-gold reserves to decline year after year.

On the size of the allocation, he agreed with the staff that, fully to satisfy through SDRs the real demand for reserves, allocations of SDR 24 billion each would be required in 1985 and 1986, Mr. de Maulde commented. It would be appropriate for the Fund to fill part of that need for reserves through allocations of SDR 10 billion a year rather than SDR 4 billion or 5 billion. In conclusion, he emphasized that to allocate would be prudent; not to allocate would be foolish.

Mr. Wijnholds remarked that he broadly agreed with the position presented in the paper, although the staff could have brought out more clearly that the amount of any allocation had to be compatible with the role of the Fund in the adjustment process. The figures for an allocation mentioned on page 9 of the staff paper--a range of SDR 24-28 billion a year--did not meet that test. The staff might be better advised to state the estimated magnitude of the real demand for additional reserves, without reference to the figures for allocations.

As stated on previous occasions, his authorities were in favor of an allocation of SDRs in modest annual amounts, Mr. Wijnholds said. They suggested an allocation of SDR 4 billion in each of the next two years, or in each year of a new basic period, on the basis of not only the arguments presented in the paper and the fact that other forms of reserves had not shown an excessive increase in recent years but also the role of the SDR. The SDR must be preserved as a valuable international component of the world stock of reserves.

Meanwhile, sharp differences of view with respect to the current and prospective role of the SDR had not yet been resolved, Mr. Wijnholds observed. The role of the SDR should not be diminished as SDRs became a smaller proportion of the stock of reserves; on the other hand, he would not advocate a strong attempt to increase that role. A moderate allocation that would roughly maintain the proportionate place of the SDR in the system would be appropriate in present circumstances. The different views on the role of the SDR--a major component of the Fund's activities--were not salutary; he hoped that the Board could undertake to reconcile its views after the April 1985 meetings of the Interim and Development Committees.

Mr. Leonard commented that, although the staff's data on movements in international reserves and liquidity and the projections of world trade and inflation provided useful information, they could not possibly demonstrate, either statistically or factually, that there must be an allocation of SDRs in the fourth basic period. That decision must be taken in the light of broader political considerations and of good management of the international economy.

His chair's position had remained unchanged since the previous discussion on SDR allocations (EBM/84/131, 8/31/84), Mr. Leonard stated. In fact, virtually all the points made on that occasion and in earlier debates still applied, and he was anxious to see a consensus on an allocation. In that spirit and with the primary aim of enhancing the role of the SDR as a reserve asset, he could support allocations of the order of SDR 5 billion in 1985 and in 1986.

The role of the SDR might require some reassessment, Mr. Leonard remarked. He would not oppose that exercise and would be happy to see the type of review that was already taking place in the Group of Ten. However, it was not necessary to defer a decision on an SDR allocation until completion of that or other studies. If the share of SDRs in international reserves were not at least maintained over the next few years, the future role of the SDR might be prejudiced. The decision to have a modest allocation at present, as he had suggested, would, on the other hand, be neutral from the standpoint of the future role of the SDR.

Present indications suggested that there were not many concrete points on which progress would be made at the Interim and Development Committee meetings in April 1985, Mr. Leonard noted, although significant results would be welcome. Meetings devoid of real results or that were merely occasions for letting off steam could have serious, longer-term implications for the future relevance of the Committees as venues of constructive debate to solve the financial problems with which the Fund was closely concerned. That view was shared by all members of his constituency, and he therefore hoped that the present discussion could clear the way for agreement on an SDR allocation at the Interim Committee meeting. Even if the allocation were modest, agreement could have an important impact on the spirit and tone of the meetings in April 1985.

Mr. Ismael said that the staff's analysis had convincingly shown that there was a global need for a steady increase in non-gold reserves during the remainder of the decade. The analysis could perhaps also be taken to show that since 1981 non-gold reserves appeared to have been growing in line with global requirements, whether measured in relation to imports, trade imbalances, or external debt, despite the absence of any SDR allocation since 1980. It might therefore be inferred that the international monetary system was functioning smoothly and that reserve needs over the next years could be met through other channels, including current account adjustments, official intervention, and borrowing from international markets; according to that view, there was no clear case, therefore, for an allocation of SDRs.

There was a great flaw in that line of thinking, Mr. Ismael stated. Holdings of non-gold reserves had actually fallen by 2 percent in 1982 and had recovered in 1983 and 1984. World imports had fallen by almost 6 percent in 1982 and by over 3 percent in 1983. That apparent "adequacy" of reserves had been brought about by sharp decreases in imports, as part of adjustment efforts in many countries. Imports of non-oil developing countries had fallen by 9 percent in 1982 and by almost 5 percent in 1983. Almost half the decline in U.S. nominal exports in 1982 and 1983 could be attributed to the decline in exports to non-oil developing countries. Thus, he could not conclude that reserve growth had been adequate. Without the adjustments involving import cuts, the apparently stable ratio of non-gold reserves to imports could not have been maintained. Those adjustments had been undertaken at considerable cost to the peoples of the countries concerned, not to mention both the effect on future productivity and the increased protectionist measures needed to bring about those adjustments. To continue to rely on current account adjustments to provide an adequate level of non-gold reserves would be tantamount to ignoring the Fund's commitment under the Articles of Agreement to "facilitating the expansion and balanced growth of international trade."

Borrowing from capital markets had played a major role in increasing international liquidity during the 1970s, Mr. Ismael commented. In view of recent developments, Directors could not expect borrowing to continue on such a scale. Nor should it, for reliance on such an unstable source of international liquidity would only lead to a repetition of the debt problems facing countries at present.

An allocation of SDRs would reduce the risk of a global contraction in world trade, Mr. Ismael remarked, while increasing the portion of non-gold reserves subject to international control. As the staff rightly pointed out, an allocation of SDRs would be appropriate under the Articles of Agreement so long as there was a global need for reserve supplementation, even if that need could be met in other ways. An allocation would also help to promote the role of the SDR as the principal reserve asset of the international monetary system and would not be inflationary if the total increase in non-gold reserves, including the SDR, were no greater than the need for reserves.

The subject of SDR allocations in the fourth basic period had been discussed by the Board many times, Mr. Ismael concluded. The outcome thus far had been disappointing, despite both overwhelming evidence of the global need to supplement existing reserves and overwhelming support by most Directors. The Interim Committee meeting in April 1985 would provide an opportunity for all members of the Fund to demonstrate the political will to act in accordance with their responsibilities under the Articles of Agreement for the benefit of the world economy.

Mr. Coumbis remarked that the principle that must guide the Board's decision on a new allocation of SDRs was the long-term global need for additional reserves. It was difficult to estimate that need precisely as it depended on many factors, such as projections of world trade growth, the Fund's appraisal of the amount of reserves needed to allow that growth, the variability in exchange rates, and the access by developing countries to international financial markets.

The staff had provided a satisfactory analysis of the global reserve situation, Mr. Coumbis commented. According to staff estimates, the volume of world imports would grow by 5.5 percent in 1985 and 5 percent in 1986, after growing by 9.5 percent in 1984. Furthermore, from 1985 to 1990, world trade was expected to register cumulative growth of 35 percent.

The corresponding growth in the overall demand for reserves was more difficult to evaluate, Mr. Coumbis continued. Table 1 of the staff report indicated that, for all countries, the ratio of non-gold reserves to imports had ranged in the past decade between a minimum of 19.7 percent and a maximum of 24.1 percent. Estimates of the effective demand for non-gold reserves were sensitive to changes in that ratio: for each change of 0.1 percentage point, the amount of reserves demanded at the end of 1986 would vary by SDR 2 billion. Furthermore, other factors could influence the demand for international reserves. As pointed out by the staff, a large variability in exchange rates affected the value of reserves and could induce larger precautionary holdings of reserves. Moreover, as a number of countries' access to international financial markets had been greatly reduced in the past few years, those countries might want to increase their nonborrowed reserves.

In sum, Mr. Coumbis said, there were clear indications that, for the rest of the decade, a global need existed for additional reserves, owing to the projected increases in world trade. The staff estimates of that need were realistic and could serve as a guide to the Board's decisions. Furthermore, the Articles of Agreement provided that the SDR was to be made the international monetary system's principal reserve asset, which required a gradual increase in the share of SDRs in global reserves even if it were accepted that there was no global need to supplement reserves. He therefore warmly supported a new allocation of SDRs, as it appeared fully consistent with the Articles. The Board should not attempt to cover the total required increase of reserves through SDRs; therefore, an annual allocation of approximately SDR 10 billion would be appropriate.

Although the benefits of an SDR allocation were not strictly relevant in determining the long-term global need for reserves, they were useful in determining the size of SDR allocations, Mr. Coumbis observed. An important issue was the composition of reserves as to borrowed and nonborrowed reserves. Those two types were not perfect substitutes: experience had shown that access to borrowed reserves diminished in critical times when countries incurred balance of payments problems. An increase in the ratio of nonborrowed reserves to total reserves was advisable, as it would increase the stability of the system. An allocation of SDRs would provide an increase in nonborrowed reserves without making such an increase contingent upon the policies and the balance of payments deficits of countries with reserve currencies. Such an allocation would also, by rebuilding to some extent debtor countries' reserves and improving their credit standing and borrowing capacity from capital markets, be of indirect benefit to virtually all countries, including those that did not have a reserve shortage. Furthermore, a moderate allocation of SDRs would not have a negative effect on the adjustment efforts of a number of countries. The amount of liquidity created would be small relative to the resources being provided by the Fund, and in many cases also by the market, in support of adjustment programs.

Finally, Mr. Coumbis concluded, there was no danger at present that a reasonable allocation of SDRs would have an inflationary impact, as those reserves would be willingly held. Moreover, the inflationary potential of an SDR allocation would be minimized if the monetary aggregates in industrial or developing countries were maintained within their target growth rates. An SDR allocation would therefore be consistent with Article XVIII, Section 1(a), which stated that SDR allocations would be done in a manner so as to "avoid economic stagnation and inflation as well as excess demand and inflation in the world."

Mr. Grosche commented that, although he could not be as positive on allocation as previous speakers, he did welcome the statements by the staff reaffirming that the sole criterion for an SDR allocation was the long-term global need to supplement existing reserves and that an SDR allocation was not intended to be a "countercyclical" policy instrument.

However, he could not share the view of the staff that the considerations offered on pages 2 and 3 of its paper actually represented all clarifications of previous discussions, Mr. Grosche continued. For example, the third sentence of the last paragraph on page 2 did not reflect the view of all Directors. He did not believe that the Fund could meet the criterion of global need by simply adhering to the broad objectives mentioned in Article XVIII, Section 1(a). Those objectives were relevant, when the need arose, to determine the manner in which the long-term global need should be met.

Nor could he go along with the staff statement that an allocation of SDRs would be appropriate even if a long-term global need could be met in other ways, Mr. Grosche remarked. The staff argument implied that only the demand for supplementing reserves was relevant, not the supply. As he had said on previous occasions, that line of reasoning in favor of an SDR allocation was not in accordance with either the spirit of the SDR's founding or with the relevant provisions in the Articles. In his view, a general shortage of liquidity that could not be met by sources other than the SDR justified an SDR allocation.

He also had problems with the assertion that the Fund had to take into consideration the share of SDRs in total non-gold reserves when calculating a global need, Mr. Grosche stated. That procedure would lead to the absurd consequence where, as more reserves were provided by other sources, more SDRs would need to be created.

According to the staff paper, the latest changes in holdings of non-gold reserves did not indicate a lack of reserves, Mr. Grosche said. The IMF Memorandum of March 4, 1985 reported a sizable increase in total international reserve holdings of 12 percent during 1984; reserves of non-oil developing countries had expanded by 22.1 percent, and holdings of non-oil developing countries in the Western Hemisphere had expanded by 64.6 percent. In the staff paper, rough calculations of the likely growth of the long-term global need for reserves had been presented; assuming that the average ratio of reserves to imports in 1973-83 had been appropriate, and using the latest projections for world trade growth, the staff had concluded that international non-gold reserves should amount to about SDR 496 billion by the end of 1986. He had, on previous occasions, questioned the relevancy of such projections, and even the staff had expressed some concerns about the usefulness of the ratio of reserves to imports. To illustrate how unreliable such projections were, he recalled that in a paper issued at the end of 1983 (SM/83/266, 12/28/83), the staff had estimated that non-gold reserves would amount to SDR 460 billion, or SDR 36 billion less than the present estimate, while in April 1981 (SM/81/74, 4/1/81), in a "low-growth/low-inflation scenario," the staff had estimated non-gold reserves at SDR 525 billion, or SDR 29 billion more than the present estimate. He acknowledged that such calculations could serve an illustrative purpose, but they should be looked at with reservations. In its calculations, the staff had not attempted to examine the extent to which the prospective need for reserves was likely to be covered by different sources of liquidity, especially in view of the present and prospective U.S. current account deficits, which were a large potential source of international liquidity.

He was increasingly doubtful about the staff's statement that an SDR allocation would not set off any inflationary pressures because those additional SDRs would be willingly held, Mr. Grosche remarked. It was the staff's view that inflationary pressures would be limited, even if SDR allocations temporarily exceeded the global need, as long as the monetary authorities in industrial countries kept the growth of monetary aggregates within the announced targets. That argument again overlooked the possibility that reserves could be provided from different sources; if they were not firmly controlled, any additional SDRs would imply a much higher growth of reserves than initially expected. The staff's implicit working hypothesis that additional SDRs would substitute, or "crowd out," reserves from other sources was not supported by sufficient evidence. He acknowledged that certain problem countries currently had only limited or no access to international financial markets. For those countries, additional reserves would become available primarily through a surplus in the balance of payments, which again could be achieved only at sizable cost. The staff held the view that an SDR allocation would reduce the cost of holding reserves without diminishing the incentives for further adjustment efforts. Although that argument might be valid, it unfortunately did not create evidence that a long-term global need existed.

The low level of reserves in some countries was only superficially a problem of liquidity, Mr. Grosche observed; it was fundamentally a problem of adjustment. If reserves were lost because of repeated delays in adjustment, any replenishment by monetary means seemed inappropriate. Without progress in the consumption, savings, and investment patterns, and without a correction of relative prices, additional SDRs would not serve a useful task. They would probably be spent and might thus delay again the inevitable adjustment. In sum, the staff paper had failed to convince him that the time had come to supplement reserves through a new round of SDR allocations.

Mr. Mtei said that he welcomed the present discussion, although he was disappointed by the inability of the Board to reach agreement on the allocation of SDRs after many lengthy discussions. In previous meetings, his chair had urged the Board to approve a substantial allocation of SDRs during the fourth basic period. In fact, a large majority of the Fund's membership agreed that an allocation of SDRs, in the wake of a growing long-term global need for reserves, would help to promote the smooth functioning of the international monetary system and, indeed, the international economy as a whole.

The fact that the Board was stalemated on the matter was not due to lack of information, Mr. Mtei continued. The staff report under consideration was but another in a long list of staff reports that had given ample justification for an allocation of SDRs. A number of informed observers outside the Fund had also argued in favor of an allocation. John Williamson of the Institute for International Economics had concluded in his recent monograph on the SDR that "never since the SDR was invented has there been a case nearly as strong as at present for a substantial allocation."

In the face of all the evidence, and given the fact that the majority of the member countries was convinced of the need for an SDR allocation, the problem was no longer whether an allocation satisfied the criteria laid down in the Articles of Agreement, Mr. Mtei remarked. Instead, the Board should determine whether there was the political will on the part of the few member countries that opposed an allocation to help achieve the needed consensus that the decision required. The Interim Committee should answer that question; if, unfortunately, no decision were reached at the present meeting, instead of referring the issue back to the Board, the Committee should make an earnest effort to overcome the political hurdles that had resulted in the fourth basic period's remaining an empty shell.

His chair's position, calling for a substantial allocation of SDRs in the fourth basic period, had not changed, Mr. Mtei stated. For three reasons, he could go along with the order of magnitude suggested by Mr. de Maulde. First, many countries had succeeded in containing inflation, and it was unlikely that SDR allocations would renew pressure on prices as long as individual countries maintained or sought to implement sound fiscal and monetary policies. In other words, in expressing fears about the likelihood of a new round of inflation, it would be a case of misplaced emphasis if attention were concentrated on SDR allocations. Of greater importance were the ability and willingness of countries, particularly those whose actions had far-reaching consequences for the global economy, to maintain sound domestic policies.

Second, Mr. Mtei went on, up to the beginning of 1985 few countries had been able to re-establish normal access to international capital markets. For that reason, the accumulation of reserves in many countries in the face of high external debts and high interest rates could take place only through an adjustment process that stifled economic growth and reduced the standard of living, a situation that those at the low end of the income scale could not afford. An SDR allocation at the present time of the magnitude suggested in the staff paper and modified by Mr. de Maulde would serve the useful purpose of helping to make the burden of adjustment more tolerable. In that connection, there should be little concern that the allocation would discourage countries in need of adjustment from taking actions to attain viable balance of payments positions and to restore their creditworthiness, because the distribution formula would ensure that the amount of SDRs accruing to developing countries, particularly low-income countries, would be small relative to their balance of payments need.

Third, it was necessary to take action to ensure that the SDR became the principal reserve asset in the international monetary system, in keeping with the Articles of Agreement, Mr. Mtei remarked. A substantial allocation was necessary as a matter of urgency, given that the share of SDRs in non-gold reserves was expected to continue to decline in the absence of further allocations in the current basic period. Although efforts were being made to improve the financial characteristics of the SDR, those efforts would do little to enhance the SDR's role in the international monetary system if the supply of the asset were inadequate.

Mr. Lundstrom stated that he was in broad agreement with the assessment of the case for an SDR allocation presented in the staff paper and supported by a vast majority of the Directors who had already spoken. The paper clearly demonstrated that many countries needed additional reserves because of an originally low level of liquidity or a desire to augment reserves in line with increasing international trade. A new allocation of SDRs could fill part of such a need for increased reserves.

The inflationary effect, if any, of an SDR allocation of a limited size would be negligible and gave no cause for concern, Mr. Lundstrom commented. In a longer-term perspective, and notwithstanding the change in the monetary environment since its introduction, the SDR could and should play an important role as an internationally controlled reserve asset. However, it was crucial for the credibility of the SDR that new allocations take place at regular intervals, with their size related to the long-term global need. The SDR's low and declining share in existing reserves was not in line with the objective of making the SDR the principal reserve asset in the international monetary system, as set out in the

Articles of Agreement. Therefore, his constituency believed that it would be appropriate for the Fund to take a decision soon on a moderate SDR allocation.

Finally, Mr. Lundstrom concluded, the Nordic constituency believed that it would be desirable to have a general discussion in the Board on the role of the SDR in the monetary system. In that discussion, the Board should consider the long-term perspective in depth, clarify the grounds on which decisions on future allocations should be based, and advance deliberations on the principles of the SDR system. The forthcoming report of the Group of Ten on the international monetary system might provide background information for such a general discussion.

Mr. Alfidja stated that his chair strongly favored a substantial and straightforward allocation of SDRs, which was long overdue. The staff paper, which mainly updated previous papers on SDR allocations in the current basic period, clearly demonstrated that, on purely technical grounds, a clear-cut case existed for a fresh allocation of SDRs. Such an allocation would meet the long-term global need for reserve accumulation resulting from the current and projected expansion in output, world trade, and financial transactions. He strongly supported Mr. de Maulde's comments on noneconomic factors that Directors needed to keep in mind when considering an SDR allocation; those factors strengthened the staff's argument.

A particularly relevant staff argument at the present juncture of the history of the international financial system was that countries that had no access to international capital markets could acquire reserves only through the net sales of goods and services to nonresidents or through intergovernmental borrowing, Mr. Alfidja noted. Thus, for those countries the accumulation of reserves imposed a real cost associated with the adjustment needed to achieve balance of payments surpluses. In the present situation, even traditionally highly rated borrowers had limited access to international capital markets. It was therefore appropriate, as suggested by the staff, to help to satisfy the long-term global need for reserves by an SDR allocation, which would alleviate the cost of acquiring reserves for the growing number of countries without access to financial capital markets.

The staff also gave ample and convincing explanations of how a new allocation of SDRs could ensure the smooth functioning of the international monetary system without creating inflationary pressures or bringing about a relaxation of present adjustment efforts, Mr. Alfidja continued. He fully supported the staff's views as summarized on page 13 of the report. Finally, he appealed to Directors who were skeptical about the genuine need to resume SDR allocations to reconsider their position so that a favorable report could be presented to the Interim Committee on the issue. If such a consensus were reached at the present meeting, it would be proof to the world that, as in the past, cooperation was not an empty word within the Fund.

Mr. Kafka said that his chair, as it had done consistently, favored an immediate allocation of SDRs for the remainder of the fourth basic period. He noted that in the staff paper no attention had been paid to the fact that the depreciation of gold in terms of the dollar added to the arguments for an allocation of SDRs.

In the report, although there was a simulation the staff did not propose, the allocation that was needed for an increase over past peak ratios of SDRs compared with other non-gold reserves, Mr. Kafka continued. The injunction in the Articles of Agreement to make the SDR the principal reserve asset seemed to require such an increase.

He favored an allocation that would be at least adequate to maintain the past peak relationship between SDRs and non-gold reserves for 1985 and 1986, Mr. Kafka concluded. Like Mr. Leonard and others, he saw no reason to postpone an affirmative decision to allocate at the next Interim Committee meeting.

Mr. Jensen said that, as other speakers had noted, the question of SDR allocations had been considered by the Board several times; he reaffirmed his chair's position in favor of an adequate allocation of SDRs for the remainder of the fourth basic period. The report was conclusive; all the criteria set out in the Articles of Agreement and in subsequent discussions in the Board had been met. The continued failure to adopt a final positive decision on the matter was therefore regrettable.

Directors questioning the allocation of SDRs for the period had argued that such an allocation could revive inflationary pressures or, more important, weaken current adjustment efforts of members facing economic imbalances, Mr. Jensen continued. The staff, however, had once again presented a clear case demonstrating that under current projected international conditions, an SDR allocation would not be inflationary and would not be counterproductive to the adjustment process. On the contrary, such an allocation would be in line with the expansion of real demand for non-gold reserves, which in turn reflected trends in trade growth and access to international capital markets. The figures and assumptions used by the staff in the present case were those considered for the World Economic Outlook exercise and the basis for the Board's assessments and decisions on other Fund policy issues. In addition, the statistics and assumptions provided for the present discussion were found in the medium-term scenarios in Article IV consultation discussions. As the assumptions were entirely consistent with the Board's policy recommendations adopted in other fields of Fund interest, they should be considered the appropriate rationale for assessing whether the need existed for an SDR allocation.

On the linkage between an SDR allocation and the adjustment process, Mr. Jensen commented, the achievement of a more viable external position required an increase in reserves for almost all countries currently undertaking adjustment. Given the limited access of those countries to international capital markets, that goal had to be pursued through balance of payments surpluses, which in turn implied the attainment of even larger trade surpluses. An SDR allocation, far from endangering the strength of the adjustment effort, would facilitate the buildup of reserves without imposing further constraints on those countries that might otherwise find it difficult to cope with their financial obligations. Far from discouraging the adjustment efforts being made by many member countries, an allocation of SDRs would contribute greatly to the consolidation of world economic recovery, constitute a recognition of the financial difficulties being faced by those countries, and reinforce the need to eliminate trade barriers. He urged member countries that had thus far not found it justifiable to reconsider their positions and to develop a consensus for an SDR allocation.

Mr. Fujino stated that his chair's position on the issue remained broadly unchanged. The latest staff paper showed that non-gold reserves for all countries had risen from SDR 334 billion at the end of 1982 to SDR 404 billion at end-November 1984. The reserves of the non-oil developing countries had increased at an annual rate of 16 percent during the same period. Those observations suggested that reserve holdings had generally continued to increase in line with the expansion of world trade associated with the recent recovery.

The staff paper argued that, under the current monetary system, the change in reserve holdings could be caused by either demand-side or supply-side factors, Mr. Fujino continued, and it was impossible to identify the underlying factors by merely observing changes in the ratio of reserves to imports. While he basically agreed with that argument, he also held the view, as noted in "The Role of Reserves in the International Monetary System" (SM/84/269, 12/11/84), that for those countries with access to international capital markets, additional reserves could be obtained at relatively low cost, as long as the country maintained prudent macroeconomic policies demonstrating its ability and willingness to make the real transfers necessary for servicing its debt. Given the availability of credit markets, the level of reserves would be determined mainly by demand-side factors rather than by supply constraints, and the recent movement of reserves could be interpreted in that way. At any rate, the staff paper did not adequately demonstrate the existence of significant supply shortages of reserves to meet demand. Of course, he was aware that access to international capital markets had been curtailed in many countries during 1981 and 1982. However, as he had said on previous occasions, that problem was not global and could best be dealt with through the countries' pursuit of prudent macroeconomic policies in order to restore creditworthiness.

In sum, from the information given, he was not convinced that a case had been made for a long-term global need for reserve supplementation, Mr. Fujino concluded. He invited the staff to comment on whether there would be a future constraint on the supply of foreign exchange through existing facilities.

Mr. Jayawardena commented that he hoped the Board could reach a constructive decision at the present meeting and influence the future course of history by giving a small push to the slowly emerging world economic recovery following a disastrous recession. He strongly urged that the staff paper be made available to the Interim Committee along with the Chairman's report. His chair had consistently held the view that the world economic situation in recent times demanded an urgent and substantial allocation of SDRs. The Group of Twenty-Four--representing all the developing countries, as well as the industrial countries with few exceptions, thus representing a vast majority of the Fund membership--had also supported an immediate allocation. However, the allocation had not materialized, as some of the major industrial countries had not found the arguments for an immediate allocation sufficiently persuasive. The staff paper presented the case for an allocation succinctly and effectively, and he agreed with several of the staff's observations. It was clear that all the criteria for an SDR allocation continued to be satisfied at the present time.

The ratio of non-gold reserves to imports, which constituted one of the important indicators for the measurement of demand for reserves, continued to be about 21 percent, much lower than the 28 percent ratio in 1972 or the 23 percent ratio in 1978, when allocations in the third basic period had been agreed, Mr. Jayawardena observed. It had to be remembered that the modest rise in non-gold reserves seen recently had been from an extremely low level in 1982, and it had occurred basically on account of a substantial accrual of such reserves to a handful of countries. In fact, in nearly 30 of 64 non-oil developing countries for which data were available to November 1984, non-gold reserves had been lower than at the end of 1979. Many of those countries' reserves had been reduced by 50-90 percent. Even among those countries that had increased their reserves, many had done so not through large increases in export earnings but through a substantial--and unhealthy--curtailment of imports.

Another indicator for the measurement of the adequacy of reserves was the ratio of non-gold reserves to aggregate trade imbalances, Mr. Jayawardena continued. That ratio was currently at about the same level as in 1980, which had been the lowest since 1974. In addition, curtailment of access to financial markets had seriously affected the availability of borrowed resources for many countries. Developing countries had been compelled to carry larger reserves, which they could build up only by running current account surpluses. The expansion of earnings was difficult in a recession and with growing protectionism and could be achieved only through substantial import compression. These developments had substantially hindered world trade and had afflicted all countries, industrial and developing alike. There was no better indication of a global need for reserves than the current international economic situation.

The staff had presented a convincing case that a long-term need for reserves existed, Mr. Jayawardena noted. On the basis of the assumptions in the current World Economic Outlook documents, it was clear that reserve holdings of countries would have to rise to SDR 496 billion by the end of

1986 and to SDR 706 billion by the end of 1990 if the ratio of reserves to imports were to be maintained at the average for 1973-83. Reserves would thus have to rise by SDR 92 billion by the end of 1986 and SDR 301 billion by the end of 1990. Those projections clearly established the long-term need for reserves.

An SDR allocation satisfying that need would not be inflationary or contractionary, Mr. Jayawardena went on; it would provide the reserves required by the current level of economic activity in the world and would underpin the evolving recovery of the world economy. At present, major countries were successfully containing inflation; therefore an appropriate SDR allocation would not be inflationary but would provide a modest means for improving trade between countries and giving momentum to the economic recovery.

An SDR allocation at the present juncture, when a large number of developing countries were undertaking painful adjustment programs, would help those countries to replenish their depleted reserves and pursue orderly adjustment policies, Mr. Jayawardena observed. It would also ease the cost burden of many adjusting countries--especially the highly indebted countries whose reserves were normally made up of borrowed resources. Hence, the argument that an SDR allocation would weaken ongoing adjustment processes defied comprehension. Moreover, an allocation of SDRs at present would also help to improve the balance between conditional and nonconditional liquidity available to the developing countries.

According to the Articles of Agreement of the Fund, the SDR was expected to become the principal reserve asset in the international monetary system, Mr. Jayawardena noted. However, cumulative SDR allocations, as a percentage of non-gold reserves, had amounted to 5.3 percent in the fourth quarter of 1984 compared with 8.3 percent in 1972, clearly indicating the sharply declining position of the SDR. It was the duty of the membership of the Fund to ensure that the objective of making the SDR the principal reserve asset, as enshrined in the Articles, was pursued in practice.

He supported the position of the Group of Twenty-Four that an annual allocation of SDR 15 billion for the remaining two years of the current basic period would be justified under all criteria for an allocation, Mr. Jayawardena stated. He disapproved of the concept of "conditional SDRs" as enunciated in certain quarters because it would be contrary to the Articles of the Fund.

The question of SDR allocations had been discussed extensively at various levels, including the Board, Mr. Jayawardena concluded. It was said that what was needed at present was a "political solution" of the issue. Did that mean that an SDR allocation had become a bargaining chip in an exercise of give and take? The SDR must be looked at as an internationally controlled reserve, not as a bargaining matter. He therefore requested that his colleagues representing countries that had been unable to agree on an allocation thus far convey to their authorities the urgent need for an early decision in favor of an allocation in order to move on to a sustainable recovery phase in the current business cycle. Moreover, the SDR represented an important concept that had had universal acceptance, and it would be unfortunate if the SDR were weakened. He appealed to the Chairman to assume, as a special responsibility, the duty of convincing the doubtful members of the urgent need to allocate SDRs at present.

Mr. Dallara said that he had carefully reviewed the staff paper and had considered once again the various facts and arguments for and against a new SDR allocation. He remained unconvinced that an adequate case for an SDR allocation had been made. Reserve data, both in absolute terms and in relation to key variables, did not demonstrate a long-term global need, as specified in the Articles. Insufficient weight had been given to the adverse effect that an allocation could have on inflationary expectations, inflation, and adjustment efforts. Arguments about reduced access to international credit and about the uniquely and arguably undesirable character of borrowed reserves did not adequately take into account the basic cause of, and appropriate solutions to, the question of creditworthiness in international markets and exaggerated the distinction between owned and borrowed reserves. In addition, the case for creating SDRs to preserve the role of the SDR in the system tended to prejudge what that role should be.

In assessing the various factors that bore upon any decision regarding allocation, it was important not to lose track of the key criteria set forth in the Articles, Mr. Dallara continued. Essentially, he remained to be convinced that there was a long-term global need and that an allocation would be consistent with the Fund's purposes. In assessing whether the need was long term, it had to be remembered that the Articles referred to a need "as and when it arises." He recognized that the phrase permitted the Board to examine not just the immediate need but also the need that might arise in the coming period. However, projections of such a need should not extend too far into the future, particularly where the recent and immediately foreseeable trend of reserves was not clearly unsatisfactory. The uncertainties became greater as forecasts were made further into the future, thus creating a temptation to allocate SDRs basically because of the wide range of unforeseen risks that could conceivably arise during such a long period.

On the global nature of the need, Mr. Dallara continued, he did not question the desirability of examining what had happened to reserves among various groups of countries, but care must be taken to avoid arguments tailored to prove either a temporary need or a need focused too much on one group of countries.

The data in the staff report indicated that the decline in global non-gold reserves in 1982 had followed a long period of substantial and fairly steady growth shared by each of the major country groups, Mr. Dallara noted. The overall decline in 1982 had been primarily accounted for by declines in the holdings of the industrial and oil exporting countries; the non-oil developing countries had not fared as badly as some had suggested, experiencing a decline of less than 1.5 percent in 1982. Since that time, global non-gold reserves had risen at an average annual rate of 10 percent, while non-oil developing countries' reserves had recovered at an average annual rate of 16 percent. Moreover, total reserve holdings had expanded in line with world imports. For all countries, the ratio of non-gold reserves to imports had remained in the narrow range of 20-21 percent from 1979 to 1984. For the non-oil developing countries, the ratio of 22.7 percent in 1984 had not only been the highest since 1979, but had also exceeded the ratio for all countries as a group.

Projections of future developments in non-gold reserves did not give particular cause for concern, Mr. Dallara commented. The staff estimated that a 10 percent annual rate of increase during 1985 and 1986 would be necessary to achieve the average ratio of non-gold reserves to imports for 1973-83, or 21.5 percent. In fact, the necessary 10 percent rate of growth was precisely the rate experienced during the past two years. While he did not wish to give too much emphasis to such a brief period, it was worth noting that the reserve growth had occurred when there had been no SDR allocations and when the private creditworthiness of many countries had been significantly reduced, a process that in many countries was being gradually reversed at present as their adjustment efforts helped to restore their external creditworthiness.

The data in Table 1 of the staff report showed a decline in the ratio of reserves to trade imbalances from 1977 through 1983 for non-oil developing countries, Mr. Dallara observed. However, no data were shown for 1984. In view of the substantial rise in those countries' non-gold reserves from SDR 79 billion at the end of 1983 to SDR 93 billion at end-November 1984, he wondered whether the ratio might have begun to rise. Table 2 also showed surprising stability in the ratio of non-gold reserves to external debt to banks for non-oil developing countries. In fact, by the second half of 1984, the ratio of 22 percent had reached the same rate as in the first half of 1981. In sum, past data and current forecasts did not present a convincing case for an SDR allocation.

In the past, his chair had expressed concern about the possible inflationary implications of an allocation, Mr. Dallara stated. Those concerns persisted, and he did not share the staff's view that they were largely unwarranted. In principle, it was possible for national monetary authorities to make whatever adjustments might be appropriate to accommodate an allocation so as to ensure that, in aggregate, official reserve creation would not be excessive. However, such matters were not so simple, and memories of inflation should not be so short. Therefore, he remained concerned about the inflationary impact of an allocation. It was necessary to avoid the implication that there had been a shift in the positions of the Fund and member countries regarding the need for continued progress against inflation. There was every possibility that an allocation would be widely perceived as a weakening of anti-inflationary resolve, which could lead to a general reduction in the anti-inflationary commitment of Fund members.

An infusion of unconditional resources through an SDR allocation would not further the adjustment process, Mr. Dallara remarked. The need to restore a sustainable balance of payments position and international creditworthiness that could provide a basis for the restoration of noninflationary growth was the driving force behind adjustment. As appropriate policies were introduced and implemented, a country's economic prospects could be expected to improve. External imbalances would be reduced; external creditworthiness, with regard to both official and private sources, would be enhanced. He was concerned that an SDR allocation could relax that discipline and discourage policymakers from taking the necessary hard decisions that would enable them to build up and maintain an adequate level of reserves.

It was clear that the recent loss of access of many developing countries to international credit markets arose not because of systemic deficiencies, Mr. Dallara commented, but because of a widely shared perception among creditors that many developing country borrowers were substantially less creditworthy than had previously been believed. As he had often emphasized, the key to resolving the problem clearly lay in effective adjustment measures designed to produce a sustainable balance of payments position over the medium term. That view was shared by others; it explained the basic thrust of Fund policy over the past few years, as articulated in both general statements and specific policy recommendations for individual countries.

It was also clear that certain countries that did not appear creditworthy in private markets at present had been creditworthy in the past, Mr. Dallara continued. Experience suggested that even those countries in the most difficult positions at present could conceivably gradually restore private market creditworthiness through the persistent implementation of appropriate adjustment measures. Even the most difficult cases therefore should not necessarily be considered beyond the reach of international capital markets on a permanent basis. Moreover, the importance of adjustment efforts to restoring a country's capacity to acquire international reserves had been increased as donor assistance was increasingly linked to performance in the adjustment process.

It had been argued that an increase in the quantity of SDRs would necessarily strengthen the SDR as a reserve instrument, Mr. Dallara noted. The non-oil developing countries currently held only about 25 percent of their gross allocated SDRs, the remainder having been exchanged for usable currencies or transferred to the Fund. On the basis of that experience, it was likely that a sizable portion of any future allocation would also ultimately end up in a limited number of countries. That result could foster the view that the SDR was a form of credit to a selected group of countries rather than a generally useful reserve asset. Such a development would certainly not further the role of the SDR as an important reserve asset.

The staff had commented on the "appropriate proportion of non-gold reserves that should take the form of SDRs," Mr. Dallara said, and on the idea that, as a result of an SDR allocation, "the SDR could also potentially facilitate future adaptation of [the monetary] system." He invited the staff to comment on what was meant by an "appropriate proportion" of SDRs in world reserves, and on how appropriateness could be measured. It was also not clear that an allocation would facilitate adaptation of the international monetary system. Such a conclusion must depend upon some preconceived notion of the direction in which the monetary system ought to evolve. For example, one possible direction of evolution of the international monetary system could be toward a multicurrency reserve system. If that were the case, how would a new allocation of SDRs promote that evolution?

His authorities, along with those of other Board members, had expressed considerable uncertainty about what the future role of the SDR should be, given the fundamental changes that had occurred in the world economic and financial environment since the SDR's creation, Mr. Dallara concluded. A careful evaluation of the role of the SDR was called for before making any assumptions about the possible effect of a new allocation on that role.

Mr. Romuáldez commented that his constituency, like the Board, seemed to be unable to arrive at a consensus concerning an SDR allocation. The views of the members of his constituency had not changed since the previous Board discussion in August 1984 (EBM/84/131, 8/31/84). Eight of the nine authorities in his constituency, on balance, supported the conclusions of the staff paper and thus favored an allocation in the remaining years of the fourth basic period.

His Australian authorities continued to hold the view that a convincing case had not yet been made in support of an SDR allocation, Mr. Romuáldez continued. They did not believe that there was a global need at present for reserve supplementation, and indeed regarded the robust growth in reserves over recent years and the recent movements in the ratios of non-gold reserves to imports and to trade imbalances as having strengthened the argument against an allocation at present. Furthermore, the Australian authorities were of the view that, if there were an allocation, it would not necessarily impart the benefits to the international financial system that were suggested by the staff.

They did not find the argument convincing that the movement of reserves in line with world imports and trade imbalances in recent years implied that reserves were not at desired levels, Mr. Romuáldez remarked. What had to be shown was an insufficiency of reserves for the smooth functioning of the financial system. The fact remained that reserves were higher, and access to capital markets at least no worse, than they had been for the past two years. The authorities regarded arguments concerning the problems in accumulating reserves experienced by countries without much access to international capital markets as being unrelated to the specified criteria for an SDR allocation to all members. An allocation should not be related to the particular adjustment difficulties of member countries.

The staff had also argued that there was a need to reduce the ratio of borrowed reserves to total reserves and, therefore, the vulnerability of the international monetary system to disturbances in private financial markets, Mr. Romuáldez continued. That argument also appeared peripheral to the Australian authorities: they believed that substantial allocations would be required to alter that ratio significantly. Moreover, the argument was most relevant to those countries which, through inappropriate past policies, no longer had ready access to borrowed reserves. Because SDRs were allocated on the basis of members' quotas, the reserve position of those countries would benefit only modestly from an SDR allocation. In the view of the Australian authorities, an allocation small enough not to adversely affect inflation or the adjustment process was unlikely to provide much assistance to countries facing reserve shortages and might give an inappropriate signal to those countries. In sum, the view of his Australian authorities was that, contrary to the staff suggestion, an allocation at present could slow economic adjustment and postpone progress against inflation to the detriment of international monetary stability and longer-term economic performance.

The other members of his constituency, however, strongly favored an early resumption of allocations, Mr. Romuáldez stated. They considered that growth in reserves was necessary to support the projected growth in world trade, and that an appropriate SDR allocation would reduce the vulnerability of the international financial system to interest rate and exchange rate shocks. In their opinion, the principles outlined in Article XVIII, Section 1(a), should be broadly interpreted with due emphasis on the objectives stated elsewhere in the Articles dealing with balanced growth of international trade and orderly exchange arrangements. Their view was that while recent reserve accumulation might strengthen global reserves, it had obviously not gone far enough to achieve those objectives. In fact, some of his authorities saw the growth of total reserves through the deficits of reserve centers and capital market recycling as having proved to be unstable.

Several of his authorities therefore viewed the objection to an SDR allocation--on the grounds that global reserves were growing fast enough to meet global needs--as ignoring the stark fact that reserves were not distributed on the basis of need, Mr. Romuáldez commented. The overall total concealed gross discrepancies in the holdings of reserves, in access to markets for borrowing reserves, and in the need for augmentation of reserves. In view of the uneven distribution, the inadequacy of international reserves was a factor underlying the current debt problem. They therefore saw a strong case for a more managed increase in global reserves through SDR creation that took into consideration the present maldistribution of global liquidity and international reserves.

Deficits in reserve centers were accommodated by the issuance of their currencies, whereas deficits in nonreserve centers had to be covered by borrowing or by the forced adoption of adjustment measures to obtain current account and balance of payments surpluses, Mr. Romuâldez remarked. Such adjustments became extremely difficult when similar actions were being undertaken by a large number of countries, giving rise, for example, to destructive defensive trade policies. From the international monetary system perspective of promoting constructive adjustments conducive to growth and development, those authorities believed that a larger role for the SDR was clearly essential.

One of his authorities argued that a modest augmentation of reserves was needed that would be globally available and redistributable, Mr. Romuâldez noted. All his authorities in favor of an allocation did not see it as being inflationary, for, in any conceivable amount, an allocation would add only marginally to global reserves. Moreover, individual allocations would be insufficient to permit major problem countries to abandon or diminish substantially the policies of adjustment that they had been forced to adopt because of extreme external imbalances. On the contrary, by enabling them to phase their adjustment at a pace that could win political consensus and support, and therefore a better chance for success, and to sustain a slightly higher level of imports, an allocation might help to reduce the antidevelopmental and politically destabilizing impact of current adjustment programs.

Given the range of fundamentally different views put forward by the authorities in his constituency, he believed that, to break the present deadlock within the Board, the more fruitful course to follow in future discussions and staff papers might be to focus directly on the merits of the main arguments of those opposed to an SDR allocation at present, Mr. Romualdez concluded. It might be necessary to "reflect in depth on the role of the SDR" as suggested by the Chairman in his statement on the Work Program of October 25, 1984 (EBM/84/162, 11/7/84), and to consider the degree to which the circumstances having led to the creation of the SDR in the late 1960s still existed in the present so-called multireserve currency system.

Mr. Salehkhou said that the long-overdue need for an allocation of SDRs had been repeatedly stressed in the Board as well as in other international forums, and the technical points in favor of a substantial allocation had been adequately established. He joined Mr. Jayawardena in suggesting that the staff paper be submitted to the Interim Committee as a supplement to the Chairman's statement. The need to bring the divergent political views closer and to reach a consensus had also been underlined at the previous meeting on SDR allocations. It was interesting to reflect on the Chairman's remarks before the past Interim Committee meeting referring explicitly to the conclusions reached by the staff on the necessity of an SDR allocation, and the endorsement of that view by a large majority of Executive Directors.

To summarize, those conclusions referred to the need for reserve accumulation by developing countries, Mr. Salehkhou went on. The continuing growth of international trade and the existing noninflationary environment made the possibility of any inflationary effects of new SDR allocations remote. Furthermore, in view of the stated objective to make the SDR the principal reserve asset, and with due regard for the dwindling share of SDRs in total reserve assets, it was clear that steps should be taken to increase, or at least stabilize, that share at a reasonable level. Moreover, it was appropriate that, in view of the inaccessibility of international capital markets to many developing countries, especially African countries, a new SDR allocation should address some of those needs.

At the previous meeting of the Ministers of the Group of Twenty-Four, it had been suggested that in view of the long delay in SDR allocations any new distribution should extend beyond 1986, Mr. Salehkhou commented. It had also been emphasized that conditional SDRs would cast serious doubts on, and contradict the basis of, those assets. The Chairman had alluded to that issue during the subsequent Interim Committee deliberations by emphasizing that there had been only minimal support for the notion of conditional SDRs.

It was therefore disappointing that the Interim Committee had not reached a consensus on the political dimension of the problem, Mr. Salehkhou noted. He hoped that, during the forthcoming meeting of the Committee, the countries that had hitherto opposed the allocation might reconsider their decision in light of developments in the capital markets and the dimension of the debt problem.

There had always been a close association and crucial link between adjustment and financing, Mr. Salehkhou remarked. In the second part of the 1980s, the adjustment process should increasingly focus on greater invigoration of the real economies of the countries to try to redress the disequilibrating forces that undermined investment and employment opportunities, with detrimental effects on growth and solvency. The weight of global adjustment should shift from import compression to export promotion to try to lay down a long-term basis for uninterrupted and noninflationary growth of income and employment.

That new and changed emphasis of adjustment required an acknowledgment on the part of all countries of the necessity for concessional and other forms of financing, Mr. Salehkhou commented. In addition, the establishment of a link between SDR allocations and development finance would provide a more equitable distribution of the adjustment burden. International financial developments of the past two decades clearly demonstrated that developing countries faced greater instability in export revenues and thus had a larger demand for reserve accumulation than did industrial countries. Only through an acknowledgment of the global need for cooperation and burden-sharing could the real problems be addressed. A substantial allocation of unconditional SDRs was the minimum that any integrated approach to global development and finance could encompass.

Mr. Rodríguez remarked that the fourth basic period had started in 1982 without any proposal for allocations. Unfortunately, three years later, the world was in the middle of liquidity crises that reinforced the validity of the principles underlying the Articles of Agreement dealing with the requirements for an SDR allocation. During the past two years, an allocation had been thoroughly debated, not only in the Board but also in other forums. The present situation was paradoxical: although one of the leitmotivs in the creation of the SDR had been to make a new international reserve asset that would stand out among the rest, the Fund was not promoting that role of the SDR in present economic circumstances. The SDR's most advantageous characteristic was that it was the only international reserve asset that could be completely controlled by the Fund; it was not subject to the direct effect of monetary decisions by individual countries. On the contrary, it was a financial valve that could allow the Fund to regulate international liquidity. The SDR was not fulfilling its potential usefulness in that its role in non-gold reserves was much weaker than previously; for instance, in the early 1970s the ratio of cumulative SDR allocations to non-gold reserves had reached a peak of 8.3 percent.

Although a number of elements were needed to convert an asset into a real means of payment, Mr. Rodríguez continued, an increase in the proportion of SDRs to non-gold reserves would be helpful, as pointed out in the staff report. Since the Annual Meetings in September 1984, his constituency's support for an allocation of SDRs had been reinforced. At that time, his authorities had stated that "the present conditions of the international economy meet the requirements laid down by the Fund's Articles of Agreement for resuming allocations. Accordingly...we still believe that a moderate SDR allocation in the present basic period is advisable and would help to resolve the aftereffects of a crisis as intense as that which the international community has suffered from."

He could not support any decision other than that to push forward a new allocation, Mr. Rodríguez stated. The lack of international liquidity continued to constitute a serious constraint for many countries with debt and adjustment problems. He did not believe, nor did the staff, that a greater availability of SDRs would be inflationary or would relax the adjustment process. On the contrary, a greater provision of resources would facilitate adjustment in many cases. At present, many countries' access to private markets had been nearly closed, and their access to financial resources, other than those provided by their own balance of payments surpluses, was practically nonexistent. Under the circumstances, a new allocation of SDRs represented the only additional source of liquidity for those countries with larger imbalances. An allocation would put into practice one of the principles that guided the Fund's role--the provision of means to reduce balance of payments imbalances. The catalytic role of the Fund had been a major positive feature in the debt crisis, and it should continue. Nevertheless, the intermediation of the Fund between creditors and debtors must be complemented by the Fund's use of its own financial instruments. The creation of additional SDRs could provide not only vital aid but also a signal to the international financial community of both the Fund's confidence that economic adjustments were on track and the Fund's will to cooperate with other financial institutions to solve the debt problem.

As on previous occasions, Mr. Rodríguez concluded, he wished to point out the severe condition of many developing economies and the need for members who had been unable to support the measure to reconsider an allocation of SDRs. He supported allocations in 1985 and 1986 of approximately SDR 10 billion annually. Regarding further allocations in the coming basic period, he supported a moderate annual allocation that could supply enough liquidity to satisfy the projected increase in real demand and to maintain a slight increasing trend in the ratio of SDRs to non-gold reserves.

Mr. Clark said that his views were well known and had not changed; the staff itself conceded that it had not introduced any fundamentally new considerations in its paper. Caution was called for in interpreting statistics on the actual level of reserves, either on its own or in relation to other variables. More important, although more difficult to assess, were the underlying supply and demand conditions and structural considerations, such as the robustness of the monetary system in the face of unexpected shocks. The issue was whether a global shortage of reserves existed, as required for an SDR allocation, or whether apparent local shortages reflected other factors and required remedies other than an increase in liquidity. He continued to believe that the latter was more important--and in particular, that the main need was to restore external positions to better balance and to put a brake on the accumulation of debt.

On a more technical and narrower point, he agreed with Mr. de Maulde that fuller discussion of the implications of the U.S. current account deficit would be of interest, Mr. Clark stated. There were certainly both large inflows to and outflows from the United States; net, the United States was supplying assets to the rest of the world at a rate of about $100 billion a year. A high proportion of those assets seemed to be liquid. Questions might remain about the distribution of reserve assets; but in terms of overall supply, which was the principal concern in the context of an SDR allocation, the prospective U.S. deficit was an important factor.

Mr. de Groote remarked that an SDR allocation was needed to improve the overall composition of reserves and to respond in a systematic way to the long-term global need demonstrated by the staff.

A gradual increase in the amount of SDRs seemed to be needed to give that instrument a chance to play its role effectively, Mr. de Groote continued. It would be imprudent in periods of great uncertainty in international payments to abandon an instrument that might have to play a useful role. In other circumstances, the payments system and the role of the Fund had been reinforced on a contingency basis, establishing the means to react in time of need to circumstances that could not be foreseen at the moment the decision was taken. In fact, reserves were required as a precaution against uncertainty in general. At present, therefore, the Fund had to confirm the possibility of the SDR's playing a larger role in future by allowing moderate increases that were sufficient to answer the effective demand that continued to exist for the SDR by many central banks. It was an interesting point that some central banks wished to accumulate a larger amount of SDR reserve assets. Meeting that demand would be an appropriate way of giving the instrument a chance to play an enhanced role when the need arose. He therefore supported allocations in the basic period in the amounts proposed by Mr. de Maulde and others.

The adjustment process had been effective under Fund monitoring, Mr. de Groote noted. Nonallocation could be perceived as an indication that the adjustment process had not been successful and that fears of inflation in the world remained. In present circumstances, it would be wrong to convey that impression, especially as the Fund was trying to present an opposite view in the documentation prepared for the World Economic Outlook exercise and for the Interim and Development Committee meetings.

It was unlikely that an agreement would be reached at the present meeting on an SDR allocation in the immediate future, Mr. de Groote observed, and it was difficult to agree on qualitative estimates of global reserve need. There was even the question whether the system was still appropriate for present circumstances. He therefore strongly supported the Chairman's suggestion to study the SDR's role in relation to the role of other reserve assets as well as the role of the Fund as a possible source of last-instance liquidity. In that context, it would also be interesting to study the effects of exchange rate uncertainty on the need for SDRs.

He wondered why increases in SDRs were considered more inflationary than increases in other reserve assets, as suggested by several colleagues, Mr. de Groote said. For instance, why would a large increase in dollar reserves, as mentioned by Mr. Clark, be less inflationary than the increase in SDRs? Further consideration should be given to changes in the modalities for use of the SDR along the lines of proposals for conditional use previously submitted to the Board. It was possible to envisage such uses, either conditional or traditional, that would contribute to the Fund's role in the adjustment process. He proposed that the Board consider again the pertinent papers by the Legal Department indicating the modalities that were technically possible. The industrial countries could, according to those modalities, put their allocation at the disposal of the Fund.

The Board would have to consider two objectives, Mr. de Groote stated: first, to ascertain that the instruments at the Fund's disposal were still adaptive to the circumstances, and second, to develop appropriate instruments to meet the needs that might arise in the future. With those considerations in mind, the Board could usefully devote time to serious in-depth studies of the role of the SDR.

Mr. Zhang said that he supported a new allocation of SDRs.

Mr. Suraisry remarked that his position remained unchanged. The staff had once again demonstrated convincingly the need for a new SDR allocation, and he continued to support the resumption of SDR allocations at a moderate rate.

Mr. Finaish indicated that he continued to support a significant allocation in the current basic period for the reasons put forward by the staff and other speakers.

The Economic Counsellor noted that some Executive Directors had referred to the figure in the staff report of SDR 24 billion for allocations. The staff did not recommend an allocation of that order; the figure was an estimate of the increase in reserves that might be appropriate in the system. As to the ratio of non-gold reserves to imports presented in Table 1 in the staff paper, the figures for the end of 1984 were available at present: 20.9, 16.2, 30, 52.9, 22.8, 1.1, and 0.9. Those figures did not differ greatly from previous estimates.

Reference had been made by Mr. Dallara to two staff statements on page 11 of SM/85/50, which had occurred in the context of a general discussion, the Economic Counsellor continued. The first sentence on the appropriate proportion of non-gold reserves that should take the form of SDRs did not present a firm staff view. The staff did not believe, in light of the Articles, that the proportion should be zero; it nevertheless had not suggested the amount it considered appropriate, although it had referred to factors that might affect the appropriate proportion. The second sentence, on whether the SDR could potentially facilitate future adaptation of the international monetary system, depended on the direction of that future adaptation.

The question by Mr. Fujino--whether there would be a future constraint on the supply of reserves through existing sources--was related to the matter raised by Mr. Clark on the contribution to the supply of reserves that any future deficit in the U.S. external current account might make, the Economic Counsellor said. The staff took the position that the system, as operating at present, was demonstrating a capacity to supply reserves through capital markets and, to a limited extent, through other channels. Those reserves were available at a price, and not to everyone. But the staff did not assume that there would be a constraint on the total supply of reserves available through existing sources.

Mr. Clark remarked that U.S. credit policy affected the total supply of liquid dollar assets. The U.S. current account deficit, on the other hand, reflected the way those assets were distributed--to domestic or foreign holders. Could Mr. de Groote elaborate on his statement regarding the relationship of various forms of reserves to total liquidity conditions?

Mr. de Groote explained that he had questioned the different reactions to increases in one form or another of international liquidity. Once part of the assets of central banks--whether the result of the U.S. deficit or another cause--SDRs, dollars, or deutsche mark, for example, were not dissimilar. Why would an increase of SDR 10 billion in reserve assets of the central banks be more inflationary than an increase of SDR 10 billion in deutsche mark? He had not reflected on the origin of the U.S. deficit but had attempted to answer the argument that when central banks had an increase in SDRs they tended to spend more. Why would the banks spend SDRs more easily than Swiss francs?

Mr. Clark stated that an allocation of SDRs, whatever the size, affected the total supply of liquid assets. In that, an allocation was more akin to a relaxation in global monetary policy; current account deficits and the domestic absorption of liquidity were related to the distribution of liquid assets, not to the global supply.

Mr. de Maulde said that the suggestion that an increase in central bank reserves led to a corresponding increase in monetary mass was untrue. Monetary authorities were following, according to Fund advice, a policy of aggregate money supply: whenever money was created in external assets, the authorities restricted credit either to the economy or to the treasury. A mechanistic relationship between central bank foreign assets and the money supply in another country no longer existed. However, an easier monetary policy in the United States could induce a tighter monetary policy in other countries simply to compensate for the global monetary mass.

The Chairman commented that a number of central banks no doubt neutralized the monetary effects of SDR allocations in their own accounts. Therefore, SDR allocations did not automatically lead to a corresponding relaxation of monetary policy.

The Chairman then made the following summing up:

> It is clear from the exchange of views in today's discussion that there has been no change in the positions of Executive Directors on the matter of an SDR allocation since our previous discussion of the subject, and I have been unable to satisfy myself today of the existence of broad support among participants needed for me to propose an allocation to the Board of Governors. In that respect, the main arguments put forward by Directors on both sides of the issue were the same as those outlined in my report to the Interim Committee in September (ICMS/Doc/84/7, 9/14/84), which I will of course update, in the light of today's meeting, for presentation to ministers in April.

Among the points of interest raised at our discussion today were the following:

1. Management and staff were asked to improve the analysis of the effects on global liquidity of the large and increasing balance of payments deficit of the United States. In attempting to meet that request, we should perhaps concentrate more on the supply-side aspects of international liquidity. We will also attempt to respond to the concerns of those who felt that, in looking at the relationship between the U.S. current account position and changes in global reserves, Directors were perhaps still laboring under the concepts and views that had come out of the period of fixed exchange rates. One Director, in particular, felt that account should be taken of other aspects as well, including the intervention policy of countries other than the United States.

2. It was observed by some that the ratio of reserves to imports might well underestimate the tightness of the reserve situation of a number of countries. Two observations were made by those who held that view: first, because imports had been severely compressed in 1983, the ratio could appear stable, even though unfavorable economic conditions had led to the compression; second, the cushion of reserves needed for any country to have access to international financial markets is generally larger for countries that are heavily indebted and that have experienced balance of payments problems and difficult economic conditions. The latter observation raised the familiar question of the distributional merits of an allocation of SDRs.

3. Well-known points of view were advanced on the possible effects of an SDR allocation on the international monetary system, and I noted differing positions on the possible inflationary impact of an allocation. Some Directors continue to fear that, in the present circumstances in which inflation has not as yet been eradicated from the system, an SDR allocation might give an inflationary signal. The preponderant view of the Board, nonetheless, was that inflation had been largely corrected in recent years and that keeping inflation under control depended essentially on the economic policies pursued by members. It was also the majority view that the mix of monetary and fiscal policies in the major countries had a far more important impact on balance of payments disequilibria and general international monetary and financial conditions than any possible inflationary consequences stemming from an SDR allocation.

4. While the classical arguments on whether or not an allocation would strengthen the SDR were advanced at today's discussion, it is important to note that no one suggested that SDRs should be allocated merely to preserve the role of this form of liquidity in the international monetary system. However,

those who held the view that there was a global need to supplement existing reserves through allocation also believed that an allocation would strengthen the role of the SDR in the international monetary system. Others, who considered that no global need for increasing reserves existed at present, held the view that any unwarranted allocation of SDRs would weaken the quality of the instrument.

5. I also took note of certain points that went beyond the more immediate statistical arguments for or against an allocation and touched on the role of the SDR in the system. It would be useful for the Board to focus at some point on the role of the SDR and related general issues.

In sum, the results of today's discussion are clear: there does not exist the necessary support at the present stage for an SDR allocation.

The number of Executive Directors favoring an annual SDR alloation--ranging from a moderate amount to SDR 15 billion, with some concentration of support for SDR 10 billion--remains unchanged at 17. Five Executive Directors--who, together, hold a substantial share of the total voting power--are still not convinced that a case for an allocation has been made.

A number of Directors considered that the April meeting of the Interim Committee would be an appropriate occasion for ministers to try to reach a consensus, at the political level, on this important matter.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/41 (3/13/85) and EBM/85/42 (3/15/85).

4. BOTSWANA - REPRESENTATIVE RATE FOR BOTSWANA PULA

The Fund finds, after consultation with the authorities of Botswana, that the representative rate for the Botswana pula under Rule O-2(b)(i) is the U.S. dollar rate obtained for the pula on the basis of a fixed relationship of the pula to a basket consisting of defined amounts of SDRs and South African rand, in which the SDR/dollar rate is the rate computed by the Bank of Botswana, based on the prevailing market exchange rates of the currencies in the SDR basket. Botswana will immediately inform the Fund of any change in the representative rate for the pula, including changes in the weightings of SDRs and the South African rand used in the basket.

Decision No. 7935-(85/42) G/S, adopted
March 14, 1985

5. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/85/54, Supplement 1 (3/13/85), EBAP/85/63 (3/13/85), and by an Assistant to Executive Director as set forth in EBAP/85/60 (3/12/85) is approved.

APPROVED: January 2, 1986

LEO VAN HOUTVEN
Secretary