INFORMAL SESSION TO ENGAGE

SM/16/115
Correction 2

CONFIDENTIAL

June 20, 2016

To: Members of the Executive Board

From: The Secretary

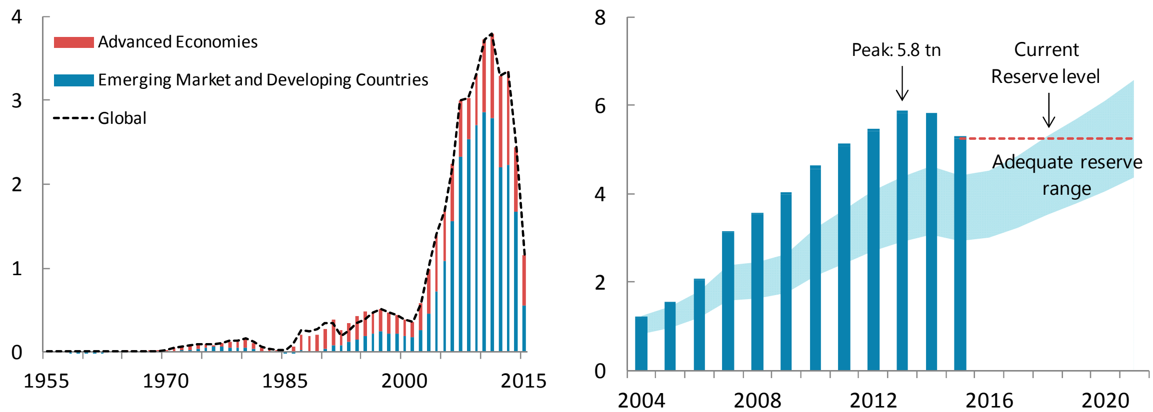
Subject: **The Case for a General Allocation of SDRs During the Eleventh Basic Period**

Board Action:	The attached corrections to SM/16/115 (5/24/16) have been provided by the staff:
Evident Ambiguity	**Page 15**
Typographical Errors	**Page 14**
Questions:	Mr. Tovar Mora, SPR (ext. 36329) Ms. Albino-War, FIN (ext. 39708) Ms. Rosenberg, LEG (ext. 37790)

Figure 1. Reserve Growth

(In trillions of SDRs)

Global reserve growth in overlapping 5-year periods 1/ | EMDCs: Reserve holdings and estimated ARA projections



Source: IMF, International Financial Statistics; and Fund staff calculations.
1/ Excluding gold.

Box 3. EMDC Reserve Demand

Estimates for EM~~C~~DC reserve demand[1/] in Table 2 in the main text are '*gross*' estimates, measuring the increase in reserves required to eliminate the shortfall between the end-2015 levels of reserve holdings and projected reserve needs to maintain reserve ratios or reach ARA thresholds. Those estimates can be decomposed into two components: (i) the endogenous, WEO consistent, creation of reserves expected over the period; (ii) a measure of '*net*' demand—the shortfall between the projected (WEO consistent) level of reserves and projected reserve needs to maintain reserve adequacy ratios or reach given ARA thresholds. Estimates place the reserve asset demand required to meet 'net' needs in the range of SDR 0.3–0.9 trillion in the next basic period consistent with meeting the 100-125 percent reserve adequacy thresholds (see text table). In short, the WEO consistent creation of reserves is SDR 0.1 trillion.

Projected 'Net' Demand for Reserve Assets: ARA-Based

(In trillions of SDRs)

	EMDCs		EMDCs ex. China	
	5-year	10-year	5-year	10-year
100% ARA Threshold	0.3	2.0	0.3	0.8
125% ARA Threshold	0.9	3.4	0.6	1.3
150% ARA Threshold	1.8	4.9	1.0	1.9
Range	**0.3-1.8**	**2.0-4.9**	**0.3-1.0**	**0.8-1.9**

Source: Fund staff calculations based on WEO.
Note: For each individual country, projections calculate the gap between the *projected* level of reserves and the 5 or 10-year ahead ARA metric. Individual country estimates for which the gap is negative are then aggregated.

1/ Demand can be influenced by recourse to the GFSN such as regional financial arrangements or bilateral swap arrangements.

SDR-specific considerations

25. **A general SDR allocation could potentially strengthen the IMS.** SDRs are not a currency, are allocated (i.e., accumulated without contributing either to global imbalances through current account surpluses or to downward pressure on reserve issuers' financing costs), and are subject to less fluctuations in their value than assets denominated in a single currency. They also can help eliminate or, at least, reduce, distortions arising from accumulations of (precautionary and non-precautionary) reserve positions. Moreover, the decision to include the RMB in the SDR basket with effect from October 1, 2016 and to adopt a new formula for determining currency weights will make the SDR more representative of currencies used in global trade and financial systems.

26. **However, there are also important architectural shortcomings that have limited the usability of the SDR.** If official holders continue to see the SDR as an imperfect substitute for other reserves due to its limited usability, an allocation will likely have a low impact on excessive reserve accumulation.[19] Also, because SDRs provide unconditional liquidity, they can be used to accommodate unsustainable policies.

27. **A forthcoming Board paper will look into the evolution of the SDR and its potential future role in addressing some of the IMS's vulnerabilities.** In particular, the paper will analyze if greater use of the SDR—including SDR-denominated assets, which could be both issued and held by any parties—could help reduce global imbalances and mitigate the impact of financial market volatility. The outcome of this discussion could result in proposals to modify the existing framework set forth in the Fund's Articles of Agreement for general SDR allocations or cancellations. The paper will also review whether there is scope for the SDR to strengthen the capacity of the GFSN, complementing other work streams, including on the Fund's lending facilities.

28. **The Articles of Agreement require a general allocation of SDRs to be consistent with "avoiding economic stagnation and deflation as well as excess demand and inflation in the world."** An allocation per se has no monetary effect—simply providing monetary authorities with an additional claim on freely usable currencies of IMF members. An inflationary impact could potentially occur only if the central bank of a reserve-issuing country creates money in exchange for SDRs without sterilizing it.[20] Overall, no significant risks of inflation arising from an SDR allocation were identified in 2009 or 2011. That assessment continues to apply. Furthermore, while there are some pockets of inflationary pressures among emerging economies, these remain low in AEs. And, with a weak growth outlook, widespread pressures are unlikely to surface anytime soon.

29. **A general allocation of SDRs is made to participants in the SDR Department in proportion to their quotas in the Fund (Article XVIII, Section 2(b)).** With the 14th General Review of Quotas shifting ~~more than 6~~ 2.8 percent of quota shares to ~~dynamic~~ EMDCs, around two-fifths of

[19] See IMF, 2011, "*Enhancing International Monetary Stability – A Role for the SDR?*" January.

[20] See Cooper, Richard, 2011, "Is SDR creation inflationary?" Report by an Independent Expert Consultant.