

INTERNATIONAL MONETARY FUND

**SDR Allocation in the Eighth Basic Period—Basic Considerations**

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In consultation with other Departments

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November 16, 2001

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## I. INTRODUCTION

1. **This paper discusses basic considerations relevant to an allocation of SDRs in accordance with Article XVIII, Section 1.**<sup>1</sup> Periodic consideration of such a general allocation takes place in the context of consecutive basic periods, pursuant to Article XVIII, Section 2. The seventh basic period (1997–2001) for a general allocation of SDRs ends on December 31, 2001, and the eighth basic period (2002–2006) will commence on January 1, 2002. Pursuant to Article XVIII, Section 4(c), the Managing Director is required to submit a report to the Board of Governors no later than six months before the end of each basic period regarding proposals for general allocations in the next (eighth) basic period.<sup>2</sup>
2. The report to the Board of Governors under Article XVIII, Section 4(c) must indicate either that the Managing Director is making a proposal for an allocation consistent with Article XVIII, Section 1 or that there is no such proposal that would attract the necessary broad support from participants in the SDR Department. In order to make this judgment, the Managing Director is to hold consultations with participants.
3. This paper is intended to provide background information for these consultations, which will be conducted through a meeting of the Executive Board, tentatively scheduled for December 10, 2001. **It does not present a specific proposal but rather sets out the issues for the consideration of Executive Directors.** The outcome of these consultations will be reflected in a report to the Board of Governors by the Managing Director, which will be issued before the beginning of the next basic period on January 1, 2002. Submission of that report would not preclude the Executive Board from continuing discussions on a general allocation of SDRs in the eighth basic period.<sup>3</sup>
4. The remainder of the paper is organized as follows. Section II sets out the framework for considering general allocations and the experience with this framework, while Section III provides the basic facts on SDRs allocated to date. Considerations relevant to an assessment of long-term global need are presented in Section IV. Some issues for discussion are suggested in Section V.

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<sup>1</sup> For presentational purposes, an allocation of SDRs pursuant to Article XVIII, Section 1 is referred to in this paper as a *general allocation* to distinguish it from the *special allocation* under the Fourth Amendment of the Articles of Agreement and various proposals for a *selective allocation* (Section III).

<sup>2</sup> The procedure and timetable for completing the report after this deadline are set out in a memorandum from the Managing Director on *SDR Allocation—Conclusion of Seventh Basic Period* (FO/DIS/01/120, 9/24/01).

<sup>3</sup> A proposal for an allocation that meets these criteria can be made at any time (Article XVIII, Section 4(c)(ii)), including as a result of unexpected major developments (Article XVIII, Section 3).

## II. FRAMEWORK FOR CONSIDERING GENERAL ALLOCATIONS

5. **This Section sets out the framework for considering the case for a general allocation of SDRs and recalls the main issues that have arisen in its application.** A decision by the Board of Governors to make a general allocation of SDRs requires an 85 percent majority of the total voting power. In accordance with Article XVIII, Section 4(a), such a decision must be based on a proposal by the Managing Director, concurred in by the Executive Board, that is consistent with Article XVIII, Section 1(a) and for which there is a broad support among participants.

### A. Long-Term Global Need

6. **Consideration of a general allocation of SDRs centers on the requirement of long-term global need set out in Article XVIII, Section 1(a) of the Articles of Agreement:**

*In all its decisions with respect to the allocation and cancellation of special drawing rights the Fund shall seek to meet the long-term global need, as and when it arises, to supplement existing reserve assets in such manner as will promote the attainment of its purposes and will avoid economic stagnation and deflation as well as excess demand and inflation in the world.*

7. **The Articles do not indicate how this requirement is to be met in practice.** Indeed, the difficulty of specifying and quantifying the long-term global need for reserve supplementation was recognized at the outset. Resolving this difficulty has been made more complicated over time by changes that have taken place in the international monetary system since the SDR mechanism was established in the 1960s, which raise fundamental questions about the role of the SDR (Box 1).<sup>4</sup> In practice, the Fund has followed a two-step process in considering a general allocation of SDRs: first, the demand for reserves to hold is projected and, second, a judgment is made about the extent to which this demand could or should be met through an allocation of SDRs.

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<sup>4</sup> The introduction of the SDR stemmed from a desire to establish a mechanism for the deliberate creation of reserve assets in order to supplement existing reserve assets, given the inherent constraints on the supply of gold and the major reserve currency (the U.S. dollar) under the Bretton Woods system of fixed exchange rates—the so-called Triffin dilemma. Since then, gold has been removed from the center of the international monetary system, the Bretton Woods system has given way to more flexible exchange rate arrangements, and international capital markets have emerged to become a key channel through which countries can add to their reserves.

### Box 1. Seminar on the Future of the SDR

A seminar on the future of the SDR was held under Fund auspices in March 1996. The seminar was convened at the request of the Interim Committee to clarify the key issues and differences of opinion that prevailed within the Fund about the role of the SDR in the international monetary system.<sup>1</sup> Seminar participants included policymakers, academic economists, and other experts on the functioning of the international monetary system. The panel sessions for the seminar covered a wide range of issues, from the history, characteristics, and role of the SDR in a multiple reserve asset system; to the case for SDR allocations under the present Articles; to the potential for the SDR in the creation of conditional and unconditional liquidity; to the future evolution of the international monetary system. The proceedings were published by the Fund in 1996 under the title *The Future of the SDR in Light of Changes in the International Financial System*.

Debate among external experts during the seminar mirrored the parallel discussions on the SDR that were taking place in the Executive Board at the time. Although views differed on most issues, several themes emerged from the seminar:

- the SDR is unlikely to become the principal reserve asset of the system;
- the SDR should not be abolished in case it is needed as a safety net for the system; and
- a solution should be found to the so-called equity problem, in that members joining the Fund since the last allocation in 1981 have never received an allocation of SDRs.

The seminar also helped to clarify the main obstacle to a consensus on a general allocation of SDRs: how to interpret the requirement of long-term global need in a world that has changed fundamentally since the SDR mechanism was established. Some participants considered that the emergence of private capital markets as a source of reserve currencies weakened the case for an allocation; others pointed to the uneven access of countries to this source of reserves and its potentially high cost, and saw in this framework a case for an allocation.

After considering the conclusions of the seminar, the Interim Committee asked the Executive Board to reflect further on the various proposals relating to the SDR and to reach a consensus on a solution to the equity problem. The resulting series of Executive Board discussions led in 1997 to the adoption by the Board of Governors of an amendment to the Articles of Agreement to provide for a one-time, special allocation of SDRs to all members (see Box 4 on the Fourth Amendment).

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<sup>1</sup> The Interim Committee was the predecessor of the International Monetary and Financial Committee.

8. **From the legislative history and subsequent experience, a few key propositions have been advanced about the concept of long-term global need that may be relevant to consideration of the matter at this time.**<sup>5</sup> Executive Directors have not always agreed on the relevance or merits of these propositions, or the lines of argument derived from them.<sup>6</sup>

9. **First, a global need for reserve supplementation does not require that all or even most members experience an inadequacy of reserves.** This being the case, a key consideration in assessing the global dimension of a possible need to supplement reserves is the potential impact of a reserve inadequacy somewhere in the system on the performance of the world economy. This line of reasoning was one feature of the argument made for an allocation in the early 1990s, where it was held that reserve stringencies in countries that had only recently embarked on the transition to a market economy could jeopardize the success of their adjustment efforts. Views differed on the impact of such reserve stringencies on the adjustment efforts of those countries and on the world economy, and on the appropriateness of addressing these risks through a general SDR allocation rather than conditional liquidity support.

10. **Second, long-term global need has a prospective character and need not be evidenced by a present shortage of reserves.** The assessment of long-term global need therefore focuses on the *future* growth of reserves and the need for their supplementation; short-term or cyclical fluctuations are less relevant. That said, views on the adequacy of the likely rate of growth of reserves necessarily take into account the *current* starting position.

11. **Third, an allocation of SDRs could be appropriate even if there were other ways to satisfy a global need for reserve supplementation—notably, borrowing from the markets.** This proposition has two lines of argument that remain relevant today.

- The first is the emphasis on the **qualitative aspects of reserves**, in particular the distinction between borrowed reserves and owned reserves. One argument in favor of increasing owned reserves through a general SDR allocation is that the resulting reduced reliance on borrowed reserves, which require periodic refinancing and are prone to volatile price movements, could contribute to greater stability in the international monetary system.

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<sup>5</sup> This Section draws heavily on *SDR Allocations—The Concept of Long-Term Global Need to Supplement Existing Reserve Assets and the Objective of Making the SDR the Principal Reserve Asset*, SM/93/146 (7/6/93); *Allocations of SDRs—Legislative History of the Concept of “Global Need” to Supplement Existing Reserves*, SM/84/148 (6/27/84); and *The Objective of Making the Special Drawing Right the “Principal Reserve Asset in the International Monetary System”—Aspects of Pre-Legislative and Legislative History*, SM/77/270 (11/16/77).

<sup>6</sup> A comprehensive summary of the competing views is contained in the *Report to the Interim Committee on the Question of an SDR Allocation and Related Issues*, ICMS/Doc/41/93/11 (9/23/93).

- The second line of argument centers on **the cost of holding reserves**. This is more controversial. With the rapid growth of international capital markets and the more widespread access of members to borrowed reserves, the focus of analysis has shifted from the adequacy of reserve levels to the cost of acquiring and holding reserves. Whereas the initial focus in the early years was on the supply of reserves (gold and U.S. dollars) generated by the system, much of the analysis and discussion in the Fund since the last allocation in 1981 has been framed in terms of opportunity cost—that is, a comparison of the cost of acquiring and holding reserves through a SDR allocation with a comparable supplementation of reserves through (i) domestic adjustment and/or imposition of external restrictions or (ii) borrowing from official and private lenders.

12. **The emphasis on cost factors has not been universally accepted.** Some Executive Directors have seen in the relatively high cost of acquiring and holding borrowed reserves for any members strong evidence of a long-term global need to supplement existing reserves. For others, the evidence has been less compelling or even irrelevant; in this view, the relatively high cost of borrowed reserves reflects country-specific risk premia, which could be reduced through sustained policies to enhance creditworthiness.

## B. The Role of the SDR

13. **The Articles of Agreement explicitly call on members to work toward the objective of making the SDR the principal reserve asset in the international monetary system.** This systemic objective for the SDR was introduced in the Articles through two separate provisions as part of the Second Amendment in 1978.

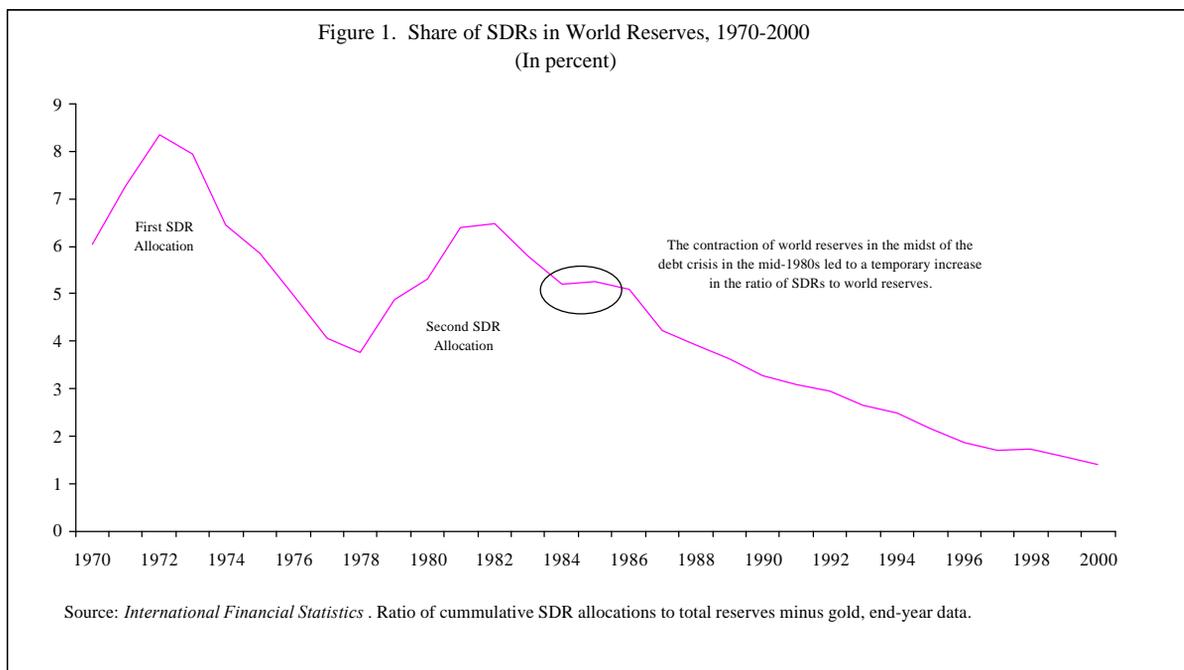
- **Article VIII, Section 7**, which deals with the obligation of members to collaborate on policies on reserve assets:

*Each member undertakes to collaborate with the Fund and with other members in order to ensure that the policies of the member with respect to reserve assets shall be consistent with the objectives of promoting better surveillance of international liquidity and making the special drawing right the principal reserve asset in the international monetary system.*

- **Article XXII**, which covers the general obligations of participants:

*In addition to the obligations assumed with respect to special drawing rights under other articles of this Agreement, each participant undertakes to collaborate with the Fund and with other participants in order to facilitate the effective functioning of the Special Drawing Rights Department and the proper use of special drawing rights in accordance with this Agreement and with the objective of making the special drawing right the principal reserve asset in the international monetary system.*

14. **These provisions do not and cannot provide a basis for determining long-term global need to supplement existing reserve assets or the size of an allocation of SDRs.** According to the official commentary on the Second Amendment, “[t]he principles for the allocation and cancellation of special drawing rights remain unchanged ...” by the introduction of this systemic objective.<sup>7</sup> Consequently, while the small and declining share of SDRs in the reserve holdings of members could be held to be inconsistent with the systemic objective for the SDR, in and of itself this has no bearing on the assessment of long-term global need (Figure 1).



15. **Nevertheless, a link between the systemic objective for the SDR and the criteria for allocating SDRs was established in support of an allocation of SDRs in the third basic period (1978–81).** At the time, it was argued that this objective was a “purpose of the Fund” within the meaning of Article XVIII, Section 1(a) and that it was therefore appropriate to take it into account in considering an allocation of SDRs. The Managing Director’s proposal for an allocation in the third basic period, concurred in by the Executive Board, indicated that the objective of making the SDR the principal reserve asset was considered relevant for a decision to allocate SDRs, but only once a finding of long-term global need had been made.

<sup>7</sup> *Proposed Second Amendment to the Articles of Agreement: A Report by the Executive Directors to the Board of Governors*, IMF, Washington D.C., March 1976, page 71.

### III. SDR ALLOCATIONS MADE BY THE FUND

16. **This Section provides basic facts on the two SDR allocations made thus far.** It includes information on the current distribution of SDRs among participants, other prescribed holders, and the Fund. Allocations are made only to participants, in amounts expressed in terms of quota.<sup>8</sup> Box 2 contains a primer on the mechanics of the SDR.

#### A. The Allocation of SDRs

17. **The first allocation followed shortly after establishment of the SDR mechanism.**<sup>9</sup> The allocation was made during the first basic period, in broadly equal installments on January 1, 1970, 1971, and 1972. The total amount allocated was SDR 9.3 billion (Table 1).

18. **Evidence of long-term global need was found first and foremost in the marked decline in world reserves (gold and U.S. dollars) in absolute terms and relative to world trade since the mid-1960s.** Other factors included the heavier reliance on trade restrictions, growing recourse to international financial assistance from the Fund and others to finance payments deficits, and increased use of capital controls.<sup>10</sup> As required by Article XVIII, Section 1(b), the decision to make the first allocation also took into account “the attainment of a better balance of payments equilibrium, as well as the likelihood of a better working of the adjustment process in the future.” The size of the allocation was based on the projected growth in the demand for reserves, and the extent to which gold and currency reserves were expected to grow over the basic period.

19. **The second SDR allocation took place in the third basic period (1978–81).**<sup>11</sup> A total of SDR 12.1 billion was allocated in three similar annual installments on January 1, 1979, 1980, and 1981. There was no allocation in the first year of the third basic period because the Resolution approving the allocation and the parallel Resolution on the Seventh General Review of Quotas were not approved until late 1978.

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<sup>8</sup> All participants receive general allocations of SDRs unless the Governor for the participant votes against a proposal to allocate and opts for the participant not to receive the allocation of SDRs (Article XVIII, Section 2(e)). Under the Fourth Amendment, which is not yet effective, the resulting SDRs allocated to a member in arrears to the Fund would be held in escrow until its arrears were cleared (Schedule M, paragraph 5).

<sup>9</sup> Resolution No. 24–12, October 3, 1969, *Selected Decisions*, Twenty-Fifth Issue, pages 633–634.

<sup>10</sup> The 1969 proposal by the Managing Director is reproduced in *The International Monetary Fund, 1966–1971: The System Under Stress*, Volume II, 1976, edited by Margaret Garritsen de Vries, pages 251–265.

<sup>11</sup> Resolution No. 34–3, December 11, 1978, *Selected Decisions*, pages 642–643. The effectiveness of the Resolution was contingent on adoption of a Resolution to increase quotas under the Seventh General Review.

## Box 2. Financial Implications of Acquiring, Holding, and Using SDRs

The SDR is a reserve asset created by the Fund. It is not a claim on the Fund but rather a means for members to obtain freely usable currencies from other members. The SDR is also used as a means of payment in international transactions, nearly always involving the Fund. Other holders of SDRs include the Fund itself and some 16 international organizations prescribed by the Fund; there are no private holders of SDRs. The value of the SDR as a reserve asset derives from the commitment of members to hold and accept SDRs and to honor the obligations underlying operation of the SDR system. The Fund ensures the liquidity of the SDR in two principal ways:

- through a designation mechanism in which members with strong external positions agree to purchase SDRs from members with weak external positions up to a uniform limit; and
- through voluntary exchanges between members in a market managed by the Fund.

All SDR exchanges since 1987 have taken place through voluntary arrangements. At present, two-way arrangements to buy and sell SDRs are in place with 13 members, and a one-way arrangement is in force with another member to sell SDRs. The designation mechanism continues to underpin the liquidity of the SDR and is available if needed.

From an accounting perspective, members generally treat their holdings of SDRs as an asset on the balance sheet of the depository. The cumulative amount of SDRs allocated to the member is recorded as an external liability. There are no currency counterparts to allocations and holdings of SDRs.

There is no obligation to maintain any particular level of SDR holdings. When the SDR was established, members were obligated to keep their SDR holdings at or above 30 percent of their cumulative allocations averaged over a five-year period; if holdings fell below this level, participants were required to reconstitute their holdings by acquiring SDRs from the Fund or a specified member (see Schedule G). This *reconstitution requirement* was relaxed over time and was abrogated altogether in 1981; it may be reinstated by a decision of the Executive Board requiring a 70 percent majority of the total voting power. The SDR system therefore provides members with access on demand to freely usable currencies on an unconditional basis and with no fixed maturity.

Members receive interest on their holdings of SDRs and pay charges on their cumulative allocations of SDRs at the same rate—the SDR interest rate. The financial implications of participating in the SDR Department therefore depend in the first instance on the size of SDR holdings relative to allocations.

- **Members acquiring SDRs** voluntarily or through designation receive net interest corresponding to the difference between their SDR holdings and allocations.
- **Members using SDRs** to acquire freely usable currencies or make Fund payments pay net interest corresponding to the difference between their SDR holdings and allocations.
- **Members that neither acquire nor use SDRs** pay no interest on a net basis.

For members that do not issue a reserve currency, the acquisition of SDRs results in a change in the composition of reserve assets from freely usable currencies to SDRs. For reserve center countries, the acquisition of SDRs results in an increase in reserve assets and, typically, a corresponding increase in external liabilities as foreign central banks increase their holdings of the reserve currency.

Table 1. Allocations of SDRs - Amount and Timing

	1970	1971	1972	1979	1980	1981	Cumulative Allocation
	(In billions of SDRs)						
Industrial countries	2.51	2.16	2.16	2.68	2.68	2.63	14.81
Major advanced economies							
Canada	0.12	0.12	0.12	0.14	0.14	0.14	0.78
France	0.17	0.16	0.16	0.20	0.20	0.20	1.08
Germany	0.20	0.17	0.17	0.22	0.22	0.22	1.21
Italy	0.11	0.11	0.11	0.13	0.13	0.13	0.70
Japan	0.12	0.13	0.13	0.17	0.17	0.17	0.89
United Kingdom	0.41	0.30	0.30	0.30	0.30	0.30	1.91
United States	0.87	0.72	0.71	0.87	0.87	0.86	4.90
Developing countries	0.90	0.79	0.80	1.36	1.36	1.42	6.62
Total	3.41	2.95	2.95	4.03	4.03	4.05	21.43

Source: *International Financial Statistics*. Country groups based on September 2001 WEO classification.

20. **The decision to make a second allocation of SDRs took into account the major changes that had taken place in the international monetary system since the inception of the SDR.** In particular, the Fund had to consider the implications of the emergence of international capital markets and the widespread adoption of more flexible exchange rates for the assessment of the long-term global need for reserve supplementation. The proposal to allocate SDRs in the third basic period rested on three arguments:<sup>12</sup>

- the demand for reserves had increased with the level of international transactions, and was expected to continue to do so even with greater exchange rate flexibility;
- a decision to allocate did not depend on a finding that long-term global need could be met only by SDRs, which in any event were not subject to the refinancing problems that were characteristic of reserves borrowed from the market; and
- the declining share of SDRs in world reserves was inconsistent with the objective of making the SDR the principal reserve asset.

<sup>12</sup> The 1978 proposal by the Managing Director is reproduced in *Selected Decisions*, pages 635–642.

21. **The size of the SDR allocation during the third basic period was based, like the first allocation, on the projected growth of world reserves relative to world trade.** It was thought that the expansionary effects of an allocation of SDRs of the magnitude suggested by these calculations would be limited. The proposed amount was scaled down, however, in view of the need to take into account “in the world of today the possible effects on expectations with respect to inflation.”

22. **There has been no allocation of SDRs since 1981.** The possibility of an allocation was discussed in the Executive Board during the fourth, fifth, and sixth basic periods but there was not enough support (that is, a majority of 85 percent of the total voting power) for an allocation on the basis of long-term global need. During this period, numerous proposals were made for combining an allocation of SDRs with mechanisms for the post-allocation redistribution of SDRs to members facing the most acute needs for international liquidity. A common motivation for considering such schemes was the fact, understood when the SDR mechanism was being designed in the 1960s, that quotas are an imperfect key for allocating SDRs to the countries most in need of reserve supplementation. Various proposals for the allocation of SDRs and their subsequent redistribution are considered in Box 3, which also discusses recent proposals by the UN and George Soros, the financier and philanthropist.<sup>13</sup>

23. **Agreement was reached early in the seventh basic period on a one-time, special allocation of SDRs on the basis of an amendment of the Articles of Agreement.** The Fourth Amendment would provide a separate basis for allocating SDRs outside the framework of long-term global need; this would be a one-time allocation, and existing provisions governing general allocations would not be affected (Box 4). Effectiveness of the Fourth Amendment requires acceptance by three fifths of the membership having 85 percent of the total voting power. At the present time, acceptance by the United States would bring the Fourth Amendment into effect. Since agreement was reached on the Fourth Amendment, there has been no discussion in the Executive Board of an allocation based on long-term global need.

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<sup>13</sup> The UN *Report of the High-Level Panel on Financing for Development* (the Zedillo Report) was circulated to the Board as FO/DIS/01/86 (7/3/01) and is available on the web at [www.un.org/reports/financing](http://www.un.org/reports/financing). The Soros proposal is in draft form and was published in George Soros, *Draft Report on Globalization*, Public Affairs, New York, 2001. The Soros and Zedillo proposals are likely to be inputs into a UN-convened International Conference on Financing for Development to be held in Monterrey, Mexico on March 18–22, 2002.

### Box 3. Proposals for Allocating and Redistributing SDRs

Under the Articles, SDRs can be allocated only on the basis of a finding of long-term global need or, upon adoption of the Fourth Amendment, through a one-time, special allocation. There are no provisions for redistributing SDRs but participants have considerable flexibility over the use of SDRs, which can for example be transferred to other holders through loans or grants.

There is a long history of proposals for allocating and redistributing SDRs. They typically fall into one of two broad categories:

**Proposals to supplement Fund resources.** These proposals seek to direct SDRs allocated to industrial countries to countries with more severe international liquidity needs. To the extent that these proposals involve balance of payments financing with conditionality, they can be viewed as essentially substituting for an increase in Fund quotas or Fund borrowing. The key difference among them is the degree of Fund involvement in intermediating redistributed SDRs, and the implications of this for conditionality and the assumption of credit risk. Many proposals in the 1980s and early 1990s fall into this broad category. Some envision a permanent transfer of SDRs, while others operate through lending schemes or an allocation/cancellation framework; cancellation of SDRs is governed by the same criteria as allocation, and a decision to allocate could not be conditioned on their subsequent cancellation.

**Proposals to finance development.** Proposals to link SDR allocations to the provision of development finance predate the establishment of the SDR system itself. Absent a change in the Articles, however, it is not possible for the Fund to allocate SDRs on this basis. Nevertheless, there is nothing to prevent countries from voluntarily agreeing to transfer SDRs to other countries or prescribed holders for reasons of their own choosing. A variation on this theme was proposed recently by George Soros, the financier and philanthropist. The mechanics of the Soros proposal are similar to earlier proposals involving a post-allocation redistribution of SDRs through quasi-independent trust funds. The redistributed SDRs would be directed not only to individual countries, however, but also toward the provision of global public goods (such HIV/AIDS programs).

A more straightforward proposal is contained in the so-called Zedillo Report, which recommends the resumption of SDR allocations. There is no provision for a post-allocation redistribution of SDRs. Implementation of this recommendation would therefore be governed only by the requirement of long-term global need set out in the Articles.

No proposal for the voluntary redistribution of SDRs has ever been put into effect. The primary obstacle these proposals face lies in the zero-sum nature of the SDR system: participants are liable to pay SDR charges on all SDRs allocated to them whether or not they hold, use, loan, or donate their SDRs. Redistribution of SDRs therefore has a real cost to the provider, which can be passed on to others only with their consent or must be borne by the provider, often requiring budgetary and/or legislative action.

#### Box 4. The Fourth Amendment

Notwithstanding sharp differences of view in the Executive Board over the long-term global need for an allocation of SDRs under Article XVIII, Section 1, a consensus emerged in the mid-1990s on the need to resolve the so-called equity problem. This problem stemmed from the fact that many members had joined the Fund since 1981, when the last allocation of SDRs was completed, and had therefore not received an allocation of SDRs; and some members joining prior to the last allocation had received only part of the allocations made to other members. The salience of this issue was heightened by the pressing needs of transition economies, including new Fund members from the former Soviet Union, to supplement their reserves holdings in order to facilitate their integration in the world economy.

The solution to the equity problem agreed by the Executive Board was to amend the Articles of Agreement to allow for a one-time, special allocation of SDRs that would double cumulative SDR allocations to SDR 42.87 billion—the Fourth Amendment. This would be achieved by raising the ratios of cumulative SDR allocations to quota under the Ninth General Review of Quotas to a common benchmark ratio of 29.32 percent. Adoption of the Fourth Amendment would not affect the existing power of the Fund to allocate SDRs on the basis of a finding of a long-term global need.

In September 1997, the Board of Governors approved the proposed Fourth Amendment, which was then submitted to the membership for ratification. The Fourth Amendment will become effective when three fifths of the membership (110 members) having 85 percent of the total voting power have accepted it. By mid-December 2001, 113 members having 72.71 percent of the total voting power have accepted the Fourth Amendment. Acceptance by the United States, which holds 17.13 percent of the voting power, would therefore put the Fourth Amendment into effect.

### B. The Pattern of SDR Holdings

24. **Holders of SDRs comprise members that have elected to be participants in the SDR Department, official institutions that have been designated by the Fund to be prescribed holders, and the Fund itself.** The SDR holdings of these three groups reflect their different roles in the SDR system: participants hold or use SDRs as part of their international reserves and in transactions with the Fund or (less often) with participants or other holders; prescribed holders cannot receive SDR allocations but may acquire and use SDRs in transactions by agreement and in operations with participants and other holders; and the Fund cannot receive allocations but acquires SDRs from members making payments to the Fund, using the resulting holdings of SDRs in the General Resources Account in purchases and to make operational payments. About 90 percent of the stock of SDRs is held by participants.

25. **The pattern of SDR holdings among participants has been quite stable since the mid-1980s.** The bulk of SDRs is held by the major industrial countries, with 43 percent held by the United States alone (Figure 2). This distribution reflects the fact that SDRs are allocated initially on the basis of quotas, the tendency for developing countries to use their SDRs and not to replenish them over time, and the observed preference of some industrial countries to maintain SDR holdings well in excess of their cumulative allocations (Table 2).

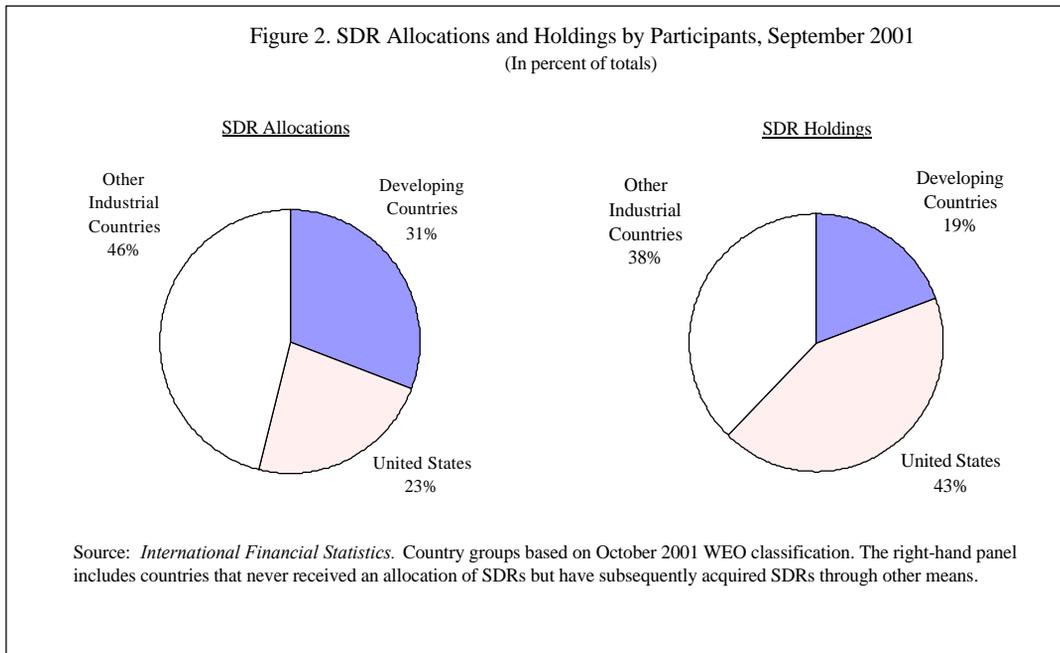


Table 2. Ratio of SDR Holdings to Allocations  
(End of period)

	1975	1985	1995	September 2001
	(In percent)			
Industrial countries	106	101	102	110
Major advanced economies	100	107	107	113
Canada	132	25	102	60
France	50	76	60	33
Germany	267	116	111	113
Italy	26	42	0	33
Japan	118	216	204	211
United Kingdom	69	54	15	15
United States	87	136	152	171
Developing countries	60	48	70	53

Source: *International Financial Statistics*. Country groups based on October 2001 WEO classification.

26. **All members are currently participants in the SDR Department.** Nevertheless, not all members have received an allocation of SDRs, notably those that joined the Fund after the last allocation in 1981. For these members, SDRs have been acquired, if at all, through Fund purchases or in transactions by agreement with other participants or prescribed holders.

#### IV. LONG-TERM GLOBAL NEED—REVIEW OF EVIDENCE

##### A. Projected Reserve Demand

27. **International reserves are used primarily to finance external imbalances directly or indirectly through intervention in foreign exchange markets.** The level of reserves would therefore be expected to bear a fairly close relationship to those factors that affect the magnitude of these imbalances. Most studies of reserve-holding behavior indicate that such holdings are positively associated with a scale variable (either aggregate output or imports) and to external payments variability.<sup>14</sup> There is less compelling evidence that reserves depend on the nature of a country's exchange rate regime, the degree of openness, and the opportunity cost of holding reserves.

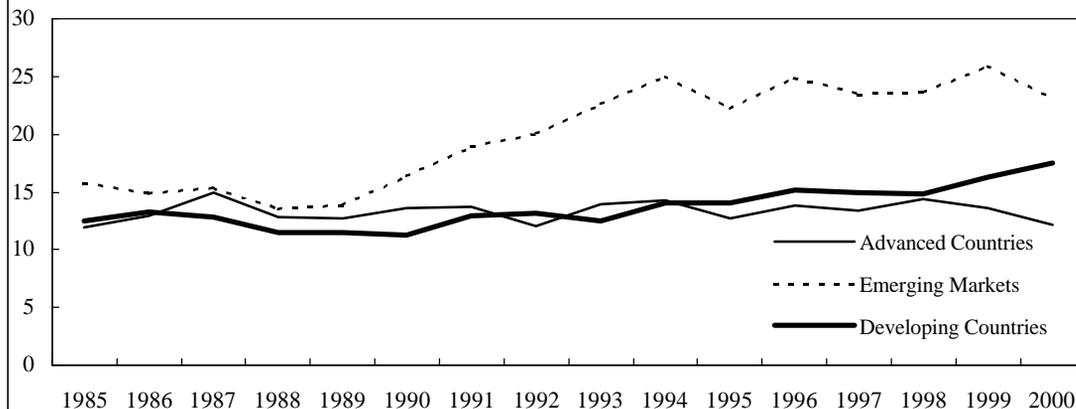
28. **The traditional indicator of reserve adequacy therefore remains relevant.** Figure 3 shows the ratio of reserves to imports of goods and services, measured as weeks of imports, for three major country groupings: advanced countries, emerging market economies, and developing countries. For the advanced countries, this ratio has fluctuated somewhat, but has not shown any significant net change since 1985. For developing and emerging market countries, there has been some upward trend, particularly evident for emerging markets and, since 1990, for developing countries. Thus, based on past trends, the long-run future demand for reserves would appear to be rising at least in proportion to imports of goods and services.

29. **The demand for reserves can also be linked to the capital account.** While reserve demand has been traditionally viewed as determined by developments in the current account, the recent crises have clearly demonstrated that changes in investors' views on a country's economic prospects can generate major disturbances to the capital account. Adverse economic developments in a country and changes in mature financial markets can lead to a sudden withdrawal of capital, and outflows can also be induced by contagion from other countries. The increasing openness of the capital account has heightened the vulnerability of emerging market economies to fluctuations arising in this component of the balance of payments.

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<sup>14</sup> For a recent survey of the literature, see Andrew Tweedie, "The Demand for International Reserves—A Review of the Literature," Note 2 in *External Review of Quota Formulas—Annex*, EBAP/00/52, Supplement 1, May 1, 2000. For a recent contribution to the literature and survey, see Robert Flood and Nancy Marion, "Holding International Reserves in an Era of High Capital Mobility," paper presented at the Brookings Trade Forum, May 10–11, 2001, revised July 2001.

Figure 3. The Mean Ratio of Nongold Reserves to Imports of Goods and Services, 1985-2000  
(Number of Weeks Import Cover)



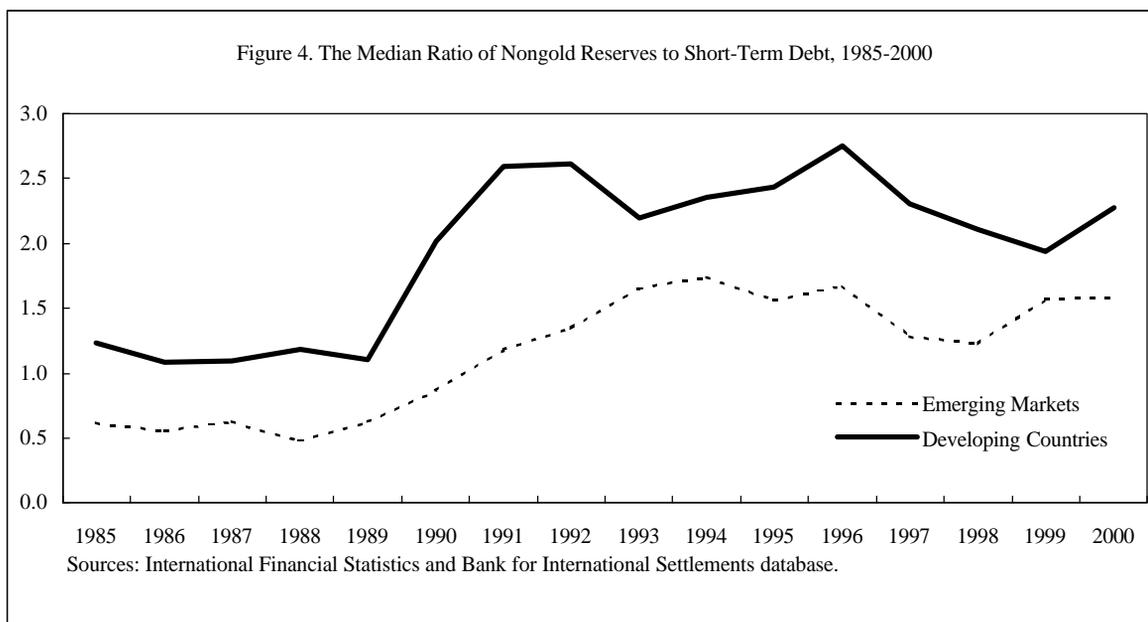
Sources: International Financial Statistics and World Economic Outlook.

30. **Research work in the Fund and elsewhere suggests that the ratio of reserves to short-term debt may be a key indicator of reserve adequacy in countries with substantial but uncertain access to capital markets.**<sup>15</sup> Moreover, this indicator is used in the Early Warning System model developed by Fund staff for emerging market economies.<sup>16</sup> As expressed by the ratio of nongold reserves to short-term debt, this indicator rose sharply in the early 1990s for emerging markets and developing countries but has shown no trend since then (Figure 4). The future evolution of the short-term debt stocks of these countries may be expected to have a bearing on the demand for reserves in addition to the growth in their imports.

<sup>15</sup> See, for instance, Rodrik and Velasco, "Short-term Capital Flows," paper presented at the ABCDE Conference at the World Bank, 1999; *Anticipating Balance of Payments Crises—The Role of Early Warning Systems*, Occasional Paper 186, IMF, 1999; and Furman and Stiglitz, "Economic Crises: Evidence and Insights from East Asia," *Brookings Papers on Economic Activity*, Vol. 2, 1998.

<sup>16</sup> See Borensztein, et al., *Anticipating Balance of Payments Crises—The Role of Early Warning Systems*, Occasional Paper 186, IMF, 1999, and *Approaches to Vulnerability Assessment for Emerging Markets*, SM/01/301 (10/3/01).

Figure 4. The Median Ratio of Nongold Reserves to Short-Term Debt, 1985-2000



31. **Other capital account indicators could also be considered.** One approach would be to combine elements of both the current and capital accounts in order to capture a broader sense of the variability of external transactions. One such measure was considered recently in the context of ongoing work in the Fund on alternative quota formulas: the variability of the sum of current receipts and net capital flows (standard deviation of a three-year moving average calculated using annual data for 1987–1999).<sup>17</sup> This is a measure of the fluctuation in external transactions over a period of time, and may contain relevant information regarding a country’s balance of payments financing needs, whether in the form of access to Fund resources or owned reserves. To be useful for assessing changes in the demand for reserves over time, a long time series for this variable would be needed, similar to that for imports of goods and services. However, lack of suitable data precludes this. Nonetheless, this measure of variability can be computed for the two halves of the sample period 1987–1999. This shows that between 1987–1992 and 1993–1999, variability increased by 25, 75, and 225 percent for developing, advanced, and emerging market countries, respectively. This finding is consistent with the very large increase in reserve holdings of emerging market countries during the 1990s.

32. **Projections in the October 2001 WEO of the increase in imports and external debt through 2005 suggest that the demand for reserves will grow over this period.** Estimates of the variability of external transactions would help to assess likely developments in the growth of reserve demand over the next basic period. Such estimates are difficult to arrive at, however, but it seems plausible to assume that this variability is related to the scale of international transactions. Table 3 shows worldwide holdings of nongold reserves from 1970

<sup>17</sup> See *Alternative Quota Formulas—Considerations*, SM/01/293 (9/27/01). Capital flows relate to cross-border transactions in all financial assets and liabilities except reserve assets, Fund credit, and exceptional financing.

as well as projections based on expected growth in imports of goods and services, short-term external debt, and total external debt from 2000 to 2005 (reserve elasticity is assumed to be 1). Based on growth in imports, total world reserve demand could expand by over half a trillion SDRs over this period, which would be comparable to the actual increase between 1995 and 2000. Most of this increase would be accounted for by advanced and emerging market economies, with only a small increase estimated for developing countries.<sup>18</sup> However, based only on projected growth in short-term debt, or total external debt, reserves could be expected to expand by smaller amounts for emerging market economies and developing countries. Projections are not available for the variability of the sum of current receipts and net capital flows, but it is likely that with further global financial integration, this measure would also show a sizable increase in the need for reserves.

**33. Other developments could act to reduce the demand for reserves—notably the trend toward greater exchange rate flexibility.** To the extent that countries respond to external imbalances by allowing the price, rather than the quantity, of foreign exchange to adjust, the need for reserves to intervene in the foreign exchange market would be expected to diminish. This expectation appears to conflict, however, with the increase in reserves for most countries, including floaters and countries that have moved to a more flexible exchange rate regime. Even if a country only lightly manages its exchange rate, with a relatively closed capital account it would still want to hold reserves and probably increase them over time in order to help smooth output fluctuations arising, for example, from large movements in the terms of trade. Some empirical studies have found that the move to greater exchange rate flexibility following the collapse of the Bretton Woods system did appear to reduce the demand for reserves for both developed and developing countries.<sup>19</sup> However, while Mussa and others show that the number of countries with de jure flexible exchange rates has increased over the past twenty years, Calvo and Reinhart argue that de facto flexibility has increased to a far lesser extent.<sup>20</sup>

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<sup>18</sup> In this exercise whereby reserves are projected to grow at the same rate as imports of goods and services, China accounts for about 40 percent of the projected increase in reserves of emerging market countries between 2000 and 2005. This reflects China's large initial reserves, rapid projected output growth, and substantial trade deepening (partly as a result of WTO accession).

<sup>19</sup> See, for example, Lizondo, J.S. and D.J. Mathieson, 1987, "The Stability of the Demand for International Reserves," *Journal of International Money and Finance*, Vol. 6, pp. 251–282; and Bahmani-Oskooee, M. and M. Malixi, 1987, "Effects of Exchange Rate Flexibility on the Demand for International Reserves," *Economic Letters*, Vol. 23, pp. 89–93.

<sup>20</sup> Mussa, Michael, Paul Masson, Alexander Swoboda, Esteban Jadresic, Paolo Mauro, and Andrew Berg, *Exchange Rate Regimes in an Increasingly Integrated World Economy*, Occasional Paper 193, IMF, 2000; and Calvo, Guillermo and Carmen Reinhart, "Fear of Floating," NBER Working Paper 7993, 2000 and forthcoming in *Quarterly Journal of Economics*.

Table 3. Worldwide Nongold Reserves, 1970-2005 1/  
(In billions of SDRs)

	1970	1975	1980	1985	1990	1995	2000	2005 Projection Based On		
								Short-term External Debt	Total External Debt	Imports
Advanced Economies	41.9	89.1	196.4	247.6	466.7	599.3	860.4	...	...	1,111.0
of which: 2/										
Canada	3.9	3.8	2.4	2.3	12.5	10.1	24.5	...	...	35.3
China, Hong Kong SAR	...	...	...	...	17.3	37.3	82.5	...	...	111.2
Japan	4.3	10.2	19.3	24.3	55.2	123.3	272.4	...	...	332.0
Korea	0.6	0.7	2.3	2.6	10.4	22.0	73.8	...	...	96.3
Emerging Markets	8.8	42.3	70.9	93.8	100.3	278.2	470.0	639.6	575.2	741.3
of which: 2/										
China	...	...	2.0	11.6	20.8	50.7	129.2	271.8	197.1	247.2
India	0.8	0.9	5.4	5.8	1.1	12.1	29.1	29.1	34.0	45.7
Mexico	0.6	1.2	2.3	4.5	6.9	11.3	27.3	32.8	34.5	44.4
Poland	...	...	0.1	0.8	3.2	9.9	20.4	28.8	23.3	30.7
Developing Countries 3/	3.7	9.4	25.5	25.5	19.2	31.1	68.5	72.2	78.8	92.9
of which: 2/										
Algeria	0.1	1.0	3.0	2.6	0.5	1.3	9.2	8.1	4.8	12.5
Kuwait	0.1	1.3	3.1	5.0	1.4	2.4	5.4	6.2	5.5	7.0
Libya	1.5	1.8	10.3	5.4	4.1	4.1	9.6	9.1	9.4	12.1
United Arab Emirates	...	0.8	1.6	2.9	3.2	5.0	10.4	15.2	16.0	14.0
Total	54.3	140.8	292.8	366.9	586.1	908.7	1,398.9	...	...	1,945.1

Source: International Financial Statistics and World Economic Outlook. Projections for short-term debt and total external debt not available for advanced economies.

1/ The increase in worldwide reserves between 1970 and 1995 is slightly overestimated because data for a few economies become available only in the latter part of the period. The eighth basic period covers 2002-2006. The projection to 2006 would be broadly similar to those presented in the table.

2/ Economies with the largest increase in reserves (in billions of SDRs) between 1995 and 2000.

3/ Excluding economies that are included as emerging markets.

**34. Forces working to reduce the demand for reserves associated with the shift away from pegged or heavily managed exchange rate arrangements appear to have been largely offset by the potential size of capital account disturbances.** Such disturbances have greatly increased in magnitude, especially for emerging market economies, which has put a premium on having a suitably large stock of international reserves to reduce countries' vulnerability to such disturbances. Indeed, the Fund has been urging members to give greater prominence to holding adequate stocks of reserves to reduce external vulnerability.<sup>21</sup>

<sup>21</sup> See *Debt- and Reserve- Related Indicators of External Vulnerability*, SM/00/65 (3/23/00) and *Approaches to Vulnerability Assessment for Emerging Markets*, SM/01/301 (10/3/01).

Moreover, even with a pure float, in countries where the banking system is exposed to foreign currency risk, the central bank may wish to hold large reserves in order to be able to stem a run on domestic currency deposits.

35. **While countries can hold larger reserve stocks to deal more effectively with external disturbances, they can also adopt other policies that will reduce their exposure to disturbances.** Monetary and fiscal policies that are conducive to stable macroeconomic conditions and avoid the buildup of significant domestic imbalances can limit the extent to which reserves will be needed to finance external financing gaps. This includes the avoidance of asset price booms that lead to large capital inflows followed by the sudden withdrawal of capital that can be highly damaging to the economy. In addition, improvements in the safety and soundness of domestic financial institutions can reduce the vulnerability of countries to major financial disruptions and likely need for reserves. While better macroeconomic management can lead to significant improvements in a country's payments position in the short- to medium-term, and if maintained, can result in lower reserve needs over the longer run, any benefits from better structural policies in terms of lower reserve needs are likely to occur over an even longer time horizon. Nonetheless, as first emerging market economies—and then developing countries—approach the depth and breadth of the financial institutions in mature economies and a similar degree of macroeconomic stability, then their reserve needs would presumably decline to the levels relative to imports shown for advanced countries in Figure 3.

## **B. Considerations Relating to Use of SDRs to Supplement Other Reserve Assets**

36. This section discusses a number of considerations that are relevant for assessing whether an allocation of SDRs should be used to supplement the expansion of other reserve assets to satisfy the likely sizable growth in demand for reserves over the next five years.

37. **The key considerations stem from the objective of avoiding “economic stagnation and deflation as well as excess demand and inflation in the world”** (Article XVIII, Section 1(a)). An assessment of whether an SDR allocation to supplement other reserve assets in a manner consistent with achieving these objectives involves considering the economic consequences of alternative means that countries can employ to satisfy the likely growth in reserve demands described above. This section considers two main facets of this issue, namely, whether reserves can be provided at lower net cost through SDR allocations, and whether meeting reserve needs in the unconditional form of SDRs is preferable to supplying resources to Fund members through the Fund facilities in the form of conditional credits. Section C that follows examines the current and prospective state of the world economy and asks whether an SDR allocation would be warranted in terms of its macroeconomic implications.

38. **Abstracting from an SDR allocation, a country can increase its reserve holdings by intervening to dampen exchange rate appreciation arising from a net capital inflow from abroad or a current account surplus.** The former channel is a means of obtaining reserves through inward foreign investment or by private and official borrowing from abroad.

This was the case for many emerging market economies in the mid-1990s, when government authorities borrowed reserves through the explicit issuance of foreign-currency denominated bonds in international capital markets or through loans from banks. Alternatively, reserves can be obtained through a current account surplus achieved by compressing domestic demand relative to production, or by raising production relative to domestic demand. Reserves can also be obtained in this way as a result of a terms-of-trade improvement.

39. **For many advanced countries, increased reserve demand can be met by borrowing at interest rates that are only marginally higher than the return on reserve assets.** Thus, as long as there is little or no credit risk associated with lending to these countries, they could finance any increase in desired reserve holdings by borrowing in international capital markets. Hence they would have no need for an SDR allocation to supplement borrowed reserves, although they may be willing to hold a portion of their reserves in the form of SDRs for the purpose of portfolio diversification.

40. **However, for emerging market borrowers, the spread between the interest rate on their sovereign bonds and the return on reserve assets is much higher and varies considerably over time.** Figure 5 depicts the EMBI sovereign spread (an average across emerging markets) from 1992 to the present. Only twice—most recently in the second half of 1997 before the onset of the Asian crisis—did this spread dip below 400 basis points; for the ten-year period it has averaged around 800 basis points. Moreover, the cost of private market financing to emerging markets fluctuates sharply in response to both conditions in emerging markets themselves—for example, the Mexican and Russian crises—and developments in mature markets. Thus for most Fund members with access to international capital markets, the cost of acquiring and holding international reserves is substantial and subject to considerable uncertainty.

41. **The majority of Fund members, however, have little or no access to private capital markets and do not have the option of borrowing foreign exchange reserves.**<sup>22</sup> For these countries the primary means of obtaining reserves in the short run is by reducing domestic demand and therefore imports, which imposes a significant cost in terms of foregone consumption and investment.

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<sup>22</sup> Members may also have access to official sources of borrowing and grants, but these resources are typically earmarked for development purposes rather than held as reserves.



42. **By contrast, it has been argued that meeting the demand for reserves by means of SDR allocations can be done with essentially zero real resource costs.**<sup>23</sup> As noted above, recipients of SDR allocations pay the SDR rate of interest (plus a very small assessment to cover the costs of administering the SDR Department) on their cumulative allocations, and receive the same rate of interest on their total SDR holdings. For countries that hold their entire cumulative allocation, the net carrying cost of these reserves is effectively zero, and their holdings of SDRs have no effect on other countries. A country may wish to exchange SDRs for other reserve assets, but the expected yield over time (including expected exchange rate changes) would tend to be the same on the SDR as on other reserve assets, given the composition of the SDR interest rate basket. If a country were to make net use of an SDR allocation and draw down its reserves, it would pay the SDR interest rate. As this is a market-determined short-term rate, the net user of SDRs compensates the holder of the additional SDRs at the SDR interest rate for the real resources acquired in the drawdown of reserves.

43. **In theory, however, the true cost of SDR allocations may not be zero.** This would be the case in particular if the substitution of SDR allocations for private market borrowing resulted in a shift in credit risk to SDR participants:

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<sup>23</sup> See Mussa, "Is There A Case for Allocation Under the Present Articles," in M. Mussa, J. Boughton, and P. Isard, eds., *The Future of the SDR in Light of Changes in the International Financial System*, International Monetary Fund, 1996, for a forceful articulation of this argument for an SDR allocation.

- **The interest rate spread on market borrowing is generally regarded as the premium that private lenders require as compensation for the risk that borrowers will not fully comply with the terms of the loan contract.** In particular, the higher the interest rate charged on a new loan or bond issuance, or observed on the secondary market for sovereign bonds, the higher the perceived risk of default. A high interest rate can be seen as reflecting a judgment that the economic outlook for the country is poor and that the country's policies are not likely to correct the underlying payments problem.
- **If the risk of default remains unchanged, providing reserves in the form of SDRs must involve a reallocation of the risk of partial repayment or default.** On the one hand, if net users of SDRs meet their SDR obligations without exception, SDR participants would face no credit risk. However, private lenders to users of SDRs would now face higher credit risks, reflecting the perception of seniority accorded to SDR obligations, which would be reflected in higher spreads faced by market borrowers. In this case there may be no net cost saving to the users of SDRs, as what they gain from low-cost SDRs would be matched by higher spreads. On the other hand, if there is a risk that some Fund members default on their SDR obligations (a risk that could only materialize in the remote event of cancellation of SDRs or liquidation of the SDR Department), the risk would be shared between SDR participants and the private sector.<sup>24</sup> In this case, the operation of the SDR system provides a subsidy to members facing expensive terms on private market borrowing, with the cost of this subsidy borne at least in part by SDR participants, as private lenders are compensated with higher spreads.

44. **A number of considerations suggest that the provision of reserves in the form of SDRs may in fact reduce credit risk.** Allocations of SDRs make more external resources available to a country, enabling it to weather potential balance of payments crises without undue reliance on import compression or the imposition of trade and other restrictions. As a country is better off to the extent that it holds more reserves, it might be a better credit risk from the point of view of private credit markets, and its credit spread could decline. However, it is also possible that a large SDR allocation could increase risk if the additional reserves were to enable a country to postpone needed economic adjustment to deal with balance of payments problems.

45. **More generally, reserves supplied by SDR allocations could reduce systemic risk.** This is the case because they are a permanent addition to the world's stock of reserves, except

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<sup>24</sup> There are currently six members in arrears on their SDR charges: Afghanistan, the Democratic Republic of Congo, Iraq, Liberia, Somalia, and Sudan (amounting to SDR 104 million or 0.5 percent of allocations). Such arrears do not give rise to an interest risk for net holders because the Fund is required under Article XX, Section 1 to pay SDR holders the full amount of SDR interest; this is achieved by issuing SDRs to meet any shortfall, which are cancelled as overdue SDR charges are settled.

in exceptional circumstances when an explicit decision is made to cancel outstanding SDRs. By contrast, reserves obtained via borrowing in the capital market may be withdrawn under inauspicious circumstances. Such reserves need to be periodically refinanced, as otherwise existing reserve assets will need to be used to pay down maturing debts. Doubts on the part of foreign creditors about the desirability of refinancing are likely to arise when a country is facing balance of payments difficulties and in need of more, not less reserves. In a general crisis situation, several countries would simultaneously face rapidly rising costs of refinancing, which would exacerbate their reserve positions, and lead to possibly self-fulfilling runs on their currencies. Borrowed reserves thus suffer from being less reliable and predictable sources of reserves than SDRs, and their cost increases in times of crises, whereas the SDR interest rate is largely unaffected, and may even decline. From this perspective, therefore, borrowed reserves entail more risk for the international monetary system than owned reserves.

46. **However, the conclusion that an SDR allocation could reduce systemic risk depends in part on whether the private market assessment of the risk of lending to sovereign borrowers is appropriate.** Under most circumstances, there seems little reason to doubt that private market assessments would be appropriate, as private lenders have every reason to use all available information to take an unbiased view regarding a country's repayment prospects. On the other hand, there are situations where this is not the case—in particular, where contagion is present. When investors tar many emerging market borrowers with the same brush of a negative outlook when only one has specific payments difficulties, the terms and conditions for private market borrowing may fluctuate sharply and not be reflective of the underlying payments situation of other emerging market countries. Indeed, in the Asian and Russian crises market sentiment may have overreacted to negative news in individual countries, adversely affecting the ability of other countries to refinance their debt.<sup>25</sup> As long as there is a risk of contagion, allocations of SDRs could reduce the risk faced by countries subject to the vagaries of the private capital market. However, recent developments suggest that markets are becoming more discriminating in their assessment of country risk, and the difficulties in Argentina and Turkey have not resulted in widespread contagion. In these circumstances, the merits of an SDR allocation depend in part on whether the high cost of borrowing reserves facing some members reflects a market failure requiring a response in the form of a general increase in unconditional liquidity or reflects an appropriate market assessment of the risk of sovereign lending, which could best be addressed through country-specific measures.

47. **Providing part of the growth in the demand for reserves through the channel of SDRs can be seen as “multilateralization” of credit risk.** This is the case to the extent that all SDR participants end up bearing the risk that net users will not honor their SDR obligations. Given the nature of SDR obligations, there is only a remote risk of default

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<sup>25</sup> Recognizing that members are subject to contagion, the Fund designed the CCL in an attempt to help insulate countries following appropriate policies from changes in market sentiment.

(see paragraph 43). In bearing this risk, SDR participants provide an international public good in the form of a more stable and reliable availability of reserves to Fund members. This benefits net users of SDRs directly as well as net holders, who gain from a better functioning of the international monetary system.

48. **This brings up the more general issue of the mix between using unconditional rather than conditional credit to meet the reserve needs of individual countries.** The benefits of unconditional reserve assets in the form of SDRs have been described above in terms of reducing the costs incurred by countries subject to balance of payments disturbances. However, as noted above, this benefit comes at some increased risk borne by all SDR participants. As conditionality reduces the risk to creditors, it is perhaps not surprising that in the past two decades, the Fund has agreed to quota increases, which determine the availability of conditional financing, but has not agreed on further SDR allocations.

49. **The provision of credit to members via the Fund's facilities has the advantage that balance of payments financing can be targeted to those countries in greatest need.** The amount and duration of Fund credit can be tailored to the specific needs of individual members. In this way the resources available to the Fund can be channeled efficiently to where they are needed. By contrast, SDRs are allocated to members in proportion to quotas and there is no clear relationship between the need for reserves and the amount of SDRs received in allocation.

50. **The conditionality associated with the use of Fund resources beyond the first credit tranche also has efficiency advantages.** There are some payments disturbances that are transitory, reversible, and require little, if any adjustment, for which owned and unconditional reserves are eminently suited. However, the financing needs of the former Soviet Union and the crises of the last two decades have clearly shown that significant macroeconomic and structural adjustments are typically called for. It is appropriate that Fund financing in such cases be in the form of conditional resources so as to best address the underlying problems in the domestic economy that give rise to the balance of payments difficulties. Moreover, the cost to members of financing through Fund facilities is below (and in many cases substantially below) the cost of private market financing. To help ensure repayment of Fund resources at below-market rates, Fund conditionality is appropriate.

51. **Finally, concerns have been expressed in the past about the potential for undesired resource transfers facilitated by the SDR system.** This can occur when a country does not use the SDRs it receives in allocation to raise its long-term desired reserve holdings, but rather draws them down, or the equivalent amount of other reserve assets, and uses them to acquire real resources on a permanent basis from other Fund members. The low cost of using SDRs relative to perceived consumption and investment needs provides an incentive to spend them. Whether the net use of SDRs gives rise to undesired resource transfers depends in part on whether countries holding SDRs above their allocations receive sufficient compensation for doing so. As noted above, the SDR interest rate is now comparable to that on other reserve assets. At the same time, it may not be sufficiently high to compensate net holders for the risk (albeit remote) of nonrepayment.

### C. Macroeconomic and Financial Conditions and an Allocation of SDRs

52. **The possible global need for reserve supplementation in the form of SDRs depends on the likely demand for reserves over the medium term and the extent to which that need can be satisfied through borrowing in private financial markets.** If there were expected to be substantial reserve demand on the part of a significant fraction of Fund members, and if there were severe continuing constraints on the ability of many members to obtain reserves by borrowing in world capital markets, there would be a prima facie case for an allocation of SDRs. However, a judgment would still have to be reached as to whether these liquidity needs could be better satisfied either by means of unconditional resources in the form of SDRs or through conditional resources via Fund facilities.

53. **The need for balance of payments financing, and therefore reserves, has clearly been intensified by a weak global economy, with a synchronized downturn across all major regions that has been exacerbated by the aftermath of the September 11 events.** Developments in the advanced economies were characterized by a further drop in financial valuations, widespread declines in industrial production, and an appreciable weakening of business and consumer confidence. Developing and emerging market economies were already experiencing slackening external demand, low commodity prices, and worsening conditions in international financial markets. The attacks and their aftermath will clearly reduce the level of activity not only in the United States but also elsewhere. The extent and duration of this reduction will depend importantly on developments in consumer and business confidence, which are difficult to assess. Nonetheless, the downside risks to world economic and financial conditions have clearly intensified.

54. **All countries with the possible exception of the major advanced economies are likely to face more acute challenges in terms of balance of payments financing and adjustment.** Emerging market economies are exposed to shocks to both current and capital accounts, with the availability of private financial flows a key vulnerability. Developing economies are now more exposed to current account shocks emanating from weaker commodity prices and reduced demand for their exports of goods and services. As the deterioration in the world economy is widespread, it is important that aggregation effects be borne in mind in considering the appropriate mix of financing and adjustment. In circumstances of overall weaker global demand, it becomes more difficult for individual countries to adjust their external financing needs by contracting domestic demand or depreciating the value of their currencies. The aggregate effect of such policies is likely to be detrimental to the world economy, as there is a risk that they will become mutually reinforcing in a downward direction.

55. **In the face of a significantly worse outlook for 2002 than foreseen in the October 2001 *World Economic Outlook*, the prospects for external financing to emerging market economies are critical.** In the first half of 2001 this financing held up at levels similar to those of 1995–96 (prior to the boom-bust episode of the Asian crisis and later emerging market crises), but has sharply deteriorated since then. Net financing flows to emerging

markets for 2001 as a whole could turn out to be negative for the first time in a decade. Contributing factors include the slowdown in the world economy, uncertainties related to the situation in countries such as Argentina, and the events of September 11, 2001, which markedly reduced investors' appetite for risky assets. Indeed, the primary market for new issues by emerging markets has been largely closed since the terrorist attacks. The near-term outlook is highly uncertain and subject to risks resulting from the possibility of a sharper-than-expected slowing in the world economy, the potential for further corrections in mature equity markets, and further contagion across emerging markets from concerns in particular countries. It cannot be ruled out that certain countries or groups of countries will have little access to financing on the global capital markets for extended periods.

56. **The case for an SDR allocation must take into account the longer-term prospects for the global economy.** Current and prospective balance of payments difficulties and external financing constraints facing many countries are systemic in nature, rather than entirely country-specific. While these conditions support the case for an SDR allocation, it is necessary to look at the outlook over the entire five years of the eighth basic period. The most recent WEO projections beyond 2002 involve a relatively benign scenario in which growth in the world economy is expected to pick up in 2003 and subsequent years, with inflation remaining subdued. In this environment, balance of payments difficulties and their financing would likely be much less acute than is currently the case. Underlying this recovery is the assumption that the improved economic fundamentals in many countries—namely, lower inflation, stronger fiscal positions, greater monetary policy credibility, and in many emerging markets, more flexible exchange rate regimes—will be sustained. In addition, there is now a sizable amount of policy stimulus in the pipeline in most major economies, even more than had been anticipated before the attacks. Finally, these attacks should not substantially affect underlying productivity growth in the United States or elsewhere.

57. **There are downside risks to this medium-term projection, which would strengthen the case for an SDR allocation if they were to materialize.** However, the world economy has demonstrated considerable resilience to shocks over the last three decades, and it is likely to do so again on the basis of the considerations described above. Thus while the short-term outlook can be viewed as suggestive of the need for an SDR allocation, the longer-term outlook over the five years of the eighth basic period does not at this stage provide strong evidence of a need to supplement global liquidity.

58. **Even if there were considerable evidence that there was likely to be widespread need for balance of payments financing, there would remain the issue of whether such financing should be made available on conditional or unconditional terms.** As noted in the discussion above, while an SDR allocation can reduce the risk of inadequate external financing for many countries and the risk facing the international monetary system, it is less efficient in targeting the financing needs and dealing with the adjustment difficulties of individual countries.

59. **One perennial concern regarding an SDR allocation is the possible adverse consequences for inflation.** If many countries were to use the additional reserve assets to finance larger payments deficits, this would add to the demand for resources in the world economy, putting upward pressure on inflation that would depend on the state of the world economy and the magnitude of the shift in demand. As has been pointed out in previous papers on the allocation of SDRs, there are good reasons to believe that a moderate allocation of SDRs is unlikely to be a problem because the magnitude of any demand increase would be small relative to the size of the world economy.<sup>26</sup> Moreover, over the next five years, excess demand conditions are not expected to prevail in the world economy.

## V. ISSUES FOR DISCUSSION

60. This paper considers factors relevant to the assessment of whether there is a long-term global need to supplement existing reserve assets via a general allocation of SDRs in the period 2002–2006. It does not make a specific proposal. Executive Board views on this matter will provide the basis for the Managing Director’s report to the Board of Governors, to be issued before the end of the year. In framing their judgments, Executive Directors may wish, *inter alia*, to touch on the following issues:

- Is the current slowdown in the world economy projected by WEO relevant to a finding of long-term global need? If not, under what circumstances and in what manner would growth in the world economy be relevant?
- Does the high cost of borrowing reserves facing many members reflect a sustained market failure suggesting a response in the form of a general increase in unconditional liquidity, or does it reflect an appropriate market assessment of the risk of sovereign lending, which should be addressed through country-specific measures, including conditional lending where warranted?
- Should the sizable projected increase in the demand for reserves during 2002–2006 be met through an SDR allocation or through some combination of external adjustment and borrowing?

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<sup>26</sup> This is similar to the case in the domestic economy, where monetary expansion on a moderate scale is unlikely to be inflationary when money demand is also expanding.