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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/129

10:00 a.m., August 30, 1985

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

Executive Directors	Alternate Executive Directors
	Mawakani Samba
	N. Toé, Temporary
C. H. Dallara	M. K. Bush
	H. G. Schneider
B. de Maulde	X. Blandin
M. Finaish	
H. Fujino	M. Sugita
G. Grosche	
J. E. Ismael	Jaafar A.
R. K. Joyce	
A. Kafka	
	H. Fugmann
E. I. M. Mtei	A. Abdallah
	M. A. Weitz, Temporary
Y. A. Nimatallah	J. E. Suraisry
P. Pérez	
J. J. Polak	J. de Beaufort Wijnholds
C. R. Rye	A. V. Romuáldez
G. Salehkhou	O. Kabbaj
A. K. Sengupta	
	T. A. Clark
S. Zecchini	N. Coumbis
Zhang Z.	

J. W. Lang, Jr., Acting Secretary
S. J. Fennell, Assistant

Also Present

European Department: P. B. de Fontenay, Deputy Director. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; G. Belanger, J. T. Boorman. External Relations Department: A. F. Mohammed, Director; A. M. Abushadi. IMF Institute: G. M. Teyssier, Director. Legal Department: G. P. Nicoletopoulos, Director; J. G. Evans, Jr., Deputy General Counsel; W. E. Holder, S. A. Silard. Middle Eastern Department: B. A. Karamali. Research Department: W. C. Hood, Economic Counsellor and Director; R. R. Rhomberg, Deputy Director; A. D. Crockett, Deputy Director; M. P. Dooley, D. Folkerts-Landau, M. Goldstein, D. J. Mathieson. Secretary's Department: A. P. Bhagwat, P. D. Péroz. Treasurer's Department: W. L. Coats, Jr., T. M. Tran. Western Hemisphere Department: S. T. Beza, Associate Director. Advisors to Executive Directors: A. A. Agah, P. E. Archibong, L. K. Doe, D. Hammann, K. A. Hansen, J. Hospedales, G. Nguyen, P. Péterfalvy, G. W. K. Pickering, A. Steinberg, E. M. Taha, D. C. Templeman, K. Yao. Assistants to Executive Directors: I. Angeloni, Bo T., M. B. Chatah, J. de la Herrán, J. J. Dreizzen, G. Ercel, C. Flamant, V. Govindarajan, N. Haque, G. D. Hodgson, L. Hubloue, O. Isleifsson, J. M. Jones, H. Kobayashi, M. Lundsager, K. Murakami, A. Mustafa, E. Olsen, M. Rasyid, J. Reddy, D. J. Robinson, J. E. Rodríguez, C. A. Salinas, M. Sarenac, L. Tornetta, A. J. Tregilgas, E. L. Walker, B. D. White.

1. REPORT BY MANAGING DIRECTOR

The Managing Director, commenting on his recent trip to Paris, informed the Executive Board that he had met with Mr. Dornelles, the Minister of Finance of Brazil at the time, to discuss the economic and financial situation in Brazil and the Fund's relations with the country. The Minister of Finance had indicated his country's commitment to implement the economic plan that had been launched in July 1985. On his return from Paris, the Managing Director had received a call from the newly appointed Minister of Finance who had informed him that the authorities remained committed to the same strategy outlined by his predecessor. While in Paris, he had also had the opportunity to meet with a number of officials from the French Treasury and from the Paris Club. They had discussed the debt problem, the role of the Paris Club, and collaboration between the Fund and the commercial banks.

2. ALLOCATION OF SDRS IN THE FOURTH BASIC PERIOD

The Executive Directors discussed a staff paper reviewing SDR allocations in the current basic period (SM/85/219, 8/2/85; and Cor. 1, 8/19/85). They also had before them as background information a staff report on the implications of U.S. external current account deficits for the volume of international reserves (SM/85/218, 8/2/85; and Cor. 1, 8/19/85).

Mr. Ismael stated that he agreed with the staff's analysis and interpretation of the criteria for an allocation established under Article XVIII, Section 1(a). More specifically, the global need for reserves supplementation could exist even if that need could be met from other sources and even if every member of the Fund did not require reserves. The long-term need for reserves supplementation should be determined not only by historical developments in the level of reserves but, more important, by trends in the world economy and the potential demand for international reserves.

The staff analysis and conclusions indicated a clear need for reserves supplementation at present, Mr. Ismael considered. The level of non-gold reserve holdings continued to be low, at about 21 percent of imports. Moreover, the increase in the ratio of non-gold reserves to imports since 1982 had taken place from a very low level.

The data for developing countries as a group suggested an improvement in the ratio of non-gold reserves to imports but hid two important developments, Mr. Ismael pointed out. First, the improvement in the reserve position in many developing countries had been largely the result of strong adjustment measures involving severe cutbacks in imports which, in turn, had led to a dramatic slowdown in economic growth and to social and political problems on a scale likely to bring about instability in some of those countries. Second, the improvement in the ratio of non-gold reserves to imports for developing countries as a whole hid the fact that about one half of them had suffered a marked deterioration in their reserve position between 1979 and 1984. Those facts suggested that many countries could benefit from an allocation of SDRs.

He agreed with the staff that there were deficiencies in using the ratio of non-gold reserves to imports as an indicator of the adequacy of reserves, Mr. Ismael remarked. Supplementary indicators further strengthened the case for an allocation of SDRs. For example, the ratio of non-gold reserves to aggregate trade imbalances had declined from 100.8 percent in 1981 to 98 percent in 1984 in spite of strong efforts by many countries to rebuild their reserves.

The adequacy of reserves had also been seriously affected by the sharp cutback in access to the international capital markets by many countries, Mr. Ismael noted. In the absence of data on international capital flows, the ratio of non-gold reserves to external bank debt could be used as a proxy: the changes in that ratio confirmed that there had been a sharp curtailment in the flow of resources to developing countries. The existence of an inverse relationship between the flow of resources from the international capital markets to developing countries and their need to maintain reserves was an interesting feature emerging from the staff report. It would be expected that developing countries would suffer reserve losses as a result of reduced access to financial markets. In fact, the increase in the demand for reserves represented caution on the part of those countries. Thus, it was inappropriate to compare present demand for reserves with previous demand, because the prevailing situation of exceptionally high precautionary demand for reserves should be met through an allocation of SDRs. As SDRs would be held by the developing countries for precautionary reasons, only a small proportion of any allocation was likely to be used. Hence, the fear among some industrial countries that a new allocation would be inflationary or that it might lead to a slackening of adjustment efforts was unfounded.

Two factors pointed to a strong need for reserves, Mr. Ismael considered. If the projected growth in world trade was to be realized, the need for a substantially larger level of international reserves would have to be satisfied. In addition, reduced access to the international capital markets by many countries suggested increased demand for both borrowed and owned resources, part of which could be satisfied through an allocation of SDRs.

There were three persuasive reasons why the Fund should resume an allocation of SDRs, Mr. Ismael remarked. First, as the existing mechanisms for the international transfer of resources were not functioning properly and as many developing countries were undergoing painful adjustment in order to generate balance of payments surpluses, an allocation would help to promote growth and adjustment in those countries. Second, an allocation would help to stabilize reserves by reducing the dependence of the supply of international reserves on the national policies of reserve currency countries and on borrowed reserves. Third, an allocation would contribute to the objective of making the SDR the principal reserve asset of the system. The Executive Board could consider the appropriate size of an allocation once the consensus necessary for an allocation had been reached, which he hoped would be at the forthcoming Interim Committee meeting.

Mr. Weitz noted that since 1980, the Executive Board and the Interim Committee had discussed the question of an SDR allocation in the fourth basic period many times. In those discussions, the relevant aspects of an SDR allocation had been tested against the basic criteria set out in the Articles of Agreement, and updated material and developments in the key indicators governing an SDR allocation had been provided by the staff. The staff had consistently concluded that an SDR allocation could satisfy part of the growth in the need for reserves and could help to stabilize the international reserve system by reducing its dependence on borrowed reserves, without introducing inflationary pressures or weakening the adjustment efforts being undertaken by many countries.

The staff paper being considered by the Board at the present meeting again reviewed the criteria for an SDR allocation in light of developments in international reserves, liquidity, world trade, and inflation, Mr. Weitz observed. The staff clearly pointed out that the recent changes in reserves and economic prospects implied a continuing global need for increased reserve holdings. The global demand for reserves--estimated by applying the average ratio of reserves to imports from a period of "normal" economic activity to the level of imports projected to prevail during the period under consideration--was likely to expand throughout the remainder of the fourth basic period and beyond as the level of international trade and financial transactions continued to grow. If the ratio of reserves to imports was to be kept at the current 21 percent, non-gold reserves would have to increase from at least SDR 70 billion in 1985 to SDR 474 billion by end-1986, based on import projections in the World Economic Outlook. In addition, a similar annual increase of non-gold reserves would have to materialize through the remainder of the decade to cope not only with an increased level of trade but also with reduced access to international financial markets by a number of countries.

Access to the international financial markets by countries facing external imbalances had been drastically restricted, often despite remarkable adjustment efforts on their part and owing to factors beyond their control, Mr. Weitz noted. As a result, there were significant net capital outflows from those economies with consequent adverse effects on growth and development prospects. The staff had pointed out that countries without access to market borrowing could satisfy their need for international reserves only by generating balance of payments surpluses, a course of action that was unrealistic given the financial costs that most indebted countries were facing and the consequently higher cost of adjustment in terms of spending and output. Clearly, if large enough, an SDR allocation should help to rebuild international reserves, while reducing the costs associated with the generation of balance of payments surpluses in countries where development needs required substantial amounts of external savings rather than net capital outflows or domestically financed reserves.

An SDR allocation would not lead to a postponement of adjustment by developing countries but would help them to strengthen their reserve position, Mr. Weitz stated. An allocation would not promote increased spending, as some Directors continued to fear. Rather, it would reduce the burden for developing countries of generating balance of payments surpluses for the purpose of reserve accumulation, and would reduce the vulnerability of reserves to financial disturbances by lowering the share of borrowed reserves in total non-gold reserves. Moreover, an allocation might help to preserve the role of the SDR in the international monetary system.

An allocation of SDRs that was intended to strengthen international reserves in line with the long-term global need was unlikely to lead to inflationary pressures, particularly given its likely magnitude and the intended objectives of an allocation, Mr. Weitz commented. Even if in an extreme case a sizable proportion of the allocated SDRs were transferred from developing to industrial countries, inflation could still be kept under control if the receiving countries kept monetary growth within their target ranges.

According to the staff projections, the demand for non-gold reserves would increase by some SDR 70 billion in 1985 and 1986 and by an additional SDR 260 billion through 1991, Mr. Weitz noted. It remained to be determined what proportion of that increase should be financed by an allocation of SDRs. While there were several alternatives to determining an appropriate share of SDRs within total non-gold reserves, his chair was of the view that an annual allocation of SDR 15 billion was the minimum amount that should be allocated in the remainder of the fourth basic period. That amount would not endanger international price stability, or the developing countries' commitment to adjustment. Such an allocation would also help to restore the ratio of SDRs to non-gold reserves to the levels prevailing at the time of the first SDR allocation in the early 1970s.

Mr. Dallara stated that he had outlined the views of his authorities on the question of an SDR allocation at the previous Board discussion on the issue (EBM/85/42, 3/15/85). Neither the updated data, nor the analysis in the staff paper had convinced him to change his views. Accordingly, he continued to oppose an allocation at the present time. In fact, the data in the staff paper suggested that there might be even less evidence of a long-term global need for a new allocation at present. The ratio of reserves to imports for all countries at end-1984 had been about equal to the annual average ratio for 1970-83. The ratio for all country groupings had been higher in 1984 than in 1981, before the emergence of the debt crisis. Even the ratio of reserves to imports for developing countries with debt problems had been higher in 1984 than the average for 1970-83. The ratio of reserves to trade imbalances had been low in 1984 primarily because of the low ratio for industrial countries, arising particularly from the large imbalances experienced by the United States and Japan. The data for those countries did not suggest an inadequacy of reserves even though the imbalances were very large.

Among the developing countries, only those with recent debt-servicing problems had a low ratio of reserves to trade imbalances, Mr. Dallara noted. Those countries should continue their economic adjustment efforts with the support of the international community, in order to re-establish their international creditworthiness and gain access to international capital markets. The ratio of reserves to external debt had fallen for developing countries as a whole from 20 percent in the second half of 1981 to 17 percent in the first half of 1984. That ratio had declined, in particular, for countries in the Middle East, which included the major oil exporters and developing countries in Africa, which had experienced serious economic adjustment and development problems. An SDR allocation would not improve the economic situation in many of the countries in those regions significantly. The ratio of reserves to external debt for countries in the Western Hemisphere had been only slightly lower in 1984 than in the second half of 1981. For developing countries in Asia, that ratio had increased significantly in the same period. Could the staff explain its comment on page 9 of the staff paper, implying that the restoration of normal access to financial markets for the indebted countries could lead to a greater need for reserves?

The staff cited three potential benefits of an SDR allocation in the remainder of the fourth basic period, Mr. Dallara observed. It would make up for the difficulties experienced by developing countries in obtaining reserves since 1982; reduce the share of borrowed reserves in total reserves and, consequently, the vulnerability of reserves generally; and contribute to the objective of making the SDR the principal reserve asset in the international monetary system. While he supported the efforts of debtor countries to overcome the difficulties that they had encountered in the past few years, the concept that an allocation would make up for those difficulties seemed inappropriate. A reduction in the ratio of borrowed reserves in total reserves could reduce the vulnerability of the reserve stock to financial disturbances. However, the staff's reference to financial disturbances in the international credit markets was potentially misleading as it did not consider the inadequacies of policies in either borrowing countries or, to some extent, in industrial countries, both of which had contributed to the erosion of creditworthiness. The discussion in the staff paper did not adequately reflect the fact that a restoration of creditworthiness must be the key to rebuilding reserve balances, whether there was an allocation of SDRs or not. The staff's reference to the objective of making the SDR the principal reserve asset in the international monetary system was disappointing. To refer to the objective of making the SDR the principal reserve asset it was prejudging the outcome of the staff's fundamental study of the role of the SDR in the international monetary system.

The staff had only briefly discussed the possible effects of an SDR allocation on inflation and adjustment in developing countries, Mr. Dallara considered. Although a modest allocation might not have a substantial negative effect on inflation or on incentives to maintain adjustment, the staff should have elaborated on the psychological considerations that might surround an allocation, particularly in light of recent monetary developments in a number of important industrial countries.

The staff had found no reliable relationship between the U.S. current account deficit and developments in world reserves, Mr. Dallara noted. It would be interesting if the staff were to analyze the relationship between the U.S. current account deficits and the external performance of debtor countries and, hence, their creditworthiness and ability to attract reserves.

Mr. Pérez remarked that the role of the SDR as an international reserve asset was dependent, among other factors, on the proportion of SDRs in total reserves. An allocation would reinforce that role, while a failure to allocate SDRs would run contrary to the Articles of Agreement.

The liquidity problem experienced by a growing number of member countries could be alleviated through a new allocation of SDRs, Mr. Pérez considered. An allocation would provide badly needed additional liquidity for a number of developing countries facing difficulties in obtaining new resources in the international financial markets. Moreover, a further allocation would give the Fund greater control over international liquidity. An SDR allocation would not jeopardize inflationary goals or lead to a relaxation of adjustment efforts.

It was a matter of concern that the issue of the role of the SDR was given less emphasis and was reviewed in a rather mechanical way in each consecutive staff paper, Mr. Pérez stated. The report of the Group of Ten on the international monetary system had also noted that the considerable change in the international monetary system since the original creation of the SDR scheme had affected the rationale for the SDR, including the objective of making the SDR the principal reserve asset. Furthermore, no measures had been introduced to increase the importance of the SDR, in particular, by promoting the private use of the SDR.

The question of an SDR allocation was closely related to the control of international liquidity, Mr. Pérez considered. One of the most outstanding features of the financial world in the past decade had been the shift in the control of international liquidity from the domestic monetary authorities and multilateral institutions to the market. The net effect of that shift was not positive, even though some advantages could be identified. On the positive side, free capital movements had helped to increase the efficiency of the financial markets in mobilizing and allocating savings worldwide. On the negative side, the exchange rate system had become highly volatile and, in some cases, large fiscal and external current account deficits coexisted with overvalued exchange rates. The

Fund should clearly be ready to assume a more active role in the management and control of international liquidity. In that regard, recent developments relating to the SDR, the sole reserve asset created and controlled by the Fund, were disappointing. He urged the authorities of those countries opposing a new allocation to reconsider their positions or to offer other alternatives that would permit more appropriate control over international liquidity.

He supported an allocation of SDRs of approximately SDR 20 billion over the remainder of the fourth basic period, Mr. Pérez indicated. In the following basic period, he supported a moderate annual allocation that would provide enough liquidity to meet the projected increase in real demand and to maintain a gradual increase in the ratio of SDRs to non-gold reserves. He could support an allocation of a lesser amount if it would enable the Executive Board to reach the necessary consensus for a further allocation.

Mr. Zecchini remarked that an examination of the question of an SDR allocation could usefully begin by considering the demand aspects of the question as specified in Article XVIII, Section 1(a), where it was stated that in deciding on the need for an SDR allocation, the Fund should seek to meet the long-term global need to supplement existing reserve assets. In order to make an estimate of reserve demand growth, the staff assumed that the ratio of non-gold reserves to imports would remain at its 1974-84 average until the end of the present decade and that world imports would increase as estimated in the World Economic Outlook. On the basis of those two assumptions, non-gold reserves should increase by SDR 71 billion in 1985-86 and by SDR 261 billion in 1987-91. While those figures might serve as a useful working hypothesis, further qualifications were needed. The average value of the ratio of reserves to imports might not give sufficient weight to some relevant factors affecting reserve needs. A country's demand for reserves could change according to its access to financial markets, the existing stock of foreign debt, and market expectations regarding its current account balances. In addition, it might be affected by large shifts in capital movements that were triggered by exogenous disturbances in international capital markets and which could not be effectively stemmed by further tightening of domestic policies.

While the ratio of reserves to imports had been relatively stable for the industrial countries, it had decreased sharply for the indebted countries between 1979 and 1982 and had risen in 1984 to the levels reached in the second half of the 1970s, Mr. Zecchini noted. Were those levels adequate for the years ahead? Debtor countries' access to the financial markets had been greatly curtailed following the debt crisis. It was therefore likely that they would wish to have a higher level of non-gold reserves as a ratio to imports than the ratio registered in the second half of the 1970s. Furthermore, in the past few years, many indebted countries had accelerated the pace of adjustment of their external accounts by sharply reducing imports. Therefore, the recent increase in their reserve/import ratios had relied only partly on reserve increases.

In addition, the ratio of non-gold reserves to external debt had decreased for all countries, but the decrease had been more marked in the developing countries.

The demand for reserves should be examined in the context of the floating exchange rate regime and large capital movements, which were not closely related to the fundamental developments in developing countries, Mr. Zecchini remarked. Those factors had been insignificant at the time that the Fund had been established and the SDR created. However, their impact on the demand for reserves had become particularly relevant as a consequence of the magnitude of capital flows in the past decade and the tendency of financial markets to overreact in the face of changes in market confidence with respect to individual currencies. Those confidence shifts were not easily countered by a tightening of adjustment in the countries concerned. To be successful, policy adjustments had to be complemented by more effective international policy coordination than had been experienced thus far. Consequently, countries felt an increasing need to build up reserves either as a precaution or for the purpose of cushioning the destabilizing impact that sudden and unmanageable capital outflows would have on their economies. In sum, there were several factors that indicated the existence of pressures on the demand for reserves. Those pressures could increase if the world economy were to grow more rapidly and only the present mechanisms for reserve creation were relied upon, or if international capital movements and the exchange markets remained unstable.

On the supply of reserves, the events following the debt crisis had indicated that borrowed and nonborrowed reserves were not perfect substitutes, Mr. Zecchini pointed out. The supply of borrowed reserves tended to contract in periods when countries were experiencing balance of payments problems. The procyclical behavior of borrowed reserves made them an imperfect substitute for owned reserves. It was therefore understandable that debtor countries, especially those that were more likely to experience losses of confidence by the banks, wished to increase the share of owned reserves in their total reserves, a factor that indicated the importance of having a stable source of resources that would supplement existing reserves and that was less dependent on business cycle developments.

In the past ten years, the share of owned reserves in total reserves had tended to decrease, and reserve growth had relied more heavily on the expansion of bank credit and international financial markets, Mr. Zecchini considered. Recently, however, the banks' role in providing reserves had diminished following the debt crisis. In addition, the large U.S. external current account deficits had not been an effective source of reserve growth, as those deficits had been financed to a large extent through private capital inflows. The lack of a clear positive correlation between reserve growth and U.S. deficits, as indicated in the staff paper (SM/85/218), might also be due to a number of other factors. Nevertheless, it remained true that a country might expand its nonborrowed reserves by running a surplus in its balance of payments with the United States. Therefore, a decrease in the U.S. deficit would reduce one of the possible sources of nonborrowed reserves.

There were indications of a long-term need for reserves, Mr. Zecchini commented. Market mechanisms alone were insufficient to satisfy those long-term reserve requirements and to achieve the desired balance between borrowed and nonborrowed reserves. To improve the stability of the international monetary system, the supply sources of owned reserves should be strengthened. An SDR allocation could play an important role in that context. An allocation was even more justified in the light of Article VIII, Section 7, which referred to the objective of making the SDR the principal reserve asset in the international monetary system. While some members were unconvinced of the validity of that objective given the changes in the international monetary system in the past 15 years, there was clearly a need to prevent the SDR becoming an insignificant component of international reserves. In conclusion, he supported a moderate allocation of SDRs that would, at least, preserve the share of SDRs in non-gold reserves, pending the conclusion of the forthcoming studies on the role of the SDR.

Mr. Salehkhou stated that he was disappointed that the Executive Board had been unable to reach a consensus on an allocation of SDRs during its numerous discussions on the issue. His position on an SDR allocation remained unchanged, and he agreed with the conclusions of the staff paper. There was a substantial global need for reserves in the remainder of the fourth basic period given the projected expansion of world trade. Part of that need could be satisfied by a new allocation, particularly as most developing countries had limited or no effective access to the international capital markets. An allocation would alleviate the cost of acquiring reserves for those countries without access to financial capital markets and would help to make the burden of adjustment more tolerable and improve the credit standing and borrowing capacity of all developing countries, including those that did not have a reserve shortage.

Since 1982, non-gold reserves had been growing in line with global requirements, while the ratio of SDRs to non-gold reserves had declined from 6.5 percent in 1982 to 5.3 percent in 1984, Mr. Salehkhou observed. That decline ran contrary to the Articles of Agreement, which stated that the SDR should become the principal reserve asset in the international monetary system and that it was to contribute to the establishment of a multilateral system of payments. The inaccessibility of developing countries, particularly the non-oil developing countries, to the international financial markets was an important factor justifying an SDR allocation, as it inhibited the expansion of international trade.

The inflationary effect of an allocation was not a cause for concern, Mr. Salehkhou considered. Assuming a total allocation of SDR 10 billion in 1985, only SDR 3.7 billion would be allocated to the developing countries, an amount that represented about 1 percent of the total monetary base of industrial countries, and the monetary base of developing countries would be increased by only 1.5 percent. Furthermore, the inflationary effect of an allocation could be minimized if monetary aggregates in industrial and developing countries were maintained within their target growth rates. It was unlikely that an allocation would renew pressure on prices as long as individual countries maintained or sought to implement sound fiscal and monetary policies. An SDR allocation would not weaken the current adjustment efforts of developing countries facing economic imbalances. On the contrary, it would ease the burden of adjustment, particularly for the highly indebted countries whose reserves were composed primarily of borrowed resources. In conclusion, an SDR allocation would be consistent with Article XVIII, Section 1(a).

Mr. Schneider remarked that as the Executive Board had reached a point at which it was difficult to find new evidence in favor of or opposing an allocation, he looked forward to the staff's in-depth analysis of the role of the SDR in the present international monetary system, a study that he hoped would allow future discussions of the subject to take place in a more constructive climate. The information presented in the staff report once again demonstrated that an allocation of SDRs in the current basic period was justified. The projected continued increase in the SDR value of world imports suggested that the global demand for reserves was likely to expand throughout the remainder of the fourth basic period and beyond. Whether that increase in reserves and, accordingly, the expansion of world trade, would take place smoothly would depend largely on an adequate supply of international liquidity by the private markets. The staff analysis of the implications for the volume of international reserves of the U.S. external current account deficit provided some interesting empirical evidence that the availability and distribution of liquidity was largely in private hands. Recent experience suggested that the stability of a reserve system in which a large part of the resources were borrowed could be seriously affected by disturbances in the international credit markets. That assessment was a strong argument in favor of increasing the share of owned reserves in total non-gold reserves or at least of ensuring that owned reserves grew at the same pace as borrowed reserves. Sufficient reserve balances were necessary so that countries could reduce their vulnerability to financial disturbances and demonstrate creditworthiness, thereby preserving their access to the financial markets. An allocation of SDRs to supplement the existing stock of owned reserves would help to improve and preserve the stability of the present reserve system.

Furthermore, recent movements in the ratios of reserves to imports and to external trade imbalances suggested that the need to demonstrate creditworthiness fell hardest on those countries whose access to market borrowing had been curtailed and whose prospects for earning reserves via external surpluses were minimal, Mr. Schneider noted. The ratio of reserves to imports for the developing countries increased from 26.5 percent in 1982 to 31.7 percent in 1984 as a result of a compression of imports. The average ratio for industrial countries over the same period was about 17 percent. The ratio of reserves to trade imbalances reflected a similar trend for the developing countries--namely, that the ratio had risen from 68 percent in 1981 to 105.7 percent in 1984, while for the industrial countries, it had fallen from 162.2 percent to 92.7 percent over the same period.

Those figures indicated that since 1982 the developing countries had made great adjustment efforts to restore their external situation, in many cases by curtailing imports substantially, Mr. Schneider pointed out. However, owing to their accumulation of external debt and the lack of confidence of the market, many of those countries continued to have only limited access to foreign borrowing. Those countries would have to reduce their imports even further if action were not taken to increase their access to resources. By deciding on an SDR allocation of a magnitude that was not inflationary, the Fund would help to reduce the burden of adjustment and demonstrate its confidence that those countries would continue their present adjustment efforts. In addition, an allocation might have a catalytic effect on private creditors, allowing the developing countries to increase their imports to a level that was needed to support the structural and supply-side adjustment.

Mr. Nimatallah stated that he supported the resumption of SDR allocations at a moderate rate. The staff had once again demonstrated the need for a new SDR allocation. As stated in Article I(ii), one of the objectives of the Fund was to facilitate the balanced growth of international trade, which would help to increase employment and real income and to develop the resources of all countries. There was a group of developing countries that had little or no foreign reserves and that could not borrow the needed reserves from the market. Those countries could earn foreign reserves only through severe adjustment, by reducing imports and increasing exports. Their need for reserves was of a global and long-term nature, as the deep-rooted structural problems facing those countries made the accumulation of reserves through adjustment a long process.

Directors were divided on whether an allocation of a few million SDRs a year would relax adjustment efforts on the part of the developing countries or would enhance the speed of adjustment, Mr. Nimatallah noted. Those Directors who emphasized the possible relaxation of adjustment believed that as allocated SDRs were unconditional, there was no guarantee that they would be used appropriately to speed up adjustment. Those Directors who emphasized the advantages of an allocation in terms of adjustment believed that the resources would be used to increase the imports needed to enhance the performance of the external sector, thus avoiding the initial import compression to reduce the balance of payments imbalances. In the end, the answer depended on factual information, which should be collected.

Directors were also divided in their views on the inflationary impact of an allocation, Mr. Nimatallah commented. Some Directors believed that additional SDRs available from unconditional allocations would be used for unnecessary expenditures rather than to increase productivity. Other Directors felt that additional SDRs would lead to an increase in productive capacity and would, in fact, lower inflation. Again, the effect of an allocation on inflation could be determined only by factual information that should be collected to show how countries had used SDRs following previous allocations. In his view, a resumption of allocations in the fourth basic period would not cause developing countries to relax their adjustment efforts and would not necessarily lead to higher inflation. Thus, the question to be addressed was whether an allocation of SDRs should be conditional or unconditional. It was unclear whether the Fund's members were committed to making the SDR the principal reserve asset in the international monetary system. However, until the in-depth study on the SDR and its role in the system was completed, SDR allocations should be resumed.

Mr. Joyce stated that his authorities would be prepared to support a modest allocation of SDR 5 billion in each of the remaining two years of the fourth basic period. The need to supplement existing reserve assets and the global long-term need for reserves were the most relevant arguments in favor of an allocation. The projections included in the World Economic Outlook demonstrated that even if the ratio of reserves to imports for the remainder of the decade were to decline from the average of the past ten years, there would still be a growing long-term need for SDRs.

Many countries had relied on external commercial borrowing to rebuild their reserves over the past several years, Mr. Joyce noted. However, developing countries' access to credit from the commercial banks had been sharply curtailed, and they had to rely increasingly on balance of payments surpluses, often with accompanying restrictions on consumption and investment, to accumulate reserves. Those restrictions, necessary as they might be in the short term, resulted in lower growth in the immediate future and threatened investment and growth prospects. A modest allocation of SDRs could help to meet the long-term need for reserves in those countries and would reduce the social and economic costs of adjustment, without necessarily implying any slackening in their adjustment efforts.

Furthermore, a modest allocation was unlikely to be inflationary, especially in a global environment of depressed commodity prices and a marked reduction in the rate of inflation in the major industrial countries, Mr. Joyce pointed out. The nature of the demand for reserves in developing countries was different at present than in the past. A higher proportion of allocated SDRs was likely to be held in reserves than would have been the case in the past.

Mr. Sugita observed that non-gold reserves for all countries had risen from SDR 327 billion at end-1982 to SDR 386 billion at end-March 1985. Furthermore, the ratio of non-gold reserves to imports had recovered since 1981, and at end-1984 had reached the level prevailing in 1974-81. Those figures demonstrated that reserve holdings had generally continued to increase, with the expansion of world trade associated with the recent recovery. A long-term global need for reserve supplementation had not been demonstrated. In the present international monetary system, the level of reserves was basically determined by demand-side factors, as those countries having access to the international capital markets could augment their reserves by borrowing at market interest rates. The problems experienced by some developing countries since 1982 in borrowing from the international capital markets should not be confused with the issue of the global liquidity need. An allocation of SDRs to deal with the debt problem did not conform to the objective, as set out in the Articles of Agreement, that an allocation should address a general shortage of reserves. He supported the conclusion of the G-10 report on the international monetary system, which emphasized, inter alia, the need to improve the creditworthiness of debtor countries through the pursuit of successful economic investment, the desirability of improving access to the capital markets by further deregulation of those markets, and the need to ensure the pursuit of appropriate fiscal and monetary policies by the reserve currency countries.

Mr. Finaish remarked that he favored a resumption of SDR allocations in the fourth basic period. The paper before the Board was the latest in a series of reports in which the staff had consistently made a case for SDR allocations. But, the outcome of consecutive Board discussions of the matter had disappointed the large majority of members supporting an early resumption of SDR allocations. Since most arguments on both sides of the issue were familiar to the Board, he would limit his intervention to a few brief remarks and would not repeat many of the arguments that had been made previously.

The SDR had been established to meet the long-term global need to supplement existing reserve assets, Mr. Finaish noted. Trends of various determinants of demand for reserves, such as expansion of world trade and financial transactions, implied almost always a growing long-term need for reserves. A few Directors considered that such a need for reserves had been adequately met in recent years and continued to be met through existing sources of reserve growth. The staff and the majority of Directors argued otherwise. At any rate, it was important to recognize, as the staff had stressed, that the need to supplement existing reserve assets could exist even if the demand for reserves was fully satisfied.

By signing the Articles of Agreement, member countries had undertaken to collaborate with the Fund to achieve the objective of making the SDR the principal reserve asset in the international monetary system, Mr. Finaish pointed out. A further significant allocation of SDRs was therefore called for. However, some members of the Group of Ten had, in the Group's recent report on the international monetary system, argued that recent developments in the international monetary system had affected the rationale for the SDR, including the objective of placing the SDR at the center of the system as a main reserve asset. The most recent communiqué of the Interim Committee had stated that "the SDR constitutes an integral part of the structure of the Fund." Therefore, the issue was not whether there was a future role for the SDR, but what that role was to be. It could be argued that pending the conclusion of further studies on the future role of the SDR, the relative share of SDRs in non-gold reserves should at least be maintained to avoid prejudging the outcome of those studies.

Under the present reserve system, the reserve currency countries had the advantage of being able to finance their external payments deficits and to acquire reserve assets when needed by borrowing abroad in their own currencies, Mr. Finaish remarked. The costs associated with financing external deficits or acquiring reserves for the nonreserve currency countries were generally higher, particularly for those countries without access to market borrowing. Those countries could increase their reserves only by generating a surplus in their external account, which involved high real costs in terms of needed economic adjustment. Under those circumstances, an adequate SDR allocation could bring about a modest correction in the asymmetry of the costs incurred by reserve and non-reserve currency countries; it could also improve the borrowed-owned reserves mix and reduce the potentially destabilizing impact of greater indebtedness or reduced availability of borrowed reserves.

The main conclusion of the background staff paper on the implications of the U.S. external account deficits for the volume of international reserves strengthened the case for an SDR allocation, Mr. Finaish considered. The staff concluded that there had been no consistent relationship between the U.S. current account and the growth of international reserves. Therefore the existence of a U.S. current account deficit did not, by itself, lead to an increase in official reserve holdings. Finally, mechanisms of practical importance available to the international community to enhance international economic cooperation were limited in number. As the SDR facility was one of those mechanisms, the role of the SDR must be strengthened in accordance with the Articles of Agreement.

Mr. Polak remarked that he supported a new allocation of SDRs. However, he was doubtful about the usefulness of holding an Executive Board discussion on the question of an allocation of SDRs at six-month intervals. There were fundamental differences of view on the role of the SDR among the members of the Fund. As long as those differences persisted, the Executive Board would be unable to reach agreement on a further allocation. He therefore urged the staff to complete the study on the role of the SDR in the international monetary system as soon as possible so that Directors could discuss the relevant issues before the April 1986 meeting of the Interim Committee.

His authorities favored a moderate allocation in the order of SDR 4 billion a year in the remainder of the fourth basic period, an amount that would roughly preserve the relative proportion of SDRs in non-gold reserves, Mr. Polak said. A substantially larger annual allocation, which would raise the share of SDRs in total reserves, could be seen as prejudging the outcome of the forthcoming discussion on the role of the SDR. But to fail to allocate any SDRs would also be prejudging that outcome. He supported the arguments presented by the staff in favor of an allocation.

Mr. Sengupta commented that during 1981 and 1982 the ability of many developing countries to maintain or increase their international reserves had been severely diminished as a result of a number of macroeconomic developments and disturbances in international markets, including a severe deterioration in the terms of trade of the non-oil producing developing countries, high nominal and real interest rates, and a substantial appreciation of the U.S. dollar. Countries without access to market borrowing could satisfy their need for international reserves only by generating a balance of payments surplus. For those countries, the rebuilding of reserves since 1982 had involved high real costs in terms of spending cuts and adjustments that had been necessary to generate a surplus in the external accounts. During the remainder of the fourth basic period total demand for non-gold reserves was projected to grow by SDR 71 billion to SDR 474 billion, and by 1991 reserves were expected to grow by a further SDR 261 billion to SDR 735 billion. He agreed with the staff that there was a growing long-term global need for reserves, which should be satisfied, in part, by an SDR allocation.

The staff paper before the Executive Board was an updated version of previous papers prepared on the subject of an SDR allocation, Mr. Sengupta noted. The paper being prepared on the role of the SDR in the international monetary system would be particularly welcome. In considering the global nature of the need for reserve augmentation, the staff had stated that "the adverse impact of a reserve shortage experienced by an individual country or a group of countries on the performance of the world economy...would be a consideration that would be taken into account in establishing whether a global need for reserve supplementation existed." Had the staff taken that consideration into account in its estimate of global need? Between 1982 and 1984, indebted developing countries had rebuilt their reserves at great costs, following the severe reserve shortage in 1974-82. In fact, perhaps the level of reserves in 1984 was considered by the developing countries as an appropriate level. That was an empirical question that should be studied in the forthcoming paper. There were problems of estimating global need for reserves in terms of projected input growth, trade imbalances, or external debt. The most important determinants were expectations about instabilities in trade volume and capital flows, which were difficult to estimate. Could global need for reserves be estimated without considering the distribution of those reserves? If reserves were created to meet the total need, as determined by an average ratio related to world imports, would it be appropriate to allocate SDRs to different countries on the basis of average need or on the basis of an index calculated according to the different needs of individual countries? The staff should also analyze the difference between borrowed and nonborrowed reserves, which were not substitutes for each other. Could the staff indicate succinctly, by providing concrete empirical evidence, the reasons why nonborrowed reserves were superior to borrowed reserves? Within the pool of nonborrowed reserves, it should be established that the SDR was superior to other reserve currencies.

The staff also suggested that the U.S. current account deficits did not have a direct impact on international foreign exchange reserves, Mr. Sengupta noted. However, the destabilizing impact of a massive U.S. current account deficit on the world economy was undisputed. Given the large amount of reserves that were held in the form of dollars, what would be the effect of a sudden collapse of the dollar in the near future? Greater stability in the international system could be achieved only by strengthening the role of the SDR.

One of the objectives of the Articles of Agreement was to make the SDR the principal reserve asset in the international monetary system, Mr. Sengupta remarked. The staff should examine the ways in which the role of the SDR could be strengthened, in particular, how the SDR could be made into a principal reserve asset that the international community would be willing to hold over a long period. On the inflationary impact of an allocation, the staff had referred to the sterilization of SDRs if they were spent by the developing countries on goods from the industrial countries. The staff had also pointed out that a low rate of inflation could still be maintained as long as the rates of growth of monetary aggregates in the countries receiving SDRs were kept within their target ranges. Did all countries include SDRs in the total monetary base? In conclusion, his authorities were of the view that the SDR was a principal element strengthening the role of the Fund.

Mr. de Maulde asked Executive Directors to refer to his statement included in the minutes of the previous Board meeting on an SDR allocation (EBM/85/42, 3/15/85):

> 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.
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> 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 in 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.

Extending his statement Mr. de Maulde noted that the information included in the staff paper confirmed that there was a large net outflow of resources from those countries in which adjustment was both more difficult and more important for the stability of the international monetary system. The net outflow from the major borrowers--including Egypt, India, Indonesia, Korea and Turkey, in addition to the largest countries in Latin America--had been some $15 billion in 1984. In the first quarter of 1985, commercial banks had continued to reduce their exposure in developing countries, contrary to the assumption in the World Economic Outlook that commercial bank flows to developing countries would increase by about 6 percent to 7 percent a year. That trend was making adjustment in debtor countries increasingly difficult.

More generally, there was a distinct risk that world trade would be constrained by the slow growth in global reserves, Mr. de Maulde considered. According to the staff paper, reserves should increase by SDR 71 billion in 1985 and 1986 in order to maintain the present ratio of reserves to imports. In other words, reserves would have to increase by 9 percent a year. In the first five months of 1985, global reserves had actually decreased by 1.3 percent. In view of the restricted access to financial markets by a number of countries, adjustment must be implemented through the generation of high current account surpluses.

A resumption of SDR allocations would reduce the relative share of borrowed reserves in total reserves, thereby making reserve holdings less vulnerable to developments in the financial markets, Mr. de Maulde noted. It was interesting that that argument had been one of the major justifications for the previous allocation of SDRs in 1978, at a time when financial market access had been widely available. The staff report reaffirmed that an SDR allocation would not be inflationary and would not weaken the adjustment efforts of developing countries.

He was somewhat puzzled by the companion paper prepared by the staff dealing with the relationship of U.S. current account deficits with the global volume of reserves, Mr. de Maulde commented. Holdings of U.S. dollar reserves by the central banks of other countries were related to all elements of the U.S. balance of payments and not only to the balance on the current account, the factor examined by the staff. The correlation between global reserves and the global U.S. balance of payments situation was closer than the correlation with the U.S. current account balance. For example, in the early 1980s, global reserves had declined slightly, while the cumulative balance of payments position of the United States had been only slightly negative. He recognized that changes in the private holdings of U.S. dollars must also be taken into consideration. But the staff had completed only the first part of their analysis and should go on to consider the relationship between global reserves and the overall U.S. balance of payments position. Such a study would be useful in the context of the forthcoming study on the role of the SDR in the international monetary system. He agreed with Mr. Polak on the need to conduct that study in a thorough and speedy fashion.

Mr. Fugmann stated that he supported the staff's conclusions. The most recent paper on the World Economic Outlook underscored the greater downside risks in the staff projections. That greater uncertainty further supported the argument that it was unlikely that a moderate SDR allocation at present would be inflationary. An allocation could promote rather than hamper the difficult international adjustment that was required. He agreed with other Directors that the Executive Board should focus its attention more on the qualitative aspects of an allocation, such as the share between owned and borrowed reserves.

The companion paper prepared by the staff indicated that there was no direct relationship between the U.S. external current account deficit and the growth in international reserves, either analytically or empirically, Mr. Fugmann observed. As the staff pointed out, that outcome did not mean that there could not be such a relationship during a particular period even if it might be difficult to establish empirically. However, the results of the study seemed to confirm that the volume of global reserves was primarily determined by demand. Those findings and their possible consequences for the SDR would be dealt with in the studies on the role of the SDR in the international monetary system together with the study on the relationship between global reserves and the overall U.S. balance of payments position suggested by Mr. de Maulde. Finally, he expressed his hope for an early agreement on moderate SDR allocations.

Mr. Toé stated that his chair supported a substantial and unconditional allocation of SDRs in the current basic period. The staff had once again convincingly demonstrated the existence of a long-term global need to supplement existing reserve assets, a need that should preferably be met by a new allocation of SDRs. Moreover, the staff conclusion that there had been no consistent relationship between the U.S. external current account balance and the growth of international reserves confirmed that an SDR allocation should not be linked to developments in the external current account of the United States.

The international monetary system would be stronger and more stable following an allocation, Mr. Toé considered. He appealed to those Directors that had not expressed their support for a new allocation of SDRs to do so in order to allow the Managing Director to make the necessary recommendations to the Interim Committee.

Mr. Kafka indicated his support for a new allocation of SDRs. The suggestion of some opponents of an allocation that reserve creation should take place through market borrowing ran contrary to the principles laid down in the Articles of Agreement. Furthermore, one of the objectives of the Articles of Agreement was to make the SDR the principal reserve asset in the international monetary system. While he urged the speedy conclusion of the staff's study of the role of the SDR, the Articles of Agreement should be respected until they were changed. Liquidity should be internationally controlled and should not be dependent on the policies of reserve currency countries and the vagaries of commercial bank policies regarding exposure.

He questioned the method of determining reserve adequacy, based on the customary ratio of imports to non-gold reserves, Mr. Kafka remarked. If gold, at market prices, was included in total reserves, then the total value of reserves for all groups of countries had declined considerably since gold prices had started falling. On that basis, reserves had been valued at 150 percent more in 1980 than at present. If the developing countries as a group had sold their gold at the market price in 1980, they would have received $100 billion, an amount that represented 70 percent of their non-gold reserves.

Mr. Rye stated that his constituency had a divided view on the question of an SDR allocation. Staff papers on the subject were becoming successively more perfunctory. The present paper did not make a compelling case for or against an allocation, and it was difficult to reach any conclusions based on the evidence and arguments contained in it. Some of the ratios included in Table 1, for example, had moved in a perplexing manner. Reserves of industrial countries, relative to their external imbalances, appeared to have become less adequate. Yet it would be difficult to argue that the correction of those imbalances was being inhibited by a lack of reserves in those countries. Conversely, reserves of the developing countries, relative to their external imbalances and imports, seemed to have risen to more adequate levels in the past two or three years. However, that increase had been achieved largely through import compression. Even more paradoxical was the fact that the reserves of the indebted developing countries had risen at a time when their access to credit had been sharply curtailed. The question whether reserves were determined by supply or demand further confused the issue of an SDR allocation. If reserves were demand determined as both the G-10 and G-24 reports suggested, the case for supplementing reserves on the supply side was weakened.

In addition, the case for an allocation of reserves rested heavily on the fact that access to credit by many countries had been sharply curtailed, Mr. Rye noted. It was unclear how that consideration related to the adequacy of the stock of reserves. The SDR mechanism involved both stocks, in the reserve context, and flows, in the credit or financing context. With which aspect should the Executive Board be most concerned when deciding whether further allocations of SDRs should be made? Those and other questions underlay the differences of view among the members of his constituency, and he looked forward to the fundamental review of the role of the SDR in the international monetary system as a potential way forward. He urged that that review be completed with haste, provided that it was not at the cost of the fundamental nature of study.

Mr. Mtei remarked that much time had been spent by the Executive Board discussing the issue of an SDR allocation in the fourth basic period. It was of some concern that even though a majority of Executive Directors considered that the evidence provided by the staff made a convincing case for SDR allocations, the Executive Board had been unable to reach the necessary consensus that would make an allocation possible. An allocation of SDRs would help to ease the burden of reserve accumulation by a large number of countries whose only alternative was to pursue policies that inhibited growth and, consequently, led to a decline in the standard of living. Clearly, the extent to which the cost of reserve accumulation would be eased for debtor countries would depend on the size of the allocation. A resumption of SDR allocations would be consistent with the objective, which had perhaps been forgotten, of making the SDR the principal reserve asset in the international monetary system. However, the problem was not whether an allocation in the fourth basic period would satisfy their needs and the general purposes of the Fund; the problem was a political one. It was a question whether the few member countries that had opposed an allocation thus far had changed their position since the previous Board discussion on the issue.

A substantial allocation of SDRs was appropriate at present and was consistent with the purposes of the Fund, Mr. Mtei considered. The hypothetical cases presented in Table 4 of the staff report, ranging from an allocation of SDR 3 billion to SDR 9 billion each year for the remainder of the current basic period fell short of what was required under the circumstances. An allocation of SDR 9 billion would be no more than a token gesture in the global context, representing only a drop in the bucket for many low income countries facing uncertain medium-term prospects. A more substantial allocation would be the logical course of action given the shortage of reserves evident in a large number of countries that were facing external payments arrears even though they were implementing austerity measures.

There was no basis for some Directors' concern that a substantial allocation would undermine the adjustment process in developing countries, Mr. Mtei noted. As most countries pursuing adjustment programs had relatively small quotas, the amount of SDRs to which they would be entitled would be modest compared with the resources they could receive from the Fund under stand-by arrangements and from donor countries that were prepared to support their adjustment efforts, or even in terms of debt relief from official creditors and commercial banks. In short, it would not be in the interest of debtor countries to abandon their adjustment efforts. The increase in the supply of reserves from an SDR allocation would be no more than a reaction to the growth in demand for reserves. Directors should recall that a number of Fund programs were aimed at rebuilding reserves. An allocation in the fourth basic period would not lead to excess reserves.

Mr. Grosche indicated that his authorities were fully aware of the difficult liquidity situation in a number of developing countries. They were convinced that the Fund had a role to play in dealing with those difficulties. The Fund had several instruments at hand that were well-suited for addressing the main causes of a lack of reserves, but an allocation of SDRs was not one of them. The creation of additional unconditional liquidity at present could have negative repercussions on a global scale. More important, an allocation could not be justified because the long-term global need for resources had yet to be demonstrated.

The long-term global need for resources continued to be the single most important criterion for a resumption of an allocation, Mr. Grosche remarked. The arguments and views that he had expressed at previous Board discussions on the question of an SDR allocation were still valid. On pages 2-4 of its paper, the staff suggested that in previous discussions all Directors had agreed on the interpretation of the criteria for SDR allocations. However, at previous discussions on the subject, he had explained at length why he could not subscribe to a number of the interpretations. In particular, he did not agree that a need to supplement existing reserve assets could in principle exist even when the demand for reserves was fully satisfied. Nor was it his view that a decision to allocate SDRs did not imply the judgment that the existing demand for reserves could be met only in that way. Such narrow interpretations of the criteria by the staff was perhaps unwise.

While it was difficult to evaluate the present adequacy of and future need for international reserves, the methods employed by the staff were questionable, Mr. Grosche considered. It seemed inappropriate to link trade balance surpluses or deficits with the adequacy or inadequacy of international reserves. He also had reservations about the issue of causality. If there were major trade imbalances and international liquidity was inadequate, as the staff suggested, why then did trade imbalances exist in the first place? The staff realized the shaky ground on which their argument was based, as evidenced by the statement on page 7, which pointed out that the increase in the ratio of reserves to trade imbalances did not necessarily mean that the reserves of the developing countries had become adequate. Should any importance be attached to that ratio at all? Why did the staff consider that an adequate level of reserves was still above the level that would be reached after the adjustment process had been completed and normal access to international financial markets had been re-established? How large was the margin between that level and the supposedly adequate level?

The staff should be mindful of the distinction between need and demand, Mr. Grosche commented. "Need" clearly had objective implications, while "demand" had subjective implications. There were several instances in the staff paper, in contrast to earlier papers, where that distinction had been blurred.

In its companion paper, the staff had found no consistent and stable relationship between U.S. current account deficits and the amount of international reserves, Mr. Grosche observed. However, it remained to be seen whether a sudden fall in the U.S. dollar, precipitated by a large private supply of dollar-denominated assets, might force a number of central banks to absorb some of those assets. In addition, given a constant global discrepancy, the U.S. current account deficit was possible only if current account surpluses existed elsewhere in the world.

Some comment on the appropriateness of the concept of international liquidity and international reserves might have been helpful, Mr. Grosche remarked. That concept depended on the, sometimes blurred, distinction between the public central bank and the private or semiprivate banking sector. The concept of international liquidity had been developed at a time that had been characterized by a different exchange rate regime and different conditions in the international financial markets than at present. Those questions should probably be addressed in the course of the fundamental studies on the role of the SDR in the international monetary system.

Mr. Clark stated that his authorities remained unconvinced that the case for a new SDR allocation had been made. Based on the information in the staff paper, the case had, in fact, weakened over the past year. The staff's comments on the mix of borrowed and nonborrowed reserves and its implications for the stability of the financial system were interesting. However, such considerations did not have any direct implication for an allocation as there were a number of other potential sources of nonborrowed reserves. Nevertheless, the issue merited close attention in the studies currently under way on the role of the SDR in the international monetary system.

The paper on the impact of U.S. current account deficits on the volume of international reserves was welcome, although he wondered whether the two variables analyzed by the staff--gross reserves and the U.S. current account balance--had been the most appropriate, Mr. Clark commented. Perhaps, the relationship would have been closer if some measure of nonborrowed reserves had been examined on the one hand and the balance of U.S. current and long-term capital transactions on the other hand.

He shared Mr. Polak's concern about the value of Executive Board discussions on an SDR allocation in the absence of any major new consideration, Mr. Clark remarked. He therefore agreed that the Executive Board should defer further consideration of the issue until the broader studies on the role of the SDR had been completed and discussed by the Executive Board.

Mr. Zhang stated that he supported the analysis and conclusions in the staff report. A substantial allocation of SDRs was justified and should begin as soon as possible.

The Economic Counsellor confirmed that the staff considered that even if normal access to the credit markets were re-established and, consequently, the ratio of borrowed reserves to total reserves increased, there would still be a total need for reserves given the uncertainty experienced by countries regarding their ability to retain or increase their borrowed reserves. However, the difference between an adequate level of reserves and the level that would be reached following a return to normal bank lending was very difficult to measure.

Based on the Articles of Agreement, it was entirely legitimate in determining the long-term global need for reserves to consider the distribution of reserves, the Economic Counsellor considered. For a global need for reserves to exist it was not necessary for every member of the Fund to have a need for an increase in its reserves. Referring to the staff's companion paper, one Director had stated that while the U.S. current account deficit might not create reserves, any uncertainty concerning the value of the dollar could increase the need for reserves. He agreed that an increase in the perceived probability of a decline in the value of the U.S. dollar would lead some countries to question whether their reserves were currently adequate. However, he was uncertain whether such a development would meet the requirement of the Articles of Agreement; that the consequent need for reserves would be long term and global.

Some Directors had suggested that the staff should have looked at the capital account of the U.S. balance of payments as a generator of reserves, the Economic Counsellor noted. The current account of the balance of payments was an indirect measure of claims against the United States. The staff would not have advanced the net new cause by looking at the capital account, which was a direct measure of the claims against the United States. The capital account reflected the choices that were made by those entities that acquired claims on the United States at the time of a current account deficit and the decisions that were made, first, in the private sector as to whether to hold those claims or to pass them on and, second, in the public sector as to whether to pick up those claims and place them in reserves.

The Deputy Director of the Research Department, responding to questions from Executive Directors, remarked that it had not been the intention of the staff to imply in its paper that there had been unanimous agreement on the interpretation of the criteria relating to an allocation of SDRs. The effect of an SDR allocation on a country's monetary base depended on the legal system and practices of that country. Allocated SDRs did not enter directly into the monetary base when they were received by the member. However, the allocation of SDRs might be monetized by the Treasury, which, for example, might issue SDR certificates to the central bank. In general, there was no tendency toward a net monetization of an SDR allocation. Even if the member allowed the SDR to enter the monetary stream, it might offset the effect of that monetization by issuing a smaller volume of debt instruments elsewhere in the market in order to ensure that the monetary target was observed.

Mr. Dallara remarked that the Executive Board needed to consider not only the differences between borrowed and nonborrowed reserves, but also how an allocation, in the current circumstances, could affect those differences. He was disappointed that the staff had not challenged the arguments opposing an allocation that had been put forward by a number of Directors at the Executive Board's previous discussion on the subject.

The Chairman made the following summing up:

It is clear from the exchange of views today that there has been no change in the positions of Executive Directors on the question of an SDR allocation since our previous discussion of the subject: 17 Directors favor an SDR allocation, although their positions differ on the size of the annual allocations; 4 Directors are against an allocation at this time; and 1 Director has a divided position whithin his constituency. I shall not attempt to make a full summing up of all the arguments because they have been summarized comprehensively following previous discussions on the matter. I shall just say a few words on some of the main themes that were underlined in the discussion.

First, Directors discussed the quantitative aspects of the need for an allocation of SDRs. Those Directors who were not convinced that an allocation would be justified at present underlined that the figures contained in the staff report (SM/85/219, 8/2/85), especially in Table 1, seemed, if anything, to weaken rather than strengthen the case for an allocation of SDRs. But other Directors, considering the same figures, stressed that in their view the recent increases in the ratios of nongold reserves to imports and to trade imbalances for the group of indebted countries--the vast majority of developing countries--reflected more a constriction of imports and the severity of the adjustment that had been taking place than a more comfortable reserve position. They also pointed out that recent evidence and projections for 1985 demonstrated that access to international financial markets has become more and more difficult for a large number of developing countries. Given the severity of adjustment efforts since 1982, and the marked reduction of new bank lending to a number of developing countries, it would be unwise in the view of those Directors to limit liquidity creation to a point where balance of payments surpluses would be practically the only way for a very large number of countries to reconstitute an adequate level of reserves.

Second, on the qualitative side of the question, there was a very interesting discussion on whether borrowed resources are a perfect substitute for owned reserves. This is a basic issue that will have to be studied in the course of the more fundamental examination of the role of the SDR in the international monetary system, as many Directors mentioned. They felt that the differences between borrowed and owned reserves merited exploration, and that the effect of an allocation of SDRs on the quality of reserves should be examined. Several Directors pointed out that there were means for acquiring owned reserves other than through an SDR allocation. Concern was expressed about the position taken by the staff that even if there were other means to provide sufficient liquidity to meet the global need for reserves, the creation of SDRs would still have a role to play. It was suggested by a few Directors that if the demand for reserves could be met through other sources of reserve creation, there might be no need for SDR creation.

A large number of other Directors held very different views. They questioned whether it is appropriate to rely exclusively on financial markets, which after their expansion of the 1970s are now subject to growing constraints and uncertainties, to furnish liquidity in a complex international economic system that is dependent on the expansion of world trade for growth. In particular, they noted that it was currently extremely difficult for a large number of countries to gain access to those markets. Allowing for some expansion of owned reserves in the form of SDRs was thus, in their view, essential to the financing of world trade and to meeting the global liquidity needs of the system.

Third, on the procedural aspect of an allocation of SDRs, there are two viewpoints. One group of Directors are of the view that as there are such profound divergences on some of the very basic issues that I have just touched on, the Executive Board should not discuss repeatedly the question of an SDR allocation until the more fundamental issues have been tackled. Their suggestion has some legal and operational implications that need to be considered. Other Directors feel that the Executive Board should not postpone consideration of an SDR allocation, as to do so would prejudge the outcome of the study and discussion on the more fundamental aspects that is to take place and would go against the basic objective laid out in the Articles of Agreement of making the SDR the principal reserve asset of the international monetary system.

Directors have expressed, today perhaps with more force than on other occasions, the need to move quickly toward the discussion of the fundamental problems underlying the question of an SDR allocation. However, it is the view of a large number of Directors that consideration of the immediate question of the need for an SDR allocation should not be delayed until the comprehensive examination of those fundamental issues is completed.

The background paper on the implications of U.S. external current account deficits for the volume of international reserves has also been alluded to by a number of Directors. Some methodological questions have been asked. We will certainly come back to this topic in the framework of our more comprehensive analysis of the role of the SDR in the system.

Directors should now report to their political authorities, who should decide in the light of the discussion and in the framework of the preparations for the Seoul meetings, what to do about the immediate question for an allocation of SDRs.

Extending his statement, the Chairman remarked that he was concerned that the financial markets would not meet the need for reserves in a smooth and nonproblematic way. There were signs that the commercial banks were reducing their exposure even in those countries that were undertaking adjustment programs. The adequacy of reserves should be looked at not only in terms of the ratios presented in the staff paper but also in terms of the working of the system of liquidity creation. While the capital markets had been very active in the 1970s and very early 1980s, there had recently been a clear contraction in lending and a further increase in the indebtedness of developing countries. The role of the SDR should be examined in the context of the realities of the current international monetary system. In reviewing the forthcoming study on the role of the SDR, Directors should consider how the SDR could be developed in a way that would reinforce the stability of the international monetary system.

Mr. Grosche stated that the Executive Board's task would have been easier if SDRs had been canceled in the late 1970s.

3. EXECUTIVE DIRECTOR

The Chairman bade farewell to Mr. Blandin at the conclusion of his service as Alternate Executive Director for France.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/128 (8/28/85) and EBM/85/129 (8/30/85).

4. MAURITIUS - REPORT ON NONCOMPLYING PURCHASE AND WAIVER OF NONOBSERVANCE

The Fund notes the report of the Acting Managing Director set forth in EBS/85/192 on the noncomplying purchase made by Mauritius on April 15, 1985 under the stand-by arrangement for Mauritius (EBS/85/27, Sup. 2) and decides to waive the nonobservance. (EBS/85/192, 8/14/85)

Decision No. 8063-(85/129), adopted
August 28, 1985

5. ALGERIA - 1985 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for completing the 1985 Article IV consultation with Algeria to not later than September 9, 1985. (EBD/85/222, 8/26/85)

Decision No. 8064-(85/129), adopted
August 28, 1985

6. GHANA - TECHNICAL ASSISTANCE

In response to a request from the Ghanaian authorities for technical assistance to review the tax system and its administration, the Executive Board approves the proposal set forth in EBD/85/223 (8/27/85).

Adopted August 29, 1985

7. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 84/173 through 84/175 are approved. (EBD/85/219, 8/22/85)

Adopted August 28, 1985

8. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/85/225 (8/27/85) and EBAP/85/226 (8/28/85) and by an Advisor to Executive Director as set forth in EBAP/85/225 (8/27/85) is approved.

APPROVED: May 14, 1986

LEO VAN HOUTVEN
Secretary