Activation of the Special Drawing Rights Facility in the IMF

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The issuance and regulation of national currencies is one of a few truly sovereign functions, one which had never had its counterpart in the deliberate multilateral control of international money. For the most part, the supply of international reserve assets of the kinds that existed before this year—the stock of gold, reserve currencies, and reserve positions in the International Monetary Fund (IMF)—has been governed primarily either by the vagaries of gold production and its flow into or out of monetary use or by such fortuitous factors as the deficits of reserve currency countries and the readiness or reluctance of monetary authorities to hold reserve currencies, principally the United States dollar and the pound sterling. For this reason alone, the first allocation of special drawing rights (SDR's), on January 1, 1970, is an event of great importance. The mechanism for the creation and use of SDR's, as it has been elaborated in an amendment to the Articles of Agreement of the IMF, is luxuriant in its detail. Stripped of its complexities, the mechanism provides a means by which existing international reserve assets may be supplemented periodically, through a process of international decision, at rates reasonably related to the world's need for reserves.

Although the first issue of SDR's represents, in a sense, an abrupt break with the past, the mechanism itself has been drafted as an evolutionary development in the international monetary system, and has emerged only after years of exhaustive study and determined negotiation. The potential need for some supplement to international reserves had long been recognized. However, in the search for a solution to the problem of a potential reserve shortage, there was a clear divergence of views on such questions as to how reserve needs should be measured, what form additional liquidity should take, and how it should be distributed initially and used in the settlement of international payments imbalances. Thus, there was a clear division of opinion as to whether any reserve supplement should take the form of increased credit facilities or should consist of an expansion of "owned" reserve assets.[1] As the discussions moved ahead, the conviction grew that it would be necessary to invent a new reserve asset, rather than provide additional liquidity by an expansion of Fund quotas or through other credit facilities. Yet, there remained for a time a difference of opinion as to whether the new reserve asset—usually designated a reserve unit—should be created by the IMF and distributed to all Fund members or should be issued through a new institutional setup more restricted in membership than the Fund and distributed only to a limited group of countries.

These were not the only clashes of doctrine or opinion that developed over the years. During 1966, however, as inquiry gave way to negotiation, the principles and many of the characteristics of a possible agreement began to emerge, and by August 1967 the Group of Ten countries had hammered out a brief outline which set forth in broad terms many of the essential features of the SDR facility. The outline was unanimously approved by the Board of Governors of the Fund at its annual meeting at Rio de Janeiro in September 1967, and over the next six months or so the outline was transformed into a legal instrument in the form of a proposed amendment to the Articles of Agreement. The amendment, in turn, was approved by the

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[1] For a survey of the various schemes that were considered in the early exploratory studies, see Group of Ten, *Report of the Study Group on the Creation of Reserve Assets*, May 1965.

Board of Governors of the Fund in May 1968, and then submitted to member governments for ratification. The amendment entered into force on July 28, 1969, following its acceptance by three fifths of the Fund's members representing four fifths of the total voting power. By August 6, 1969 the required majority of Fund members had become participants in the SDR system, so that it became legally possible for the group of participating members to decide to activate machinery by allocating SDR's to all participants.

ACTIVATION AND ALLOCATION

The amount of SDR's allocated at any time is intended to meet a long-term global need for liquidity, and not the requirements of one or more individual participants for additional reserves to enable them to avoid measures that may be needed to correct payments deficits. Accordingly, the amendment provides that decisions to allocate SDR's will be made for "basic periods"—normally five years in duration—and that any allocation of SDR's will be distributed at a uniform rate, on the basis of IMF quotas, to all members of the Fund participating in the SDR system. However, since there is no generally accepted mechanical test by which to gauge additional liquidity needs, the amendment makes no attempt to fix an elaborate or detailed list of criteria for decisions on the amount of SDR's to be allocated. Instead, the formulation in the amendment clearly recognizes that judgments must be made whether there is too much, enough, or too little liquidity in the international monetary system. More importantly, the amendment is designed to ensure that there is broad support among both surplus and deficit countries for any proposal to create SDR's.

In the process of reaching a decision on the timing and creation of SDR's, the Managing Director of the Fund plays a central role. Any decision to create and allocate SDR's must be made on the basis of a formal proposal by the Managing Director. Before he can make a proposal, he must conduct consultations among participating members to ensure that there is, in fact, widespread support for the proposal. To become effective the proposal must be concurred in by the Executive Directors of the Fund and must then be approved by a majority of the participating countries with 85 percent of the weighted voting power of the Fund.

The 85 percent requirement ensures that the need for SDR's, in the amounts proposed, is generally recognized. Clearly, the workability of the mechanism itself would be impaired if a proposal to create SDR's resulted in dissension, or led to a collision of interests, between participants in balance-of-payments surplus and those in deficit. Of course, the very process of consultation, both within and outside the Fund, tends to reduce the importance of the voting procedure by which a proposal is formally approved. As early as July 1969—even before the amendment actually entered into force—the Group of Ten countries had agreed to support a decision to allocate $9.5 billion in SDR's over a period of three years. Involved and comprehensive consultations in the Fund toward the same end were proceeding during the summer as well. In September the Managing Director, with the concurrence of the Fund's Executive Directors, made a proposal to begin allocations on January 1, 1970 with the creation of $3.5 billion for the first year and $3 billion at the beginning of each of the two following years. On October 4 the Governors of the Fund members that had become participants in the SDR mechanism adopted this proposal by a vote far in excess of the required 85 percent of weighted votes.[2]

With the establishment and activation of the new facility, the Fund now conducts its operations through two separate accounts. All the traditional operations and transactions of the Fund, including drawings and repurchases by members, are carried on through what is now known as the "general account". Transactions and operations involving SDR's are conducted primarily through the "special drawing account". The clear distinction between the two accounts does not mean that they are rigidly separated. In fact, the Fund itself may accept and use SDR's in connection with certain transactions conducted through the general account. Nevertheless, the two accounts are fundamentally different. In the general account, the Fund holds large resources of gold and currencies, which have been derived primarily from the subscriptions of members to their quotas. Insofar as a member's subscription consists of gold, it involves of course a corresponding loss of reserves to the member, but at the same time the member acquires rights to draw on the resources of the Fund in amounts which, though subject to conditions, are potentially much larger than its gold subscription. In contrast, when a participating member receives an allocation of SDR's, it is not required to deposit an equivalent amount

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[2] Although every participating country has a right to receive SDR's in the initial allocation, no country is obligated to do so. If the Governor of a Fund member has not voted in favor of a proposal to create SDR's, but the proposal has been approved nonetheless by an 85 percent vote, that country may refuse to receive its allocation of SDR's or "opt out" of the decision. The amount of SDR's created in the initial allocation, $3,414 million, was slightly less than the amount proposed, because one country opted out.

of gold or currency for the purpose of any subsequent transactions involving SDR's. Thus the effect of any allocation of SDR's is to increase the international reserves of each recipient without reducing the reserves of any country.

Although SDR's are issued by the Fund, they do not constitute a claim on the Fund to provide currency. If a participant wishes to use its SDR's to obtain foreign currency, it obtains the currency directly or indirectly from another participant and not from any pool of resources contributed to, or deposited in, the Fund. The fact that the Fund is able to issue SDR's without the use of resources as "backing" is one of the most fundamental differences between the two accounts. This does not deprive SDR's of their usability as an asset, however, since any participant, whenever designated by the Fund, is obligated to accept SDR's and provide convertible currencies to other participating members. Indeed, the right to obtain convertible currency in exchange for SDR's and the corresponding obligation of members receiving SDR's to deliver convertible currency on demand is the fundamental proposition on which the entire facility rests.

While no country is obligated by the provisions of the amendment to treat SDR's as reserve assets for all purposes, the overwhelming majority of participants have chosen to include SDR's in their international monetary reserves.[3] The reasons are not hard to find. SDR's are endowed with a variety of characteristics that enable monetary authorities to regard them as assets with complete confidence. First, SDR's are expressed in terms of a fixed amount of gold, equivalent to the gold content of the United States dollar. Thus, countries that receive SDR's, whether by allocation or as a result of subsequent transfers, can be certain that there will not be a reduction in the gold value of their rights and, therefore, that they can accept SDR's in transfers without fear of loss. Second, each participant receives interest on its holdings of SDR's in excess of the amount of SDR's received in allocation. Interest is paid in effect by other participants whose holdings are less than the amount of SDR's allocated to them.[4] Despite these provisions, no country would accept SDR's when in balance-of-payments surplus, unless it enjoyed absolute assurance that it could transfer SDR's to other countries when in deficit. Fundamentally, SDR's derive their essential character as a reserve asset from the fact that they can be used, with complete confidence, for the settlement of payments deficits.

THE FACILITY AND ITS USES

Once held by monetary authorities, SDR's can be transferred by participating countries whenever they have a balance-of-payments or reserve need to do so. SDR's cannot be used to intervene in the foreign exchange markets, but can be used only to acquire currencies convertible in fact, and these currencies can then be employed, alone or in combination with other reserve assets, for the settlement of payments deficits. When a transfer of SDR's takes place, the use by a participant results in a debit to its holdings as recorded in the special drawing account and in an equivalent credit in favor of one or more other countries to which SDR's are transferred. The movement of SDR's from the user to the recipient is accompanied by a counterflow of currency from the one to the other. For the United States, an increase in holdings of SDR's acquired in transfers from other countries may be matched by an increase in dollar liabilities to foreign official institutions. For most other countries, any increase in holdings of SDR's derived from transfers (rather than from allocations) will involve the substitution of one kind of international reserve asset for another. SDR's may flow back and forth, but unlike foreign exchange assets that are created as a by-product of credit operations and extinguished with the repayment of the credit, SDR's represent a permanent addition to the stock of international liquidity.

All participating countries are able to use SDR's unconditionally, but are expected to do this only to meet balance-

[3] In the United States, SDR's are held along with certain other reserve assets by the exchange stabilization fund of the Treasury. Against these SDR's, the stabilization fund may issue special drawing rights certificates to the Federal Reserve System. On the Federal Reserve's balance sheet, these certificates are recorded as an asset and the offsetting liability is a deposit credit in the stabilization fund's account maintained with the Federal Reserve Bank of New York. This process is virtually the same as the monetization of gold through the issue of gold certificates to the Federal Reserve. In January 1970 the stabilization fund monetized $200 million of the $867 million of SDR's distributed to the United States in the first annual allocation.

[4] In addition to the interest on its holdings, each participant pays a charge on the amount of SDR's allocated to it. Under the provisions of the amendment, the rate of interest and the rate of charges must be the same. This rate has been set initially at 1½ percent per annum, although the Fund at its discretion may vary this rate within a range of 1 to 2 percent. As a matter of accounting practice, the amount of interest to be paid to a participant and the amount of charges paid by that participant are offset, and only the balance is paid or collected. The net effect of these provisions is that any participant holding more SDR's than its allocation will receive a net payment, and one holding less than its allocation will make a net payment. Both charges and interest are payable in SDR's.

of payments needs or in the light of developments in their aggregate reserves. In broad terms, this means that SDR's can be used to forestall or reduce a drop in other components of reserves, resulting either from a balance-of-payments deficit or from a desire on the part of other countries to convert balances of the using country's currency into gold, but SDR's cannot properly be used for the sole purpose of changing the composition of the using country's reserves. In either case, a country's use of SDR's cannot be questioned on the grounds that it has failed to pursue appropriate corrective policies, nor can their use be challenged on the grounds that the country has not satisfied the "requirement of need". If a country has failed to observe this requirement and uses SDR's simply to alter the composition of its reserve assets, that abuse can shortly be reversed by the Fund, simply by directing subsequent transfers of SDR's to the offending country.

Among the major issues that developed in the negotiation of the agreement was whether a participant should be able to choose the country to which it transferred drawing rights, or whether participants should be able to agree freely on transfers between them, or whether transfers should be subject to criteria applied by the Fund. Unilateral choice by a participant might have resulted in a forced acceptance of drawing rights by other countries. This difficulty can be avoided through bilaterally negotiated transfers, but a system of transfers solely by agreement might have resulted in a haphazard distribution of drawing rights that would leave no margin for acceptance by transferees at a time when countries needed to use SDR's. In order to avoid this result, the amendments provided for a system of guided transfers by the Fund as well as for transfers by agreement.

The provisions for transfers by agreement give a participant the right to use SDR's to purchase balances of its own currency from the monetary authority of another participant, even if the latter has not been designated by the Fund as a transferee. However, a country can exercise this right only if the receiving country agrees to the transfer and if the currency provided is the currency of the transferor. If both parties agree to the transaction, the guidance of the Fund is not needed. Although any country may exercise the right to transfer SDR's by agreement, this option has special significance for the United States. It is through transactions of this kind that the United States might to some extent direct its use of SDR's to those countries having dollar balances that might otherwise be converted into gold. Of course, the necessity for agreement means that other countries may refuse a transaction of this kind.

Under the system of guidance, a country may be designated to provide currency for SDR's if it has a sufficiently strong balance-of-payments and reserve position. Among those countries designated by the Fund, SDR's are expected to be allocated in order to produce insofar as possible equality in the ratios of their holdings of SDR's in excess of net cumulative allocations to their gross holdings of gold and foreign exchange. In short, the general principles for guidance are intended to promote a balanced and equitable distribution of drawing rights among those countries designated by the Fund.[5] Despite the importance of these provisions, the Fund may designate a country to receive SDR's to ensure certain specific operational objectives of the facility. Thus, if a country used its SDR's simply to get rid of them and to obtain reserve assets that it preferred, that country may be designated by the Fund as a transferee, even though the country does not satisfy the general criteria for designation. This abuse of the facility, if it happens at all, may not occur with frequency. Indeed, the fact that the Fund has the authority to designate participants to accept SDR's as well as other sanctions should by itself obviate the need to exercise that authority.

SAFEGUARDS AND LIMITATIONS

In the negotiations that preceded the establishment of the SDR facility, it was agreed that the new reserve supplement should be endowed with certain characteristics which would enable monetary authorities to accept it as an asset with complete confidence. Because SDR's are a new feature of the international monetary system, a number of safeguards and limitations have been incorporated into the amendment in order to increase confidence in them. Perhaps the most fundamental of these safeguards is provided by the basic "rule of need" itself, which protects participating countries from the risk that a country might use SDR's simply to get rid of them. If a country violates this rule, the Fund may direct subsequent trans-

[5] This system of guidance builds on the experience and practice of the Fund in the selection of currencies for regular transactions through the general account. Among the countries whose currencies are usable for drawings, preference is ordinarily given to those enjoying payments surpluses, those with large reserves, and those where the Fund's holdings of their currencies are not unduly high in relation to quota. In the selection of currencies to be used in meeting repurchase commitments, preference is given to countries with high Fund positions relative to quota and to countries in payments deficit. The net effect of these policies has been that the gold tranche positions of those countries whose currencies are used for drawings and repurchases have, on the whole, moved in the same direction as their reserves and have tended to move toward a uniform ratio to reserves.

fers to that country, and if that practice fails to ensure compliance, the Fund may suspend the participant's right to use SDR's altogether. Even when SDR's are used for appropriate purposes, excessive use is restrained by the "reconstitution requirement", and still another safeguard is provided by the "acceptance limits".

RECONSTITUTION. Perhaps the most controversial of all questions connected with the facility was whether a participant using the facility should be obligated to restore its holdings of the asset and, if so, to what extent. Some feared that, without an obligation of this kind, the asset could be used to finance unduly protracted or permanent balance-of-payments deficits and thereby impose a continuous strain on the real resources of surplus countries. Accordingly, it was argued that SDR's should be regarded as a credit and, when used, should be subject to repayment just as purchases of foreign currencies in drawings from the Fund through the general account must be reversed within three to five years from the date of purchase. It was generally conceded that international monetary reserves by their very nature can be used only to meet temporary balance-of-payments deficits and, in practice, a country's reserve holdings are usually restored following a correction of the difficulty in which they are employed. However, the transformation of a practice of restoration into a repayment obligation was resisted by many countries as inconsistent with the essential character of a reserve asset.

These conflicting views gradually converged on a solution that necessarily involved a compromise. Under the amendment, a participant is entitled to use all of its SDR's, but the average of its daily holdings over any five-year period must be no less than 30 percent of its average daily net cumulative allocations over the same period. Stated in another way, this provision means that a participant can use its drawing rights up to the hilt, but must reconstitute its holdings from time to time, so that its average daily use of SDR's over a five-year period is no more than 70 percent of its cumulative allocation. For example, if a participant used no more than 70 percent of its average cumulative allocation, it would automatically comply with the reconstitution requirement. However, if it should use more than that amount for some part of the five-year period, it would be required to increase its holdings above 30 percent for a period long enough to bring its average use to no more than 70 percent for the entire five-year period. This requirement, which is designed to promote a degree of circumspection in reducing holdings too far, has been described as analogous to a compensating balance requirement or to a repayment provision. Neither analogy is strictly correct, since a participant is not required to retain a permanent minimum balance of the drawing rights allocated to it, nor is it obligated to recapture SDR's, after having used them, in accordance with a strict repayment schedule.

The amendment provides detailed arrangements by which participants are to reconstitute their holdings of SDR's to satisfy the minimum holding requirement. Indeed, the amendments contain not one, but two, sets of reconstitution arrangements. Under certain circumstances, a country with deficient holdings of SDR's may transfer its foreign exchange holdings to another country in exchange for SDR's, if the latter country agrees to the transfer and if the currency provided is that of the transferor. However, as already noted, a system of transfers by agreement might result in a maldistribution of SDR's which would leave no margin for acceptance by transferees at a time when some participants were in difficulties and needed to use their SDR's. Thus, the main mechanism for promoting the performance of reconstitution obligations will be the designation of participants to accept transfers of SDR's from other countries. If for any reason the designation procedure fails to ensure reconstitution, then the participant must obtain the necessary SDR's from the general account of the Fund, by selling at its option gold or convertible currency acceptable to the Fund. If the Fund does not hold enough SDR's, then the participant is obliged to obtain them from other countries specified by the Fund. In any event, countries are expected to maintain a balanced relationship between their holdings of SDR's, on the one hand, and their total holdings of gold, foreign exchange, and reserve positions in the Fund, on the other. If they fail to do so, the process of reconstitution will ordinarily result in the use of gold or other reserve assets which have not already been used in financing payments deficits.

ACCEPTANCE LIMITS. As already noted, countries are able to use SDR's whenever they have a balance-of-payments or reserve need to do so. On the other side of the transaction, countries are obligated, whenever designated by the Fund, to accept SDR's in exchange for convertible currency. Normally, a country will be designated for this purpose only when its balance-of-payments or reserve position warrants designation. Once designated, however, a country must accept drawing rights up to three times its cumulative allocation; that is to say, a participant's obligation to accept drawing rights ceases at the point at which its holdings in excess of its net cumulative allocation reach twice the amount of its allocation.

The acceptance limits are designed to protect parti pants from too onerous an obligation to provide convertible currencies. At the same time, however, the limits appear to be large enough to ensure that, if any participant finds it necessary to use its SDR's, there will always be other countries in a position to accept them without transcending their obligatory acceptance limits. As already noted, the United States has received about $867 million in SDR's in the initial allocation, and the European Economic Community (EEC) countries taken as a group have received approximately $634 million. The potential acceptance commitments resulting from these allocations would be twice these amounts, assuming that the United States and the EEC countries hold and retain all their initial allocations. Thus, the United States could be required to provide about $1.7 billion equivalent in convertible currency to other participants—an amount large enough to accommodate easily a transfer of all EEC holdings. Similarly, the Common Market countries' acceptance undertakings are large enough to absorb a transfer of all United States holdings. Although the system is not expected to work in such a way that these extremes would be reached, the margin between the amounts created and the acceptance commitments should prove ample enough to ensure full coverage for any likely transfers of SDR's.

CONCLUDING OBSERVATIONS

The Fund's policies and practices with respect to regular drawings and repurchases have changed considerably since the Bretton Woods Agreement was negotiated more than twenty-five years ago. And the new facility will undoubtedly become more flexible over time as familiarity with, and confidence in, the new asset grows. Indeed, some of the possibilities for greater flexibility in the operation of the system are already built into the facility. The amendment provides, for example, that the Fund must review the rules for reconstitution at the end of the first and each of the subsequent basic periods. On any one of these occasions the Fund may modify existing rules, or go so far as to abrogate the reconstitution requirement altogether. If the latter action were taken, there would be no obligation to restore holdings of SDR's, even to the limited average level required for the first basic period. And, of course, it would be possible to reduce the holding requirement if it were not eliminated completely. However, in view of the importance attached to the reconstitution provisions, any modification will require a majority of 85 percent of the total voting power. Similarly, the acceptance obligations may be raised from time to time. Even if they are not raised, the acceptance limits should not impair the effective operation of the facility. Indeed, the term "acceptance limit" is somewhat of a misnomer. The limit is simply a country's maximum legal obligation to accept SDR's, but any participant is free to hold SDR's in amounts beyond the obligatory limit, if it chooses to do so.

Even in its present form, the facility clearly constitutes a useful mechanism for supplementing existing reserve assets through a process of deliberate international control. It is equally clear, however, that the control applies only to SDR's and not to other components of international liquidity, except indirectly, in the sense that changes in the amount of other reserve assets may affect subsequent decisions to increase allocations of SDR's. Moreover, the control exercised through the allocations or recall of SDR's is intended only to meet long-run needs. The facility does not allow for short-term, much less day-to-day, management of liquidity, nor does it provide for specific injections of liquidity where it may be most needed at a particular time. For these needs, countries will continue to rely—perhaps to a greater extent than before—on their regular drawing rights in the Fund and on central bank credit facilities.

The first issue of SDR's, however important or historically significant, does not obviate the need for a more balanced pattern of international payments—especially between the United States and Europe—and the activation of the facility comes at a time when there is still little agreement on how the burdens of balance-of-payments adjustment should be distributed between surplus and deficit countries. However, the SDR mechanism does provide an environment in which measures to reduce payments deficits may become more effective. In recent years it has become increasingly evident that few countries are prepared to see their national reserves decline by significant amounts, and most countries wish to raise their level of reserves by amounts which, in the aggregate, are substantial and exceed the assets available under the present system of reserve formation. Consequently, fears of a decline in national reserves have induced surplus countries to follow policies which have tended to frustrate the attempts of other countries to reduce or eliminate their payments deficits. In short, the allocation of SDR's provides a means to reconcile the reserve needs and objectives of both surplus and deficit countries. More importantly, the accrual of reserves through the acquisition of SDR's may reduce efforts to add to reserves through surpluses on account of other balance-of-payments transactions. It is through these alterations of incentives that the allocation of SDR's may exert a beneficial influence on the adjustment process.

The negotiation, ratification, and activation of the SDR facility is a major achievement in the history of international financial cooperation. That the agreement was reached in spite of divergent national interests indicates that national interests can be and have been submerged in the joint interest that monetary authorities in all countries share in the effective performance of the international economy and in the further growth of trade and payments. Indeed, the relative ease with which the amendment was approved by national legislatures suggests that this joint interest is generally recognized in a wider circle as well.