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Evolution of the SDR: Paper Gold or Paper Tiger?

When the IMF amended its Articles of Agreement to create the SDR in 1969, the oddly named newborn soon acquired a more descriptive, though rather pretentious and not very accurate, moniker: "paper gold." The SDR thus quickly came to epitomize both modernity and a traditional solidity and stability. When the Fund again amended the Articles nine years later, it decreed that the SDR was to become the "principal reserve asset in the international monetary system." That description turned out to be equally pretentious and no more accurate, as the SDR played a small and even diminishing role throughout the 1980s and seemed more like a paper tiger. In another twist of phrase, the Dean of the Executive Board, Alexandre Kafka (Brazil), lamented in 1989 that the Fund's "basket currency" had become a "basket case."[1] What had gone wrong?

Background

To understand the strengths and weaknesses of the SDR, one must first tackle the complex question of what the SDR is.[2] That question has four dimensions, corresponding to the four classic properties of money: its service as a unit of account, a medium of exchange, a store of value, and a standard of value.

As a unit of account, the SDR began life as the equivalent of the gold content of the U.S. dollar. The SDR and the dollar were initially equal in value, but when the dollar was devalued against gold and against other major currencies, the SDR retained its nominal gold value: hence its reputation as "paper gold."[3] In 1974, it

[1]Minutes of EBM/89/10 (February 1, 1989), p. 4.

[2]Although SDR is formally an abbreviation of "special drawing rights," the asset has little to do with drawing rights in the Fund. The terminology was chosen in 1967 because it seemed less evocative of reserve creation than the more straightforward alternatives. See Gold (1971) and de Vries (1976), p. 154. Later efforts to get agreement on a more palatable name all failed. In an explicit acknowledgment of the lack of meaning in the phrase, the Fund decided in 1983 to make the acronym an official term in its own right.

[3]For the history of the negotiations on the creation of the SDR, see Part One of de Vries (1976), Vol. 1. The reference to "paper gold" is on p. 177. The term "paper gold" was common vernacular usage in the mid-1960s to refer to any scheme to supplement official reserve balances with a fiat monetary asset. Also see Solomon (1982), Chapter 8.

was redefined as a basket of 16 widely used currencies, which was simplified to 5 currencies in 1981. The currencies that composed the simplified SDR basket were those of the Group of Five industrial countries (the G-5): the U.S. dollar, the Japanese yen, the deutsche mark, the pound sterling, and the French franc.[4] This basket was intended to be simple enough to be readily understood in financial markets while still ensuring that the value of the SDR would be fairly stable in the face of wide swings in exchange rates. The Fund's own accounts are maintained in terms of SDRs, and several other international organizations also have adopted the SDR as a unit of account.

By design, the SDR has a very limited role as a medium of exchange. Official SDRs can be created only through an "allocation" or issuance by the Fund to "meet the long-term global need . . . to supplement existing reserve assets," and the stock can be reduced only through a "cancellation" by the Fund. Once created, these assets can be used only in specified transactions involving the Fund, its member countries, and a short list of other "prescribed" holders. Private SDRs (i.e., private sector assets with the same composition as official SDRs) can be created and used for any purpose, but that market never developed any breadth or depth.[5]

As a store of value for a member country, the SDR is the equivalent of foreign exchange reserves. This is really the heart of the issue. An allocation of SDRs by the IMF provides each recipient (a participating member country) with an unconditional and costless line of credit, on which the holder neither earns nor pays interest.[6] That line of credit is an asset for the holder (normally the central bank), and the offsetting entry is only a contingent liability in the event that the Fund cancels SDRs or the member terminates its participation in the SDR Department (IMF, Treasurer's Department, 1995, pp. 41–42). The use of SDRs (i.e., drawing on one's line of credit to settle a financial obligation or to acquire another good or asset) creates a liability to the SDR Department of the Fund, which is exactly offset by a claim held by the counter party to the transaction (another central bank, a prescribed holder, or the Fund). Those net liabilities and claims (i.e., holdings of SDRs below or above allocations) carry a market-based rate of interest, which since 1981 has been equal to the appropriately weighted average of yields on highest-grade short-term securities issued in the corresponding countries.

An allocation of SDRs has little economic value for a country that has ready access to international capital markets on favorable terms. If a country can obtain a line of credit from commercial creditors, then the value of an SDR allocation is measured by the difference between the SDR interest rate and the rate charged by

[4]In January 1999, the SDR was redefined as a four-currency basket, with the euro replacing the mark and the franc.

[5]For analyses of the requirements for development of a market for private SDRs, see Coats (1982) and van den Boogaerde (1984). Typical of the period, both papers proved to be overly optimistic in assessing the prospects for the market. For the technical characteristics of the official and private markets for SDRs, see IMF, Treasurer's Department (1995) and Wragg (1984), respectively.

[6]Technically, the recipient earns interest on its holdings and pays interest on its allocations, but the two interest rates are identical and exactly net out. The use of SDRs (reduction of holdings below allocations) is of course not costless.

the market and (less tangibly) by the removal of the risk that the line of credit could be withdrawn if market conditions or the country's financial reputation were to deteriorate.[7] For countries without market access or for which access is expensive and uncertain, an SDR allocation may have substantial value. The standard terminology in the Fund for this phenomenon is that the allocation of SDRs gives rise to a "net transfer of real resources" to countries that lack ready access to capital markets. That terminology is misleading to the extent that the process involves the creation, rather than the transfer, of resources. Allocating SDRs is a positive-sum, not a zero-sum, game.[8]

Finally, as a standard of value, the SDR can serve both as a peg for a country's exchange rate and a means of denominating contracts and other obligations. Pegging currencies to the SDR achieved a measure of popularity in the late 1970s in reaction to uncertainties about the value of the U.S. dollar, but it faded away after that. The SDR has had a more lasting but still limited success as a means of denominating obligations to maintain value over time. Nearly all of the Fund's claims and liabilities are denominated in SDRs,[9] and it is also used by a number of other international organizations, mostly regional development banks.

The SDR was designed originally to vitiate the problem known as the Triffin dilemma.[10] As long as the U.S. dollar was the primary international reserve asset,

[7]The SDR has a potential value as a reserve asset for all countries, in comparison with ordinary foreign exchange, in that its value is more stable than any single currency. Any country, however, can replicate that value perfectly by holding the equivalent combination of currencies. Similarly, proposals to enhance the SDR by "hardening" it so as to maintain its value in relation to real goods or assets (see notably Coats, 1990) apply with equal force to other available options and do not directly affect the arguments for or against allocation of SDRs.

[8]Measurement of the extent to which an SDR allocation creates aggregate utility is not straightforward. If other potential creditors price the riskiness of sovereign credits rationally and with complete information, if SDR obligations are de facto senior to other obligations, and if the allocation of SDRs has no effect on any country's creditworthiness, then the value of the allocation will be exactly offset by the increased cost of other lines of credit. If creditors fail to price risk correctly and the other conditions still hold, then the recipient of the allocation will gain utility at the expense of those creditors. If the allocation enhances creditworthiness and confidence by providing a virtually costless liquid asset to the central bank that cannot be withdrawn capriciously by the market or by a bilateral official creditor; or strengthens the international monetary system by improving the distribution, stability, and other qualities of international reserves, then no offsetting costs will arise. The economic value of the stock of outstanding SDRs thus is related only loosely to the size of the stock. For Fund staff views on this issue, see Coats, Furstenberg, and Isard (1990) and Mussa (1996).

[9]As Polak (1979) has stressed, although a large portion of the assets of the Fund's General Department are formally the "currencies" of member countries, the Fund's claims are actually denominated in SDRs. The amounts of currencies held by the Fund are regularly adjusted to maintain their value in terms of SDRs. The accounts of the staff retirement plan and the investment account for benefits for retired staff are maintained in U.S. dollars.

[10]Triffin (1960). For a thorough history of the rationale for creating and developing the SDR as a means of strengthening the international monetary system, see Cumby (1983). Sobol (1982) analyzes the views of European officials in the 1960s and concludes that Europe's primary goal in supporting creation of the SDR was to strengthen the system rather than to supplement the supply of reserves. For the basic history of the evolution of the SDR, see IMF Research Department (1983) and Mussa, Boughton, and Isard (1996), pp. 423–35.

a growing level of world trade and finance required a growing stock of dollars in international supply. That growing stock, however, required persistent deficits in the U.S. balance of payments and thus was a threat to the stable value of the dollar, on which the system depended. The solution to this dilemma lay in creating an international asset to supplement dollars in official reserve holdings. By the late 1970s, however, that problem had vanished from the radar screen, only partially because of the advent of generalized floating of major exchange rates. Most industrial countries and a growing number of developing countries had ready access to international liquidity by drawing on official swap arrangements or by borrowing from official agencies such as the Bank for International Settlements (BIS) or from rapidly expanding private capital markets. Even with no growth in liquid assets, the global demand for liquidity could be satisfied through liability management.

In these new circumstances, the value of official assets such as the SDR was confined to countries with less ready access, as noted above. From about 1976 on, the staff consistently argued that the requirement of a "global need to supplement reserves" did not imply that there had to be a global shortage, but only that the quality and distribution of existing reserve assets had to be so impaired as to be creating serious and widespread economic problems.[11] This shift in the rationale for the SDR led to controversy and ultimately to stalemate between a few of the major industrial countries, who argued against additional allocations on the basis of the original global rationale and who continued to equate "global need" with "global shortage" of reserves; and most other countries, who made the case for expansion (at least implicitly) on the basis of the SDR's ability to improve the quality of the international monetary system and its direct economic value to a subset of the Fund's membership.

Limited Role of the SDR

The history of the SDR, as noted at the outset, is fundamentally a story of the failure of the asset to achieve the dominant position that its designers and defenders imagined for it (see Rhomberg, 1991). It has, however, maintained an important, though limited, role in the Fund and in the international monetary system.

In some respects, the SDR did grow in importance and acceptability during the 1980s. As a glance at the balance sheet of the Fund's SDR Department reveals

[11]A September 1978 staff paper put it this way: "There is a strong economic case on the need for additional reserves to deal with potential payments imbalances. . . . The existence of a global need does not require that there be a shortage of reserves; . . . present exchange arrangements and countries' widespread access to international capital markets now virtually preclude the emergence of a global shortage of international reserves." "Revised Draft Report of the Executive Directors to the Interim Committee on Special Drawing Rights, Rev. 1," SM/78/215 (September 7, 1978), p. 5. Also see "Allocations of SDRs—Legislative History of the Concept of "Global Need" to Supplement Existing Reserves," SM/84/148 (June 27, 1984).

Table 18.1. Balance Sheet of the SDR Department
(Millions of SDRs)

	April 30, 1978	April 30, 1990	Change
Allocations			
Net cumulative allocations to participants	9,314.8	21,433.3	12,118.5
Charges due but not paid	0.3	44.7	44.4
Total	9,315.1	21,478.0	12,162.8
Holdings			
Participants with holdings above allocations			
Allocations	2,644.3	11,408.3	8,764.0
Net receipt of SDRs	1,023.3	5,891.0	4,867.7
Total holdings	3,667.6	17,299.3	13,631.8
Participants with holdings below allocations			
Allocations	6,670.6	10,025.0	3,354.5
Net use of SDRs	2,394.1	6,494.1	4,100.0
Total holdings	4,276.5	3,530.9	(745.6)
IMF (General Resources Account)	1,371.1	628.5	(742.6)
Prescribed Holders	. . .	19.3	9.3
Total	9,315.1	21,478.0	12,162.9

Source: *Annual Report*, 1978 and 1990.

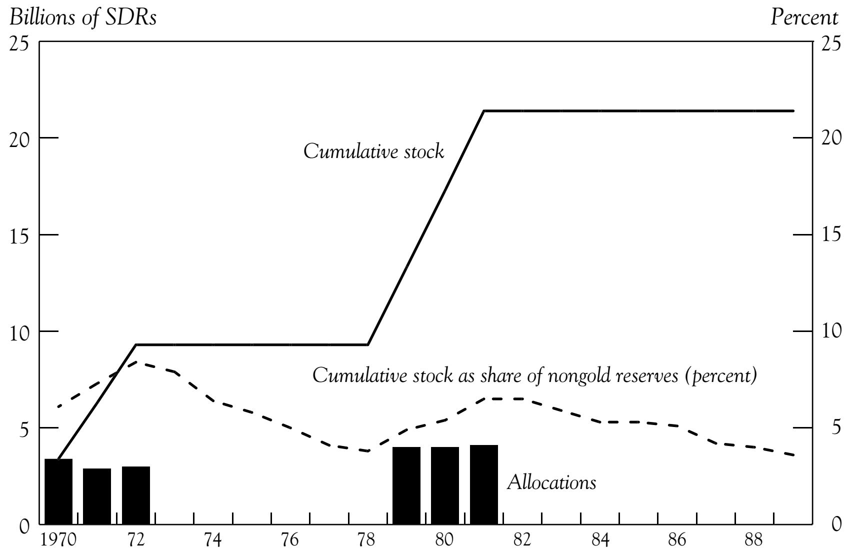
(Table 18.1), the total amount of SDRs in existence rose by 130 percent during the 11 financial years, 1979–89.[12] The initial stock (SDR 9.3 billion) was created through a series of allocations in the early 1970s, and the increase (SDR 12.1 billion) resulted from a second round of allocations in 1979–81 (Figure 18.1). After 1981, however, there were no further allocations in the period covered by this History.[13] Nonetheless, the volume of transactions in SDRs rose sharply from 1978 to 1984, especially transactions among participants, and then remained high (Figure 18.2). Also of significance was a marked rise in the apparent acceptability of the SDR as a reserve asset. Until the mid-1980s, less than half of the total stock was held by countries that were net holders of SDRs (i.e., holding SDRs in excess of their allocations). By 1990, about 80 percent was held by net holders (Table 18.1 and Figure 18.3).[14] As the major creditor countries increased their holdings, the large majority of countries that were net users were able to use their allocated balances with greater ease and liquidity.

[12]The SDR Department is separate from the accounts in the Fund's General Department, through which the Fund extends credits to member countries. Those accounts are discussed in Chapter 17.

[13]For the history of allocations before 1979, see de Vries (1976), Vol. 1, Part Two; and de Vries (1985), Chapter 45. In 1997, the Fund approved a proposal to amend the Articles of Agreement to permit a one-time special allocation of SDRs, which would double the outstanding stock and equalize the cumulative ratio of allocations to quotas for all member countries.

[14]The IMF's own holdings included both normal working balances and the temporary effects of payments to the Fund in SDRs by member countries. The two large spikes shown in Figure 18.3 reflect members' subscriptions to the quota increases of 1980 and 1983.

Figure 18.1. SDR Allocations, 1970–89



These shifts in the distribution of holdings are not unambiguous indicators of acceptability, and it must be noted that the positive aspects were overshadowed by a persistent concentration of net holdings in a few countries. Throughout the 1980s, about 80 percent of the membership were net users of SDRs, and net hold-

Figure 18.2. Transactions in SDRs, 1970–90

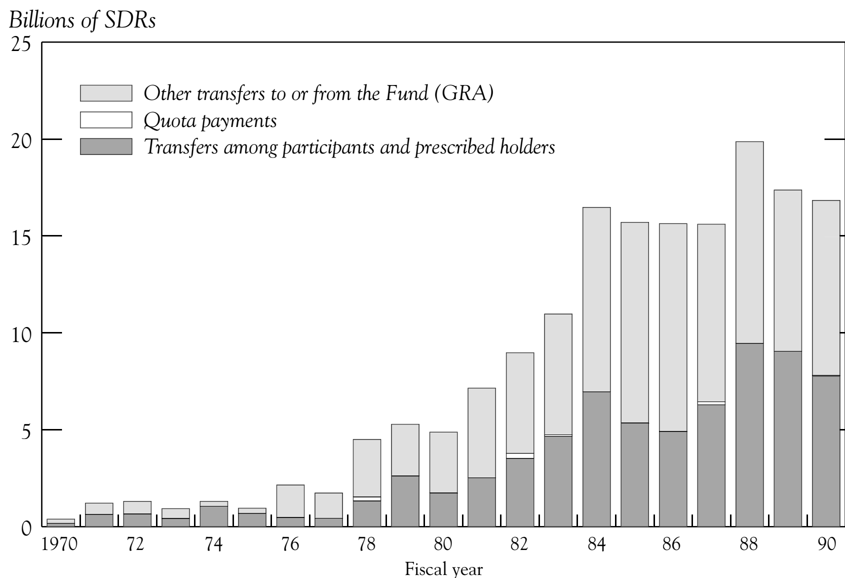
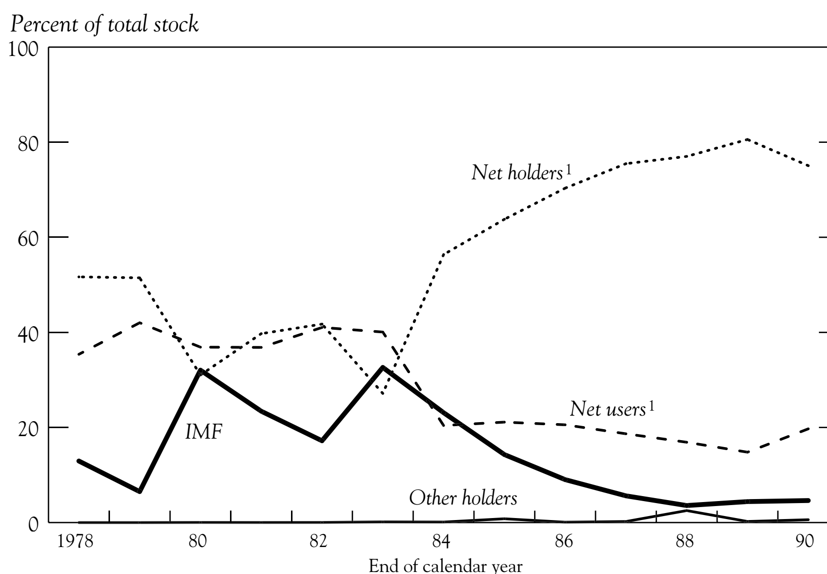


Figure 18.3. Distribution of Holdings of SDRs, 1978–90



[1]Percent of total stock held by member countries that are net holders or net users, respectively.

ings were concentrated primarily in the large industrial countries (Table 18.2). At the end of 1989, out of 138 countries that had received allocations, all but 31 were net users. Moreover, most net users had used most of their allocations: 91 countries (two-thirds of the membership) had used at least 75 percent, and 53 countries (three-eighths of the membership) had used at least 99 percent (Table 18.3). Finding ways to encourage or even to compel more countries to hold SDRs had become an important concern of the Fund.

Another positive indicator is that all Fund members chose to become participants in the SDR Department in the 1980s. Participation is voluntary, and in the 1970s a number of countries—including several oil exporters with strong balance of payments positions—chose to opt out. Although participation in general and receipt of allocations in particular are both costless, participants are potentially subject to "designation" to provide currency in exchange for SDRs, and some countries may not have felt comfortable with the transparency of transactions in SDRs.[15] Over time, however, such concerns diminished in importance. All but two countries that joined the Fund from 1970 on became SDR partici-

[15]The designation provisions of Article XIX are limited to countries whose "balance of payments and gross reserve position is sufficiently strong." More generally, participants are required by Article XXII "to collaborate with the Fund and other participants in order to facilitate the effective functioning of the Special Drawing Rights Department and the proper use of" SDRs.

Table 18.2. Leading Holders of SDRs, 1978 and 1989

	End-1978			
	Amount held (SDR millions)	Percent of allocation	Percent of total	Cumulative percentage
Germany	1,379	254	17.0	17.0
United States	1,196	52	14.8	31.8
Japan	1,053	279	13.0	44.7
United Kingdom	415	41	5.1	49.9
Belgium	414	198	5.1	55.0
Canada	401	112	4.9	59.9
France	286	59	3.5	63.4
Netherlands	244	103	3.0	66.4
India	226	69	2.8	69.2
Italy	226	71	2.8	72.0
Brazil	184	121	2.3	74.3
Venezuela	167	149	2.1	76.3
Argentina	162	106	2.0	78.3
Sweden	112	105	1.4	79.7
Austria	105	136	1.3	81.0
Spain	103	81	1.3	82.3
Australia	99	44	1.2	83.5
Denmark	98	118	1.2	84.7
Norway	96	126	1.2	85.9
Iran	96	156	1.2	87.1
	End-1989			
United States	7,572	155	37.0	37.0
Japan	1,862	209	9.1	46.1
Germany	1,373	113	6.7	52.8
Canada	1,048	134	5.1	57.9
France	1,011	94	4.9	62.8
United Kingdom	870	45	4.2	67.1
Italy	759	108	3.7	70.8
Netherlands	590	111	2.9	73.6
Spain	523	175	2.6	76.2
Saudi Arabia	467	239	2.3	78.5
Belgium	423	87	2.1	80.5
China	411	174	2.0	82.6
Norway	345	206	1.7	84.2
Iran	305	125	1.5	85.7
Mexico	292	101	1.4	87.1
Sweden	260	105	1.3	88.4
Libya	249	424	1.2	89.6
Australia	234	50	1.1	90.8
Austria	227	127	1.1	91.9
Denmark	213	119	1.0	92.9

Note: Leading holders in this table are those countries holding at least 1 percent of the total stock held by participants.

pants straight away. By April 1980, those two (the United Arab Emirates and Qatar) and all ten of the original holdouts (Ethiopia, Iraq, Kuwait, Lebanon, Libya, Nepal, Portugal, Saudi Arabia, Singapore, and Thailand) had become

Table 18.3. Leading Users of SDRs, 1978 and 1989

	End-1978			
	Amount used (SDR millions)	Percent of allocation	Percent of total	Cumulative percentage
United States	1,098	48	34.6	34.6
United Kingdom	592	59	18.7	53.3
France	199	41	6.3	59.5
Australia	127	56	4.0	63.5
India	100	31	3.2	66.7
Italy	92	29	2.9	69.6
Mexico	82	66	2.6	72.2
Egypt	57	87	1.8	74.0
Pakistan	51	63	1.6	75.6
Turkey	50	100	1.6	77.2
South Africa	50	56	1.6	78.7
Philippines	38	75	1.2	80.0
Peru	36	88	1.1	81.1
Congo, Dem. Rep.	35	89	1.1	82.2
Chile	34	62	1.1	83.3
Greece	33	71	1.0	84.3
Indonesia	33	36	1.0	85.3
	End-1989			
United Kingdom	1,043	55	15.8	15.8
India	595	87	9.0	24.9
Brazil	359	100	5.4	30.3
Argentina	318	100	4.8	35.1
Venezuela	281	89	4.3	39.4
Indonesia	238	100	3.6	43.0
Australia	237	50	3.6	46.6
South Africa	219	99	3.3	49.9
Pakistan	169	99	2.6	52.5
Nigeria	157	100	2.4	54.9
New Zealand	141	100	2.1	57.0
Egypt	136	100	2.1	59.1
Algeria	126	98	1.9	61.0
Philippines	116	99	1.8	62.7
Turkey	112	100	1.7	64.4
Israel	106	100	1.6	66.1
Chile	103	85	1.6	67.6
Greece	103	100	1.6	69.2
Peru	91	100	1.4	70.6
Morocco	85	100	1.3	71.9
Congo, Dem. Rep.	83	96	1.3	73.1
Thailand	72	85	1.1	74.2
Korea	72	98	1.1	75.3
France	69	6	1.0	76.4
Iraq	68	100	1.0	77.4
Zambia	68	100	1.0	78.4

Note: Leading users in this table are countries with net holdings below allocations, with usage of at least 1 percent of the total for all net users.

participants.[16] From then on, all Fund members participated in the SDR Department.

The Fund did take several measures to increase the liquidity and acceptability of the SDR during the 1980s, some of which were effective.[17] One such step was to enable central banks to use SDRs routinely without having to justify or later reverse the transaction. Until the Second Amendment of the Articles took effect, the SDR was conceived as a vehicle for temporarily financing a balance of payments "need." A country using its SDR allocation was generally expected to represent that it had such a need, and it was expected eventually to partially "reconstitute" its holdings.[18] The 1978 amendments deleted the "need" requirement in cases where the transaction was by agreement between the user and the recipient, so that central banks could make more routine use of SDRs in transactions. The reconstitution requirement remained in place, but the rules for reducing or eliminating it were relaxed. The minimum required level of average holdings was reduced from 30 percent of allocations to 15 percent in January 1979, over the objections of some large creditors who argued that it would lead to excessive reliance on SDRs as a permanent source of credit. The requirement then was reduced to zero (and thus "abrogated") in April 1981, as part of a package of measures in which the SDR interest rate was raised to a market level (see the section on Valuing the SDR, pp. 950–54). As is evident from the tables and charts presented above, many countries did begin to use their SDRs more permanently, and the Fund had to look for ways to offset this effect by making the SDR more competitive as an asset to hold.

Because SDRs exist as bookkeeping entries on the Fund's accounts, the range of transactions in which they can be used is limited by rules established by the Fund. Originally, the Fund intended that SDRs be used only in spot (i.e., immediate-settlement) transactions between participating countries or between a participant and the Fund. By the late 1970s, however, that policy conflicted with the broader goal of promoting the SDR as a financial asset. As part of the transition to a more market-oriented role for the SDR, the Executive Board adopted a series of enabling decisions from December 1978 through March 1980. Those decisions specifically permitted participating countries and other holders to use SDRs in swaps, forward transactions, loans, collateralization, and grants (*Annual Report 1979*, pp. 130–34; *Annual Report 1980*, pp. 140–43). Two factors, however, limited the effectiveness

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[16]Three of the ten initial holdouts (Iraq, Nepal, and Thailand) became participants during 1970, and Portugal did so in 1975. The imminence of a resumption of allocations induced all of the others except Kuwait, as well as the United Arab Emirates and Qatar (both of whom had joined the Fund in 1972), to become participants during 1978. Kuwait became a participant in 1980.

[17]One action that was not taken might have had a major impact. As discussed in Chapter 17, the Fund from time to time considered the possibility of borrowing from private capital markets. Had it done so, the resulting claims would have been denominated in SDRs. It seems likely that commercial banks then would have developed an active market in private financial instruments in equivalent denominations ("private SDRs").

[18]The reconstitution requirement specifies that a country's holdings of SDRs must be at least a designated percentage of its cumulative allocations, averaged over a five-year period.

of this liberalization. First, the decisions were entirely driven by the Fund's desire to promote the SDR, not by a latent demand by others to use SDRs for these purposes. Second, the Fund was unwilling to issue blanket approval for the use of SDRs in any nonproscribed activity. The message therefore was mixed: the Fund wanted to encourage use, but it also wanted to retain a degree of residual control over the types of allowable transactions. For whatever reason, liberalizing the rules stimulated very little new activity. Throughout the 1980s, spot transactions accounted for more than 96 percent of all transfers of SDRs.

Another step by the Fund to broaden the market for SDRs was to create a network of "prescribed holders" among multilateral development banks and regional central banks. The BIS had been named as a prescribed holder in January 1974, to serve as a short-term supplier of currencies to central banks by making temporary exchanges of currencies for SDRs. (See de Vries, 1985, pp. 898–99.) Other than the BIS, only the Fund and participating countries could hold or transact SDRs. The Fund named five more institutions as prescribed holders in April 1980, and over the next five years expanded the list to 16, where it remained.[19] Holdings by these institutions were insignificant (less than 1⁄10 of 1 percent of the total stock of SDRs at the end of the 1980s), but they did conduct transactions that helped reduce the illiquidity of the market.

Despite the Fund's multipronged efforts to strengthen the SDR in the first half of the 1980s, the market for it remained illiquid and limited in scope. In 1986, the Fund staff conducted a survey of 27 central banks, representing a broad cross section of the membership, to learn their attitudes about the SDR as a reserve asset. Most respondents indicated that they regarded the SDR as having poor liquidity and that it played only a minor role in their strategy for managing their reserves. The Executive Board lamented this finding and concluded that the qualities of the asset should be improved, but its recommendation did not lead to concrete changes other than a greater emphasis on promoting voluntary exchanges of SDRs.[20]

Perhaps the greatest success of the 1980s was the practical elimination of the need for designation as a means of transacting SDRs. For most transactions through the mid-1980s, a country seeking to use its SDRs would notify the Fund, which would designate a country with a strong balance of payments and reserve position to accept the SDRs in exchange for a reserve currency. To simplify the process and improve the liquidity of the market, several countries made standing commitments to buy and/or sell SDRs when necessary. In addition, the Fund acted as a broker by matching participants for voluntary transactions. After September 1987, no further designations were needed.

One general reason, possibly the main reason, for the limited attractiveness of the SDR as an asset in the 1980s was that concerns about the stability of the U.S.

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[19]For a complete list of the prescribed holders approved in the 1980s, see *Annual Report 1987*, p. 66n. After Switzerland became a member of the Fund (and a participant in the SDR Department) in 1992, the list was reduced to 15 with the deletion of the Swiss National Bank.

[20]"The SDR in the Reserve Management Practices of Monetary Authorities," SM/87/72 (March 17, 1987) and minutes of EBM/87/55–56 (March 27, 1987).

dollar were greatly reduced in comparison with the 1970s. From 1981 to 1984, while the dollar was appreciating strongly against other major currencies, holders of dollars were more impressed by the currency's strength than by the ever-increasing risk of a reversal. (For example, see Hilliard, 1983.) Subsequently, fears of a collapse in the value of the dollar were tempered by the more cooperative policies of the G-5 (see Chapter 4). More generally, capital markets had developed to a point where central banks and other agents could diversify their risks through a variety of techniques of asset and liability management, which provided far more flexibility than holding SDRs. And to satisfy any remaining demand for a standard multicurrency basket, the ECU (European currency unit)—subject to fewer restrictions, with a broader market, and a cleaner substitute for dollars because the dollar was not a component in the basket—was a generally superior alternative to the SDR.[21]

A second general reason for weak demand, more intrinsic to the SDR, was the absence of a system for pricing the official SDR to market. Since 1981, the interest rate on the SDR has been equal to the weighted average of interest rates on three-month government securities in the countries whose currencies constitute the SDR, with the weights equal to the basket weights recalculated at current exchange rates. (The interest rate is discussed more fully below.) That procedure leads to a possible discrepancy between the SDR interest rate and the rate that would equilibrate an open market for SDRs, because the SDR is not a three-month instrument with the same properties as a government security. As Rudolf Rhomberg (1996, p. 51) has argued, "its maturity seems undefined, and the comparison with specific debts . . . is arbitrary." If the SDR is viewed by market participants as less liquid than the corresponding national securities, the equilibrium interest rate would be above the official SDR rate.

Notwithstanding the efforts made by the Fund to enhance the liquidity and the market characteristics of the SDR, neither management nor the Executive Board was willing to take the final step and relinquish control over the asset's value in financial markets. To the contrary, the Fund felt bound to preserve the "equal value" principle in all SDR transactions and to fix the quantity outstanding.[22] The existence of an official asset that was in fixed supply, had a rate that was imperfectly related to market valuation, and was subject to complex rules discouraged the growth of a commercial market for a similar but more user-friendly private asset. Without official support or even much encouragement from the Fund, private

[21]See IMF, Research and Treasurer's Departments (1987), Part Two; Aggarwal and Soenen (1988), and Allen (1993). The ECU was created by the European Communities at the beginning of 1979 to serve as a common unit of account for countries participating in the European Monetary System. It was supplanted by the euro in January 1999.

[22]The "equal value" principle states that, unless the Executive Board adopts policies providing for exceptions, "the exchange rates for transactions between participants . . . shall be such that participants using [SDRs] shall receive the same value whatever currencies might be provided and whichever participants provide those currencies" [Article XIX, Section 7(*a*)]. The Board recognized that allowing for transactions at different interest rates would be financially equivalent to allowing for different exchange rates.

agents had little incentive to mimic the official SDR in their own instruments. An effective linkage would have required more flexible pricing of the official SDR and the maintenance of a more open market for it.[23] A staff proposal for the Fund to make a market in SDRs was rejected by the Executive Board in 1982, and a proposal to allow for flexible pricing through exceptions to the "equal value" principle was rejected in 1983. Despite the growing evidence that the poor liquidity of the asset was discouraging central banks from holding SDRs, both proposals were rejected again in 1987.[24]

Over time, as countries became less concerned about their ability to diversify their portfolios and more concerned about the poor marketability of the SDR, they gradually lost interest in pegging their currencies to it. Pegging to the SDR peaked around the middle of 1980, when the dollar was at its weakest; 15 currencies were pegged, making that one of the more popular choices among exchange regimes. Over the next few years, several of those countries decided to adopt other (usually more flexible) arrangements, and very few new SDR pegs were introduced. By the end of 1989, only seven countries were officially pegging to the SDR and only four of those were adhering closely to the peg.[25] The number declined further in the early 1990s.

Similarly, interest in the SDR as a unit of account and a standard of value flared up for a few years in the late 1970s and then petered out during the 1980s. From 1975 to 1981, 13 bond issues totaling SDR 563 million, issued mostly by official institutions, were denominated in SDRs. After that, as the market for ECU-denominated bonds began to grow, the market for SDR bonds disappeared.[26] By 1982, 15 international organizations were using the SDR as a unit of account, and 16 international conventions were based on it. The list of such applications, however, showed no further growth.[27]

Proposals for a Substitution Account

Although the original purpose of the SDR was to *supplement* the U.S. dollar as a reserve asset, it quickly became apparent that it could also serve as a *substitute* for a portion of the dollars that central banks were already holding in their portfolios. That realization led the Fund to devote considerable energy to an effort to develop

[23]For a discussion of technical issues related to the linkage between official and private SDRs, see Coats (1990).

[24]Minutes of EBM/82/78 (June 7, 1982) and EBM/87/102 (July 10, 1987), p. 30.

[25]Two of the seven countries (Saudi Arabia and Bahrain) had undefined margins against the SDR and were de facto pegged to the U.S. dollar. One country (Libya) maintained unusually wide (±7½ percent) margins.

[26]For the structure and evolution of markets for bonds denominated in SDRs and ECUs, see Wragg (1984), Chapters 5 and 10.

[27]One notable exception occurred: effective August 1984, the International Air Transport Association (IATA) began using the SDR as the basis for changing cargo tariffs. For detailed lists, see *Annual Report 1983*, p. 102; *Annual Report 1988*, p. 78; and IMF, Research and Treasurer's Departments (1987), pp. 56–59.

a workable scheme for promoting reserve diversification into SDRs on a large scale. The story of why that effort failed—first in 1974 and again in 1980—reveals much about the broader weaknesses of the SDR.

When the U.S. dollar first displayed persistent weakness in the late 1960s and early 1970s, analysts both at the Fund and in national central banks began looking for alternatives to the dollar-based system of international reserves. When the U.S. government announced the formal suspension of convertibility of the dollar into gold in August 1971, an estimated 70 percent of all official reserves other than gold was held in dollars. If a central bank wanted to reduce the exchange risk on its reserves, the obvious solution would be to diversify into a balanced portfolio of widely traded currencies. In the 1970s, however, that option was not viable, because both of the countries whose currencies were the main alternatives—Germany and Japan—were reluctant to see their currencies "internationalized" and used as reserves and were actively discouraging central banks from diversifying into marks or yen. Moreover, the prospect of a system of multiple reserve currencies was widely viewed, both inside and outside the Fund, as a potentially destabilizing development that was to be avoided if possible. If central banks held several different currencies, then they would be likely to shift the composition of their portfolios to optimize expected returns. Such speculation could magnify the effects of market shifts in confidence or in expected relative returns.

The SDR offered an alternative channel for diversification. By acquiring SDRs through allocations by the Fund or in exchange for dollars through transactions with other central banks, a country could gain a single asset with a more stable exchange value than the dollar. Several difficulties had to be surmounted, however. First, the SDR was then still a fledgling, and its properties were little understood. Second, the outstanding stock of SDRs was quite small relative to the stock of dollars held in reserve. Third, although SDRs could be readily exchanged among central banks and other official agencies, there was virtually no private market. Fourth, the SDR was not a financially attractive asset, especially because it paid an interest rate well below prevailing market rates on the underlying assets.

Despite these obstacles, the Committee of Twenty (C-20)—as part of its study of possible reforms of the international monetary system in 1972–74—considered proposals to encourage or even to require member countries to replace a portion of their existing foreign exchange reserves with SDRs. Those who favored an obligatory scheme (including notably the French delegation) argued that voluntary substitution could encourage speculation and lead to instability. Others, however, felt that mandatory substitution was unnecessary and excessively costly.[28] The committee's final report provided for the possibility of establishing a substitution account, but it stopped short of endorsing a specific proposal.

The idea of a substitution account lay dormant during the next few years, but it sprang to new life after the dollar again came under heavy selling pressure toward the end of 1977. In the course of an Executive Board meeting on SDR allocations,

[28]See de Vries (1985), pp. 180–86 and 248–49, and Sobol (1979).

Jacques de Groote (Belgium) suggested that allocations might be linked with the "consolidation of other reserve assets." That is, countries receiving SDRs through allocations could be expected to exchange dollars or other reserve currencies for them, in order to both promote the SDR as an asset and absorb any inflationary impact of the allocation.[29] De Groote's suggestion piqued the interest of the Managing Director, H. Johannes Witteveen, who asked the staff to look into it. Two requisite differences from the earlier proposal soon became clear. First, a revived substitution account would have to be voluntary to have any chance of being approved, or even to be legally possible under the amended Articles of Agreement that were about to take effect.[30] Second, the inherent asymmetry between the effects on the United States and on all other countries could be minimized if the United States could be excluded or at least discouraged from participating. If any country could deposit dollars in exchange for SDRs, then the United States alone could finance a deficit by issuing its own currency and bypassing the foreign exchange market.

Witteveen was convinced that the problems that had doomed the substitution account four years earlier could be overcome and that the weakening dollar and the prospect of a resumption of SDR allocations made 1978 the right time to put it back on the agenda. When the Interim Committee met in Mexico City in April, he brought up the idea and won a lukewarm mandate to have the Executive Board come back with a more concrete proposal.[31]

Ministerial-level enthusiasm for creating a substitution account was not overwhelming, but some disparate interests were converging to create a general willingness to consider it. Developing countries saw little value in the idea on its own merits; few of them had even comfortable, much less excess, dollar balances, and they had little to gain directly. But they desperately wanted the Fund to start allocating SDRs again, and a substitution account might help promote that objective. At least some U.S. officials saw merit in the idea of promoting the role of the SDR as a means of limiting speculative pressure against the dollar. The most pronounced enthusiasm came from European countries itching to diversify their reserves, though even there the degree of support was quite mixed. Some creditors, including the German authorities, were wary of any initiative that might lead to back-door credit expansion; others, including Japan and Saudi Arabia, argued that stabilizing the dollar required much more fundamental measures than this.

Witteveen's initiative failed to take root, only partly because of these underlying concerns. Another factor was his decision not to seek a second term as Man-

[29]Minutes of EBM/77/166 (December 9, 1977), p. 16.

[30]Memorandum from George Nicoletopoulos (Associate General Counsel) to the Managing Director (December 20, 1977), in IMF/CF (S 2040 "Substitution Account, January 1977–October 1978").

[31]"Some members believe that agreement on a substitution account would facilitate an allocation of SDRs. The Committee agreed that this suggestion of the Managing Director should be considered further and that a report should be submitted by the Executive Board for consideration by the Committee at its next meeting," Communiqué (April 30, 1978), para. 5, in de Vries (1985), Vol. 3, p. 237.

aging Director. When he left the Fund in June 1978, the proposal was not yet fleshed out, and its sketch had some troubling features. The most notable problem was that depositors were to be asked to bear the exchange risk for an account that would hold dollar assets and SDR liabilities. In effect, depositors would still be holding dollar-denominated claims, just in a different form. Trying to remedy that defect would dominate much of the subsequent effort to refine the proposal, and the Fund's failure to devise an acceptable solution ultimately would doom the whole enterprise.

The momentum from Mexico City was completely dissipated by the time the Interim Committee next met in Washington that September. The Board's report to the committee concluded gloomily that "an initiative along these lines is not feasible for the moment," and the committee's communiqué merely "noted that the Executive Board intends to keep under review the question of a substitution account." That might have been the end of the story, except that the U.S. dollar was continuing to depreciate in exchange markets and was about to be hit with what the new Managing Director, Jacques de Larosière, would privately call a "crisis of confidence." As soon as the crisis hit its peak, at the beginning of November, de Larosière and the Fund's chief economist, Jacques J. Polak, set out to develop a revised and more detailed plan for a substitution or "reserve diversification" account.

As the revised proposal emerged in the first half of 1979, the Fund would establish and administer an account in which central banks would voluntarily deposit dollars (typically, short-term U.S. treasury bills). In exchange, they would receive SDR-denominated claims, which they could use in the same limited manner as any other SDRs. The account would convert its assets into longer-term dollar-denominated claims on the U.S. Treasury, which would pay a suitably long-term interest rate on them. Interest would be paid to depositors at the official SDR interest rate (which at the time was maintained below the market rate). The intention was that the account's exchange risk would be covered by the difference between the long-term U.S. bond rate and the official SDR interest rate.

De Larosière took this idea to the Interim Committee, which considered it informally over a working lunch in March 1979. Delegates, including the U.S. authorities, indicated an openness to the idea, and they gave the Managing Director their "broad support . . . for active consideration of such an Account."[32]

A more sustainable momentum now was beginning to build, driven both by a general desire to fulfill the objective of the amended Article VIII, to make the SDR "the principal reserve asset in the international monetary system," and a more specific and immediate desire to combat the weakness of the U.S. dollar in exchange markets.

Although Executive Directors from some of the major industrial countries were maintaining a formally noncommittal stance during the Board discussions, their remarks usually focused on technical problems rather than broad issues of principle. Central banks with most of their reserve assets in U.S. dollars were confirming to the Fund that they had a latent demand for diversification and were

[32]Press Communiqué, Twelfth Meeting of the Interim Committee, March 7, 1979, para. 6.

prepared to bear some cost in exchange for a more stable investment vehicle. That message was coming not only from developing and smaller industrial countries, but also from the largest surplus countries. By the end of 1979, it was reinforced by the example set by the initial stabilizing success of the EMS and the ECU, and by concerns in some quarters over the freezing of Iranian assets by the U.S. government following the occupation of the U.S. embassy in Tehran in November.

On the other side of the balance sheet, the U.S. government appeared to have an interest in stabilizing the demand for dollars and in removing the overhang in official holdings without depressing the dollar's value. If so, the United States also could be expected to bear some portion of the cost, either by paying a higher interest rate than it was paying on reserve assets or by assuming a contingent liability for covering the account's exchange risk. That positive a view was not widespread in the U.S. Treasury, but it was taking hold. With the active encouragement of Princeton University economist Peter B. Kenen (who was spending the year in Washington as a senior treasury consultant), the Under Secretary for Monetary Affairs, Anthony M. Solomon, became the standard bearer and spokesman for the substitution account within the U.S. administration.[33]

Support continued to spread throughout the summer of 1979, and it culminated in a solid endorsement from the Interim Committee at the beginning of October. The substitution account proposal was the main operational item on the committee's agenda in Belgrade, and the communiqué asked the Executive Board to "continue to direct priority to designing" such an account (para. 7). For the moment, the promise that the SDR would become the principal reserve asset was on the verge of being fulfilled.

Despite the emergence of broad support and this official endorsement, the Polak–de Larosière proposal was soon revealed to be politically unacceptable, for three interconnected reasons. First, the U.S. authorities balked at the idea of converting short-term liabilities to central banks into a long-term liability to the IMF. Since long-term interest rates were normally higher than short-term rates, the conversion could be expensive, and the treasury judged that cost to be higher than the systemic benefit from establishing the substitution account. Second, potential depositors balked at converting U.S. treasury bills into assets paying the lower official SDR interest rate. Whatever benefits they would gain from having claims with a more stable value were seen as outweighed by the direct financial cost. Third, even though the interest differential had been and was expected to be large, the staff

[33]The definitive statement of U.S. support for establishing a substitution account was made by Solomon in the course of an address before the Alpbach European Forum in Alpbach, Austria (August 27, 1979). Four weeks later, at a press briefing before departing for the Annual Meetings in Belgrade, Solomon explained that in the U.S. view, the "primary justification" of the account would be to promote "the further evolution of the international monetary system . . . with the focal and primary reserve asset ultimately becoming the SDR. We do not think of it as a dollar support fund even though there would be probably some incidental . . . beneficial side effects in terms of accommodating off-the-market diversification." (Official transcript, U.S. Treasury, September 24, 1979.) The speech and the transcript are in Box 12, Anthony M. Solomon Collection, Jimmy Carter Library, Atlanta, Georgia.

could provide no assurance that it would even be positive in the future or that the scheme would be financially viable.[34] Staff simulations using data from the 1970s revealed that the plan would have fallen far short of covering the exchange risk because of the combination of a declining value of the dollar and low U.S. interest rates.[35] Clearly a more direct method of sharing the risk would have to be devised.

One option that was not seriously considered was to structure the substitution account to reduce its exchange risk or even eliminate it altogether. Instead of holding dollar assets and SDR liabilities, the account could have diversified its own assets to match or approximate the 16-currency composition of the SDR. To avoid a direct effect on exchange rates, this diversification could have been achieved through off-market trades with central banks of countries whose currencies were components of the SDR. The Bundesbank, for example, could have been asked to add to its own holdings of dollars, with a corresponding deutsche mark liability to the substitution account. Even though such an exchange would have been automatically sterilized, the transfer of exchange risk to these central banks would probably not have been politically viable.

When it became clear that neither side wanted to absorb much risk or cost, the staff came up with an alternative plan for the Fund itself to absorb some risk by pledging part of its stock of gold. De Larosière then offered a comprehensive proposal on the further use of the Fund's gold, under which 7–9 million ounces (out of a stock of 103 million ounces) would be sold and another 23–32 million ounces would be transferred to the substitution account.[36] Proceeds from the sale would be invested in interest-bearing assets, and the income would be used partly to subsidize the high cost of credits through the Supplementary Financing Facility (see Chapter 15) and partly to finance the rising cost of remuneration to creditors.[37] The pro-

[34]The main risk to the account would arise from a shift toward monetary expansion in the United States, relative to other major countries (or, equivalently, a relative tightening abroad). Such a policy shift, which had in fact prevailed in the 1970s, would generally lead both to a relative weakening of U.S. short-term interest rates and to a depreciation of the dollar. The SDR value of the assets in the substitution account would fall, and the value of interest income would fall relative to interest expense both in dollars and (a fortiori) in SDRs. The shortfall in net interest income would then further reduce the value of the account's assets and reinforce the initial deficit.

[35]From 1971 Q3 through 1979 Q1, the yield on U.S. treasury bills was 6.02 percent, and the full combined SDR market rate was 6.95 percent. Allowing for the depreciation of the dollar during that period, the yield on SDR assets in terms of dollars was 10.64 percent. Subsequent staff estimates generated similar comparisons for longer periods. See "Interest Rate Simulations," SM/79/95, Sup. 3 (June 1, 1979); "A Substitution Account and the Less Developed Countries," SM/79/236 (August 31, 1979); "Substitution Account—Balance Between Interest Received and Interest Paid," SM/79/279 (December 6, 1979); and "Substitution Account—Results of a Simulation Study of the Account's Financial Balance," SM/80/83 (April 2, 1980).

[36]Minutes of EBM/80/5 (January 11, 1980), pp. 3–9, and EBM/80/6 (same date), p. 20.

[37]As discussed in Chapter 17, the Fund was then in the early stages of making both the SDR and countries' reserve tranche positions into competitively structured and priced financial assets. By the late 1980s, that process would sharply raise the Fund's outlays to creditors. In 1981, the Fund began determining the interest rate charged on Fund credits as the residual factor to generate a target level of net income. Although the Managing Director couched the proposal for selling gold in terms of protecting the Fund's financial position, the practical effect after the 1981 policy change would have been to subsidize the basic rate of charge to borrowers.

posal thus had something for everyone, but it depended on a broad consensus in favor of disposing of a substantial portion of the Fund's "crown jewels."

When the Executive Board considered the Managing Director's proposal in March 1980, the discussion revealed that a consensus on disposing of gold would not be easy to achieve. Although most Executive Directors seemed prepared to consider the use of gold to back up the substitution account, many were willing to do so only if the main participants were committed to shouldering a significant share more directly. Notably, H. Onno Ruding (Netherlands) made a plea for a more balanced "tripartite support mechanism," and both Alexandre Kafka (Brazil) and S.D. Deshmukh (India) argued that the Fund should not compromise its ability to reserve its gold for the benefit of low-income developing countries. Sam Y. Cross (United States), however, denied that the account would provide special benefits to his country and insisted that the United States would not be prepared to make a budgetary contribution for this purpose.[38]

While the Board debated these technical problems, de Larosière devoted a considerable amount of personal energy to an effort to secure a final political approval of the proposal. With the assistance of the Interim Committee Chairman, Filippo Maria Pandolfi (finance minister of Italy), he managed to get the developing countries on board by persuading them that their concerns would be outweighed by the systemic benefits.[39] The G-5 finance ministers met in January and agreed on most, though not all, substantive issues. In February, the German finance minister, Hans Matthöfer, further signaled the strong support of his government. In meetings during March with the U.S. Treasury Secretary, G. William Miller, de Larosière got encouraging feedback and saw no reason to doubt that the United States continued to back the idea. But when the Interim Committee met in April, in Hamburg, Germany, support from the United States, Germany, and a few other creditors suddenly vanished, to the surprise and shock of the Managing Director and of those whom he had persuaded to support him.[40] The most that de Larosière could salvage in the communiqué was a bland statement that "some issues remained to be solved" and that the committee "expressed its intention to continue to work on this subject" (para. 6). In fact, however, the proposal to establish a substitution account was dead and would not be revived.

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[38]Minutes of EBM/80/40–41 (March 10, 1980).

[39]Pandolfi and Polak made a whirlwind tour of several Latin American capitals in late February, 1980. Although they encountered considerable doubts about the value of the proposed scheme for developing countries, they apparently succeeded in defusing overt criticisms. Memorandum from Polak to the Managing Director (March 3, 1980), IMF/CF (S 2040 "Substitution Account, February 16–March 12, 1980").

[40]Miller, Matthöfer, Geoffrey Howe (United Kingdom), and John Howard (Australia) declined to speak on the matter. Those who did speak gave no indication of awareness that the United States and Germany would withhold support. Governors from industrial countries broadly supported the plan on the assumption that the United States was prepared to shoulder part of the potential cost, while most of those from developing countries supported it on condition that it be adopted along with the Program for Immediate Action of the G-24 (on which, see Chapter 20, pp. 1009–10, and references therein). Minutes of the Second Session, pp. 27–56; IMF/CF (ICMS Meeting No. 14—Master File).

As was so often the case where the SDR was concerned, a concerted drive to strengthen its role had come to nothing. Three reasons for the failure stand out. First, on the surface, the withering away of American support can be attributed partly to Solomon's departure from the U.S. Treasury to become president of the Federal Reserve Bank of New York, since he and Kenen had been virtually alone in their willingness to fight for the account.[41] Second, the tightening of U.S. monetary policy that began in late 1979 eased fears of a continuing glut of dollars (see Wijnholds, 1982). Third and more fundamental, however, was the dissatisfaction with the stalemate over how to cover exchange risk. Without a consensus on the use of the Fund's gold as part of an overall burden-sharing plan, the proposal had no hope for success.

It is ironic that the substitution account was doomed by concerns over its potential cost. If the Polak–de Larosière plan had succeeded in 1980, the account would have enjoyed an initial five years in which its dollar-denominated assets would have appreciated by 28 percent against its SDR-denominated liabilities and in which its positive interest margin would have averaged 26 basis points. Its operations in those years would have generated large profits that could have been invested so as to carry it through at least the next decade. Unfortunately, that rosy scenario was unforeseeable in the bleak economic environment of 1980, and it carried no weight in the debate.[42]

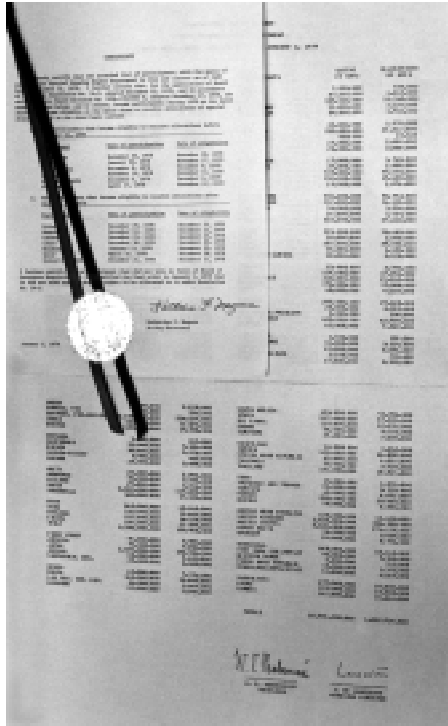
SDR Allocations

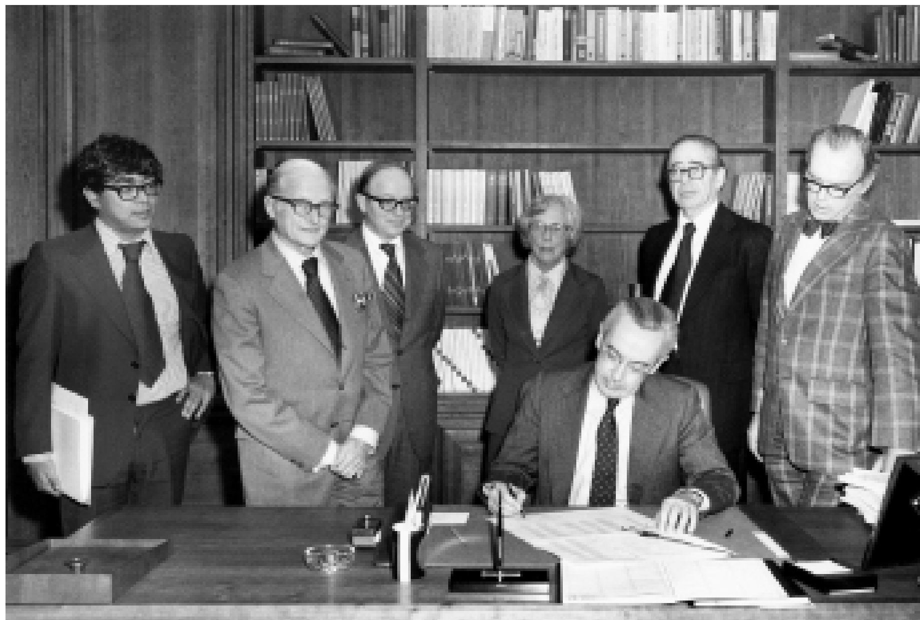
All of the SDRs in existence through the 1990s were put into circulation through two series of allocations by the Fund to participating countries. The first round of allocations, totaling SDR 9.3 billion, was made in 1970–72 during the "First Basic Period" after the creation of the SDR in 1969.[43] No allocations were made in the quinquennial Second Basic Period (1973–77), but the process resumed in the second year of the Third, which lasted four years (1978–81). Those

[41]In August 1979, Michael Blumenthal resigned as Secretary of the Treasury and was replaced by Miller, who had been chairman of the Federal Reserve Board. Paul A. Volcker, who had been president of the New York Federal Reserve, was then named to replace Miller. Solomon remained at the Treasury to cover the transition until February 1980, at which time he moved to New York to fill Volcker's position. For Kenen's views on the substitution account, see Kenen (1981, 1983).

[42]Although the staff recognized that the account might be profitable, the question of how to deal with that contingency was not raised until shortly before the Hamburg debacle and consequently was never considered in detail. An ex post simulation reveals that if the account had been established at the end of 1980, by 1985 it would have generated a net cumulative profit in SDRs equal to more than 40 percent of the initial deposits. Assuming no deposits or withdrawals after the initial setup, that profit would have been gradually offset by losses in the next seven years (through 1992) and would have been of a negligible amount for the following five years.

[43]The 1969 amendment to the Articles of Agreement specified that decisions to allocate SDRs shall be made with reference to "basic periods," normally of five years' duration, and that any allocations shall be made at yearly intervals during such a period. The First Basic Period was shortened to three years, and allocations were made each year at the beginning of January. See de Vries (1976), Vol. 1, Part Two.





Managing Director Jacques de Larosière signing document authorizing SDR allocation, January 2, 1979. Also in attendance, from left to right: Dhruba Gupta (Treasurer's Department), Sir Joseph Gold (General Counsel), Walter Habermeier (Treasurer), Katherine Magurn (Secretary's Department), Jacques Polak (Economic Counsellor), William Dale (Deputy Managing Director)

allocations, which were equivalent to just over 30 percent of end-1978 quotas for most eligible countries, brought the total stock to SDR 21.4 billion ($27.3 billion).[44] The process then stopped. Throughout the 1980s, countries holding close to two-thirds of the votes in the Executive Board favored making further allocations, but support continually fell short of the required 85 percent.

When the Board first discussed the possibility of allocations in the Fourth Basic Period, in January 1981, most creditor countries seemed open to at least considering the idea. The Alternate Executive Director for Germany, Guenter Winkelmann, noted that his authorities had "some reservations," but he did not preclude their ultimate approval. The U.S. Alternate, Donald Syvrud, was similarly noncommittal and noted that the Reagan administration, which had just taken office, had not developed a position on the issue. John Anson (United Kingdom) concluded that the wisdom of a further allocation was an "open question," and Tiruo Hirao (Japan) urged "prudence." Of the G-5, only Thierry Aulagnon (Alternate—France) expressed clear opposition at the outset, stating that there was "no technical justification" for further allocations. Most other Directors expressed neutral or tentatively positive responses.[45]

Those preliminary views were ambiguous enough to leave room for hope, and they were conveyed in that spirit to the Interim Committee for its May 1981 meeting in Libreville, Gabon. Ministers recognized that developing a consensus on new allocations was going to be difficult, but they urged the Executive Board to develop an acceptable proposal "at the earliest possible date." That order, however, could not be filled. A hard core of opposition was already forming from four countries (all of the G-5 except France, which swam against the current and abandoned its opposition soon after the election of François Mitterrand as president in May 1981), and it would not be reduced through the next decade of debates. Remarkably for a body that thrives on negotiation and compromise, positions on SDR allocations just never evolved and never even inched toward reconciliation.

Those who were opposed were concerned primarily about aggravating inflation and weakening discipline in national monetary policies. They viewed the allocation of SDRs as tantamount to money creation, and they feared that deficit countries would use additional reserves to postpone needed adjustment. This view was reinforced by the unfortunate timing of the first two rounds of allocations, both of which had coincided with major inflationary episodes. In addition, as noted in the introduction to this chapter, opponents argued that the sole criterion for alloca-

[44]On January 1, 1979 and 1980, each eligible country, except for a few that opted out, received an allocation equal to 10.4 percent of its quota as of the preceding day. For all but a few countries, quotas were unchanged between those two dates. On January 1, 1981, each country received an allocation equal to 6.8 percent of its quota on December 31, 1980, which reflected the quota increases under the Seventh General Review. This last percentage was calibrated to generate a commensurate aggregate allocation, adjusted upward to allow for new participants. For a country with an average quota increase, total allocations for 1979–81 amounted to 31.2 percent of the end-1978 quota. The agreement to make those allocations, which came at the Interim Committee meeting of September 1978, is covered in de Vries (1985), Chapter 45.

[45]Minutes of EBM/81/10–11 (January 21, 1981).

tion in the Articles of Agreement was the need to supplement the existing stock of reserves, a criterion that they interpreted as quantitative and aggregative. That is, they interpreted the Articles as stating that the existing supply of reserves had to be globally inadequate to satisfy the "need" (and not the possibly larger "demand") for reserves.[46] The strongest position in this regard was taken by the German authorities, who rejected the prevailing view—and the view of the Fund's Legal Department—that a decision to allocate SDRs could be taken even if the global demand for reserves could be met in other (but less satisfactory) ways.[47]

Those in favor of allocations offered several more qualitative arguments, and they generally interpreted the criterion itself as qualitative. That is, an allocation was justified under the Articles if the quality or the distribution of the existing stock of reserves was inadequate, and if an increase in the stock of SDRs could be shown to ameliorate that condition. In addition, they often cited the provision in the Articles that the SDR was to become the principal reserve asset in the system, which in their view could not happen if the stock of SDRs continued to decline in relation to world finance and to total reserves.[48]

This political impasse did not discourage the Fund's management from continuing to place the question on the Board's agenda. After the Fourth Basic Period (1982–86) passed without any agreement, the Board duly began discussing the possibility of resuming allocations in the Fifth. At the first meeting on that question, in March 1987, almost everyone spoke in favor except those in the same four chairs that had steadfastly blocked allocations for the preceding five years.[49]

A year later, the Managing Director, Michel Camdessus, tabled a specific proposal to allocate SDR 20–30 billion "over the next two years." Camdessus cited two factors that together, in his view, constituted a "global need" in the sense of the Articles. First, a large-scale allocation of SDRs would help to prevent a renewal of the disruptive conditions in exchange markets that had characterized the mid-1980s. Second, it would further the resolution of the international debt crisis. The existing level of official reserves, he argued, was inadequate to enable many of the

[46]The requirement of a "need" was introduced to convey that a judgment of adequacy was to be made by the Fund. This "need to supplement existing reserve assets" is thus distinct from and does not depend on the economic concept of a shortage in relation to the demand for reserves. The requirement of a "global" need conveys the sense that an allocation of SDRs responds to a problem related to the performance of the world economy and of the international monetary system, not to the need to finance the balance of payments deficits of individual countries or groups of countries. "Allocations of SDRs—Legislative History of the Concept of 'Global Need' to Supplement Existing Reserves," SM/84/148 (June 27, 1984).

[47]See, for example, the statement by Guenter Grosche at EBM/84/131 (August 31, 1984), pp. 25–28.

[48]For a retrospective and evaluation of these views on allocations, see Polak (1988) and the various contributions in Mussa, Boughton, and Isard (1996).

[49]Ian Sliper (Temporary Alternate—New Zealand) noted that his constituency was divided. Australia was opposed to resuming allocations, while most others in the group (which included several developing countries) were in favor. Since no vote on allocations was ever taken, that chair's position was never clarified. (Executive Board rules do not allow Directors to split their votes.) Minutes of EBM/87/55–56 (March 27, 1987).

highly indebted middle-income developing countries to carry out proper adjustment policies.[50]

Camdessus's arguments had virtually no impact on the Executive Board. Discussions on the Fifth Basic Period continued in the same vein through 1989, with no shift in the position of any chair. From then until the period ended in 1991, the Managing Director regularly reported to the Interim Committee that he had determined through informal consultations that the impasse was unchanged.

A Link to Development Finance?

One possibility for reconciling the two opposing camps on allocations would be to dedicate any newly created SDRs to those countries where they are most needed. Since SDRs are valuable primarily to countries without good access to international capital markets, and since the opponents of allocations feared that a global allocation would fuel inflationary pressures, why not target allocations toward developing countries? Targeted allocations could be a valuable addition to foreign aid from scarce budgeted resources and would directly supplement the foreign exchange reserves that developing countries need to sustain growth in international trade. As it happened, however, these arguments hardened rather than softened the opposition to SDR allocations.

The idea of linking SDR allocations to a country's need for development finance was first raised during the earliest discussions of reserve-creation schemes in the 1960s. Some schemes, such as the "Stamp Plan" of 1962, envisioned that reserves would be created only for developing countries, while others aimed only at the main industrial countries. As a compromise, UNCTAD (the United Nations Conference on Trade and Development) and other groups pushed for a scheme that would ensure that any new and deliberate creation of reserves would simultaneously serve to correct the particular shortage of reserves held by developing countries. While most officials and economists from the major industrial (G-10) countries insisted that those two issues—reserve creation and development finance—should be tackled separately, they did come around to the view that newly created reserve assets should be distributed proportionally to all countries. The allocation of SDRs was therefore based on the distribution of quotas in the Fund.[51]

Developing countries continued to raise the issue of linking SDR allocations to development finance—which came to be known simply as "the link"—throughout the 1970s, but as long as support was lacking even for a conventional SDR alloca-

[50]Minutes of EBM/88/45 (March 23, 1988), pp. 12–13.

[51]On the discussions in the 1960s leading up to the design of the SDR system, see de Vries (1976), Vol. 1, pp. 61, 72, 84–85, 110–11, and 219–20. The two key reports dealing with this issue were those of the Ossola Group of experts from industrial countries (August 1965) and of an experts group for UNCTAD (November 1965). UNCTAD's proposal was kept alive through the work of the Committee of Twenty in 1972–74, but the Interim Committee failed to agree on any plan to implement it. See the relevant passages of the C-20 Report of June 1974 and the Interim Committee communiqué of January 1975; in de Vries (1985), Vol. 3, pp. 173 and 219, respectively.

tion, the link remained in abeyance. Then in 1979 and 1980, after the Fund resumed allocating SDRs, the link was given a new chance at coming to life. The Group of Twenty-Four developing countries (G-24) renewed its appeal by including link proposals in the September 1979 "Program of Action on International Monetary Reform." The UN General Assembly endorsed that report in January 1980 and asked the Fund to implement its recommendations. At the same time, the report of the Brandt Commission called for further SDR allocations and suggested that the "distribution of such unconditional liquidity should favor the developing countries who presently bear high adjustment burdens" (Brandt Commission, 1980, p. 219). Responding to these appeals, the Interim Committee asked the Fund to "examine in depth" the G-24 recommendations, including the link (communiqué of April 25, 1980, para. 3).

To kick off that examination, a July 1980 staff paper set out six possible linkage schemes. Essentially, the point of the paper was that if a direct link was politically controversial and would require an amendment of the Articles of Agreement, an indirect link could be implemented just as effectively. In its simplest form, an indirect link might involve an agreement by some countries to contribute their allocated SDRs to other countries or to prescribed holders that provide development assistance, such as the World Bank.[52] The Executive Board held a preliminary discussion in August. In general, those who favored further allocations also favored a link (direct or indirect), and vice versa. Overall, however, support for a link was a little below that for proportional allocations. Tom de Vries (Alternate—Netherlands), for example, noted that although his authorities were favorable in principle, they feared that confidence in the monetary quality of the SDR was too low for such a scheme to work at present.[53]

After the Interim Committee asked for a closer examination and the staff refined its proposals a little, the Board gave the link a final hearing in December 1980. Positions did not soften, however, and de Larosière had to conclude that there was "no scope now for agreement on a specific link scheme."[54]

After 1980, the link was effectively abandoned, but related proposals to modify the allocation of SDRs to make the scheme more suitable for developing countries surfaced occasionally. Three notable suggestions were made by Executive Directors in the mid-1980s, each of which aimed to improve the distribution of SDRs without weakening the incentives for developing countries to implement effective adjustment programs. First, Jacques de Groote (Belgium) proposed in 1983 that the Fund allocate SDRs that could be used only conditionally on approval of an adjustment program, and that surplus countries make their own conditional SDRs available to deficit countries by lending them to the Fund. The following year, Bruno de Maulde

[52]"Considerations Relating to a Link Between SDR Allocation and Finance for Developing Countries," SM/80/188 (July 25, 1980).

[53]Minutes of EBM/80/125 (August 8, 1980); for de Vries, see p. 11.

[54]Minutes of EBM/80/185–186 (December 17, 1980). The quotation is from meeting 80/186, p. 9. Also see "Further Issues Relating to a Link Between SDR Allocations and Finance for Developing Countries," SM/80/266 (December 1, 1980).

(France) proposed establishment of a scheme under which industrial and certain other creditor countries would agree to lend newly allocated SDRs to developing countries, conditional on approval by the Fund of recipients' policies and the Fund's certification that the loan would strengthen recipients' reserve positions. And in 1986, Arjun Sengupta (India) proposed that industrial countries reallocate their SDRs to developing countries, subject to a requirement that these reallocated SDRs could be used only temporarily (say, for three years). Although these proposals were designed to overcome specific objections raised earlier to a general allocation, opponents concluded that none of the schemes seemed consistent with the original character of the SDR or with reliance on quotas as the basis for financing Fund lending. In July 1986, the Executive Board rejected all three proposals.[55]

One more effort at reform was made in 1988, when consideration was given to resuming SDR allocations as one means of finally resolving the international debt crisis. The main advocacy organization for commercial banks, the Institute for International Finance (IIF), issued an innovative report that year calling for a doubling of the stock of SDRs, on the same order of magnitude as Camdessus's proposal mentioned above. The IIF's intention was that heavily indebted countries would use their increased holdings of SDRs to purchase U.S. treasury securities and would pledge those bonds as collateral for debt conversions or new bank borrowing. Similarly, French President François Mitterrand proposed that industrial countries could set aside their own allocations to guarantee debt payments by qualifying developing countries.[56]

Both of those ideas were overtaken by more direct debt-relief proposals, primarily the 1989 Brady Plan (Chapter 11). Moreover, they were seen by some in the Fund as conflicting with the SDR's basic role as a global monetary asset. The IIF and French proposals, along with other ideas on enhancing the role of the SDR, were on the Executive Board agenda in March 1989, coincidentally just a few days before the Brady Plan was to be introduced by the U.S. Treasury Secretary. Once again, however, no consensus was reached and no action was taken.[57]

In 1989, the U.S. government responded to a request from congress by preparing a study on the possible use of SDRs for financing debt relief for heavily indebted low-income countries. The report, however, concluded that the SDR was an inappropriate vehicle for that purpose, because such usage would compromise the asset's properties as a monetary reserve asset and because debt-relief financing should be made conditional on improved policy performance (U.S. Treasury, 1989).

A central criticism of the early linkage proposals was that development finance should be made conditional on strong policy performance, not unconditional as

[55]See "Proposals for Post-Allocation Adjustment in the Distribution of SDRs," SM/86/154 (June 27, 1986), which includes the original proposals in an Annex; and minutes of EBM/86/125 (July 30, 1986).

[56]The IIF proposal, which was circulated as a letter to the Chairman of the Interim Committee, was published in the *IMF Survey*, Vol. 17 (April 4, 1988), pp. 102–06. Mitterrand's proposal was made in a speech to the UN General Assembly in September 1988.

[57]"The SDR and the International Monetary System," SM/89/32 (February 8, 1989); "Further Consideration of Issues Relating to Post-Allocation Adjustment in the Distribution of SDRs," SM/89/45 (February 24, 1989); and minutes of EBM/89/28B29 (March 6, 1989).

would have been the case with SDR allocations. The revised proposals of the 1980s recognized that allocations could also be made conditional, if that was desired. Voluntary redistribution by creditor countries to those in need, as discussed in 1980 and revived for consideration on several later occasions, could also have been made conditional on policy performance. More generally, in February 1989 the staff proposed a two-step procedure in which the Fund could first decide on an aggregate allocation of SDRs and then decide whether countries qualified to receive allocations, based on surveillance criteria. That is, only countries pursuing appropriate economic policies would be certified as eligible to receive SDR allocations. As with the earlier linkage proposals, the Board expressed some uneasiness about that idea and again preferred to reserve the SDR for circumstances related to global liquidity concerns.[58]

Valuing the SDR

The SDR was originally defined in a way that made its value equal to one U.S. dollar. The dollar was convertible into gold at a rate of $35 = 1 fine ounce of gold (or, equivalently, $1 = 0.888671 grams of gold). The SDR was not directly convertible into gold, but it was convertible into dollars or other convertible currencies, at a rate equivalent to 0.888671 grams of gold. After the United States suspended the convertibility of the dollar into gold in August 1971, the relevance of this "unit of value" provision in the Fund's Articles of Agreement became limited to the determination of an exchange rate between the SDR and the dollar.[59] When the dollar was devalued in 1972, the link with the value of the dollar was broken and the formal link to gold was retained. That is, the exchange value of the SDR became approximately $1.09. When the dollar was devalued again in 1973, the rate automatically changed to $1.21. By then, however, the valuation link to gold had become meaningless, because neither the SDR nor any currency was convertible into gold. The Committee of Twenty therefore agreed in 1974 to ignore the official price of gold for this purpose and to determine the value of the SDR by reference to a basket of currencies.[60]

[58]"The SDR and the International Monetary System," SM/89/32 (February 8, 1989), pp. 26–27, and minutes of EBM/89/28–29 (March 6, 1989). The Deputy Managing Director, Richard D. Erb, suggested this idea to the staff. Several years later, the proposal to make targeted allocations conditional on policy reforms was reintroduced by Ariel Buira, the Deputy Governor of the Bank of Mexico. See Buira (1996).

[59]Article XXI, Section 2, of the Articles that were in effect from 1969 to 1978. See de Vries (1976), Vol. 2, p. 121.

[60]Joseph Gold, the Fund's General Counsel, described the murky legal situation to the Executive Board as follows: ". . . the legality of adopting the [basket] mode of valuation . . . was derived from the present circumstances of disorder in which the par value system was not operating as it was intended to operate. . . ." Unless the Fund were to suspend all operations, "the only choice left . . . was to attribute gold value in some way, and to select the appropriate mode of valuation. In present circumstances the gold value would become a notion rather than a datum . . ." Minutes of EBM/74/28 (April 1, 1974), p. 17.

Table 18.4. Composition of the SDR, 1969–90
(In local currency units)

	July 1969–June 1974	July 1974–June 1978		July 1978–December 1980		1981–85		1986–90	
	Weight	Initial weight	Amount of currency	Initial weight	Amount of currency	Initial weight	Amount of currency	Initial weight	Amount of currency
Gold (grams)	0.888671								
U.S. dollars		0.330	0.4000	0.330	0.400	0.42	0.540	0.42	0.4520
Deutsche marks		0.125	0.3800	0.125	0.320	0.19	0.460	0.19	0.5270
Japanese yen		0.075	26.0000	0.075	21.000	0.13	34.000	0.15	33.4000
French francs		0.075	0.4400	0.075	0.420	0.13	0.740	0.12	1.0200
Pounds sterling		0.090	0.0450	0.075	0.050	0.13	0.071	0.12	0.0893
Canadian dollars		0.060	0.0710	0.050	0.070				
Italian lire		0.060	47.0000	0.050	52.000				
Netherlands guilders		0.045	0.1400	0.050	0.140				
Belgian francs		0.035	1.6000	0.040	1.600				
Swedish krona		0.025	0.1300	0.020	0.110				
Australian dollars		0.015	0.0120	0.015	0.017				
Danish krone		0.015	0.1100						
Norwegian krone		0.015	0.0990	0.015	0.100				
Spanish pesetas		0.015	1.1000	0.015	1.500				
Austrian shillings		0.010	0.2200	0.015	0.280				
South African rand		0.010	0.0082						
Saudi Arabian riyals		0.030	0.1300						
Iranian rials		0.020	1.7000						

In June 1974, the same month that the C-20 Report was issued, the Executive Board redefined the SDR as a basket of the currencies of the 16 countries with the highest share in international trade (see Table 18.4). The number 16 was chosen because it happened to be the cutoff point for countries accounting for at least 1 percent of world exports (see de Vries, 1985, pp. 290–93). It thus had an internal logic, but the large size of the basket eventually would make it difficult for the SDR to become accepted by financial markets. One difficulty was that as economic conditions changed, so would the composition of the basket. In 1978, the Fund dropped the Danish krone and the South African rand from the SDR, added the Saudi Arabian riyal and the Iranian rial, and changed the weights on several other component currencies. Those changes, which were cosmetic and made little difference in how the SDR behaved, were intended to keep the basket up to date and to reflect carefully considered principles on the selection of currencies. In practice, they merely reinforced the perception that the composition of the SDR was elusive and ephemeral.

A second problem was that few of the 16 currencies had a significant role in international finance. At the same time that the Fund adopted the 16-currency basket for valuing the SDR, it defined a much smaller 5-currency basket for determining the SDR interest rate (see below). As the Fund attached an increasingly higher priority to the SDR's acceptability in financial markets, this dichotomy between the interest rate basket and the valuation basket became an obstacle to rational pricing and no longer made sense.

In December 1979, the Executive Board took up the question of whether the SDR interest rate was being calculated in a satisfactory way for purposes of paying interest on the claims to be issued by the proposed substitution account. In the course of that discussion, the Board became attracted to the idea of unifying the two baskets, with something less than 16 currencies in each one.[61] In March 1980, after reviewing a detailed staff analysis on the matter, the Board narrowed the options to a range of five to nine currencies. Only nine currencies had well-developed financial markets (i.e., deep enough spot and forward markets to get efficient pricing on exchange and interest rates). In addition to the G-5 currencies, these included the Italian lira, the Netherlands guilder, the Canadian dollar, and the Belgian franc. As a practical matter, the question was whether to simultaneously raise the interest rate basket from 5 to 9 and reduce the valuation basket from 16 to 9, or to reduce the valuation basket all the way from 16 to 5. The nine-currency option was seen as less radical and as more likely to produce a stable value, while the five-currency option was seen as more sustainable, given the sharp drop-off in the depth and stability of financial markets between the top five and the other four. A clear majority of the Board favored the smaller basket, but some Directors were reluctant to go that far.[62]

Because the Executive Board normally reaches agreement by consensus, it is least effective when confronted with several options. In the spring of 1980, the Board was nearly unanimous in wanting to reduce the size of the basket, but it was far from agreeing on how small to make it. The Fund's management and staff were convinced that a five-currency basket was both the most desirable outcome and the most likely to secure a consensus, but they faced a real danger that the Board would deadlock over details. To focus attention on the preferred outcome, de Larosière proposed making the valuation basket identical to the five-currency basket already used for determining the interest rate, and he took that proposal to the Interim Committee for its Hamburg meeting in April 1980.[63]

The Interim Committee endorsed unification in principle, but as usual it left the details to be worked out by the Executive Board (communiqué of April 25, 1980, para. 7). A decision to change the basket required at least a 70 percent majority (and possibly 85, if a simple majority of the Board judged it to be a "fundamental" change in the valuation scheme),[64] which gave the developing and smaller industrial countries a key role in the decision.

What should have been a straightforward decision got a little ugly that summer, as a few countries objected to having their currencies cut out of the basket and a few others objected to the high weight that the U.S. dollar would have in the shrunken basket. At a Board seminar on the subject in July, some chairs indicated

[61]Minutes of EBM/79/188 (December 19, 1979).

[62]Minutes of EBM/80/54 (March 26, 1980). Also see "Substitution Account—Choice of Number of Currencies in SDR Valuation and Interest Rate Baskets and Timing of Change" SM/80/60 (March 13, 1980).

[63]Minutes of EBM/80/68 (April 9, 1980), pp. 17–18.

[64]"SDR Valuation—Majority for Decision," SM/80/180 (July 18, 1980).

that they could go along with a five-currency basket only if the weight on the U.S. dollar was constrained well below the level indicated by the standard formula (which gave equal weight to trade and reserve shares). Lionel D.D. Price (Alternate—United Kingdom) argued that it made little sense to apply a formula that gave the dollar a high weight because of its predominance in reserve balances, "when the major objective of the SDR was to cut back on that predominance." Ruding agreed and asked that the dollar's weight be constrained, perhaps to about 33 percent (its then-current level) instead of the indicated 44 percent.[65] That proposal might well have killed the entire simplification effort, but the staff managed to head it off by determining that artificially lowering the dollar's weight would constitute a "fundamental" change in the method of valuing the SDR.[66]

As late as mid-August 1980, a 70 percent majority appeared unobtainable for any specific reduction in the 16-currency basket, even though all chairs favored or at least said they could accept some sort of reduction. But the staff and the Managing Director kept pushing, and eventually they carried the day by proposing to make a nominal reduction in the weight on the U.S. dollar, from 44 to 42 percent. Although that adjustment was a transparent face-saver, it gave the holdouts something to take home, and the Board approved the implementing decisions on September 17 (see the Appendix to this chapter).[67]

The fuss over small shifts in weights was soon overtaken by events. By January 1, 1981, when the new basket went into effect, exchange rate changes had already pushed the U.S. dollar's weight up to 43 percent (from 31 percent under the old basket). As the dollar appreciated throughout the next four years, its weight continued to rise and reached a peak of 56 percent in February 1985 (Figure 18.4). It then declined again, and by the end of the decade was back to 34 percent.[68]

The correction of the dollar's weight in the SDR after 1985 partly reflected the reversal of the earlier shifts in exchange rates (Figure 18.5), but it resulted more directly and importantly from a revaluation of the basket effective at the beginning of 1986. The decision to convert the SDR into a five-currency basket provided that its composition would be reviewed and revised once every five years. Although it was unlikely that the selection of currencies would change, the amounts of each currency in the basket would be adjusted to restore the weights periodically to levels that reflected each currency's importance in world trade and finance.

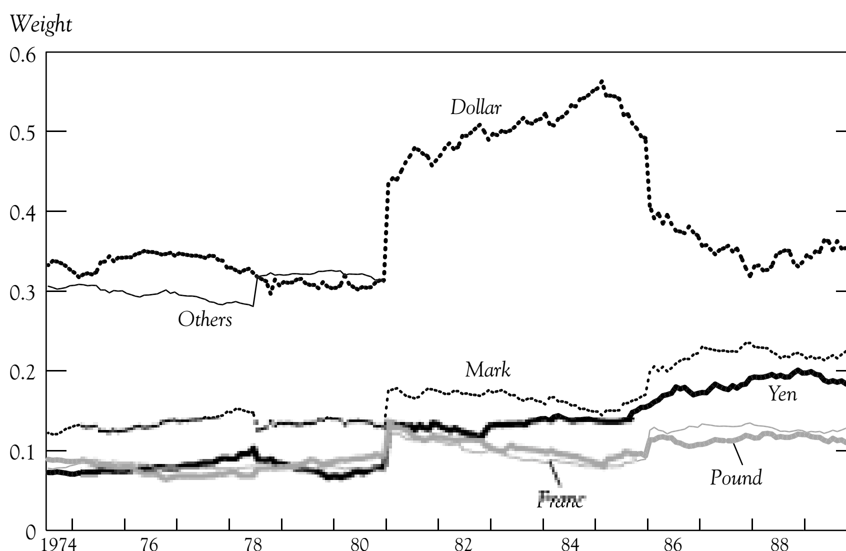
[65]Minutes of Executive Board Seminar 80/3 (July 10, 1980), pp. 8 (Price) and 12 (Ruding).

[66]Specifically, the Board accepted the view of the Legal Department that reduction of the basket to five currencies would not constitute a fundamental change unless the weight on the dollar were constrained. Thus a five-currency (or a nine-currency) basket could be adopted by a 70 percent majority, but only if the dollar's weight was determined by the previously agreed methodology. Minutes of EBM/80/116 (July 31, 1980).

[67]Minutes of EBM/80/145 (September 17, 1980). Three Directors objected to the decisions and abstained in the voting: Joaquín Muns (Spain), Tom de Vries (Alternate—Netherlands), and Heinrich G. Schneider (Alternate—Austria).

[68]Because the SDR is defined as the sum of specific fixed amounts of each currency, the weights vary daily in response to exchange rate fluctuations. That property gives the SDR a "hard currency" bias, which the Executive Board periodically offsets by revising the basket.

Figure 18.4. Weights in the Valuation of the SDR, 1974–89
(Valued at monthly average exchange rates)



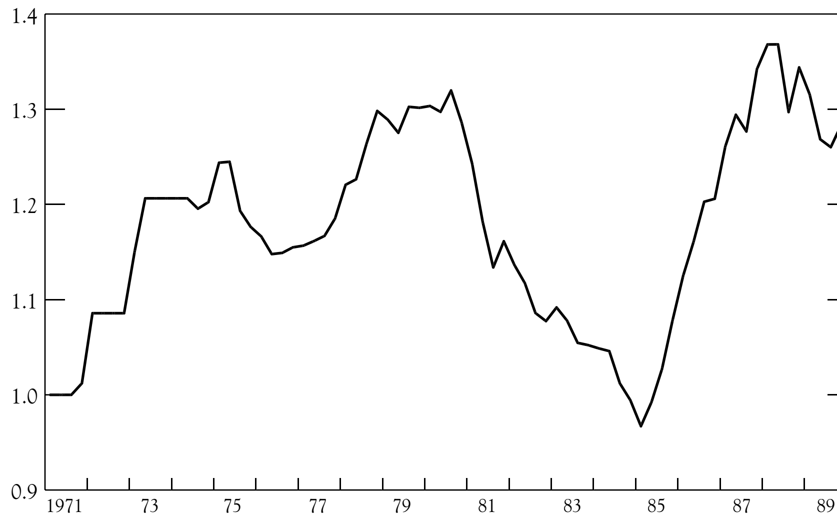
When the first review was held, the Executive Board agreed to drop the weight of the dollar back to 42 percent. Correspondingly, the weight of the deutsche mark would be raised back to 19 percent, and the relative weights of the other three currencies would be shifted slightly (see Table 18.4 and Figure 18.4). To achieve that rebalancing, it was necessary to reduce the amount of U.S. dollars in the SDR by about 16 percent (from 54 cents to 45.2) to compensate for the dollar's appreciation in the intervening years. The amount of yen was reduced marginally so as to yield a slightly higher weight for the yen than in 1981. The amounts of the other three currencies were increased.[69]

The lack of stability in the dollar throughout much of the decade may not have done much to stimulate demand for the SDR as an asset or as a measure of value, but it did enhance the quality of the SDR as a more stable alternative to any single major currency. Partly as a result of the narrowing of the basket but mostly as a result of the increased volatility of the component currencies,[70] each major currency fluctuated markedly against the SDR throughout the 1980s, and the stability of the SDR reflected the offsetting effects of those movements (Figure 18.6).

[69]On the determination of percentage weights, see "Review of the Valuation of the SDR," SM/85/163 (June 7, 1985) and minutes of EBM/85/102 (July 1, 1985).

[70]For a statistical analysis, see Pozo (1984), which rejects the hypothesis that narrowing the basket led to significantly greater variability of the exchange rate of the SDR against major currencies in 1981.

Figure 18.5. Exchange Rate: U.S. Dollars per SDR, 1971–89
(Quarterly average)

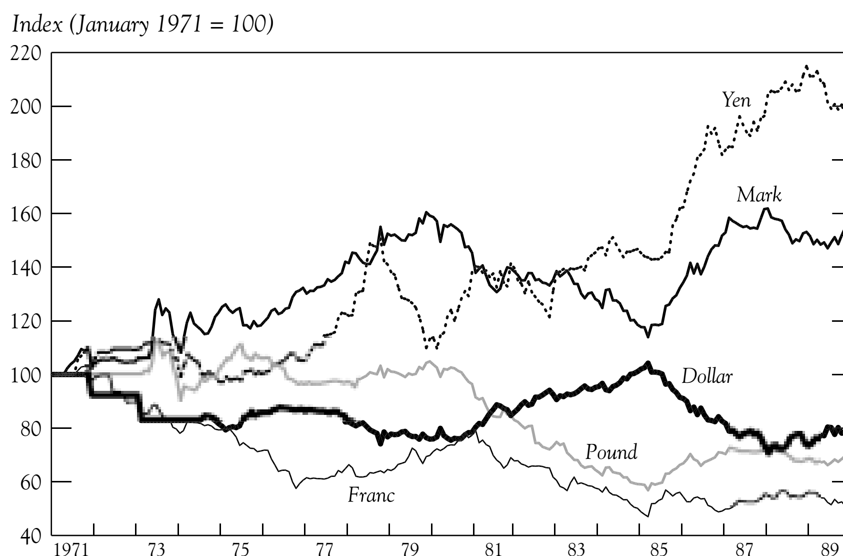


SDR Interest Rate

When the Fund designed the original SDR in the 1960s, the staff did not see the necessity or even the desirability of setting the interest rate at a market-clearing level, because the SDR was seen primarily as a substitute for gold reserves (de Vries, 1976, Vol. 1, p. 182; de Vries, 1985, pp. 282–83). The role of the SDR would be limited to a narrow range of official transactions, and the reconstitution requirement would ensure that participating countries would hold SDRs in reasonable amounts. In those conditions, a stable low interest rate was judged to be both a good means of making it affordable and attractive for countries to use SDRs and a sufficient incentive to induce them to hold SDRs as reserves. The 1969 amendment to the Articles provided that the Fund could set the SDR interest rate between 1 and 2 percent, or outside those limits under certain conditions.[71] In the event, the Board set the rate at 1.5 percent and left it there for 3½ years (Figure 18.7). In June 1974, the rate was raised abruptly to 5 percent, on the understanding that henceforth it would be set periodically at a rate approximately *half* of an appropriately weighted average rate on short-term money market securities in the

[71]The rate of remuneration on eligible reserve tranche positions (then known as "super gold tranche" positions) was 1.5 percent in 1969. Article XXVI, Section 3, provided that the Fund could set the SDR interest between 1 and 2 percent without regard to the rate of remuneration. If it set the remuneration rate outside that range, it could also set the SDR rate as high or as low as that rate.

Figure 18.6. SDR Exchange Rates, 1971–89



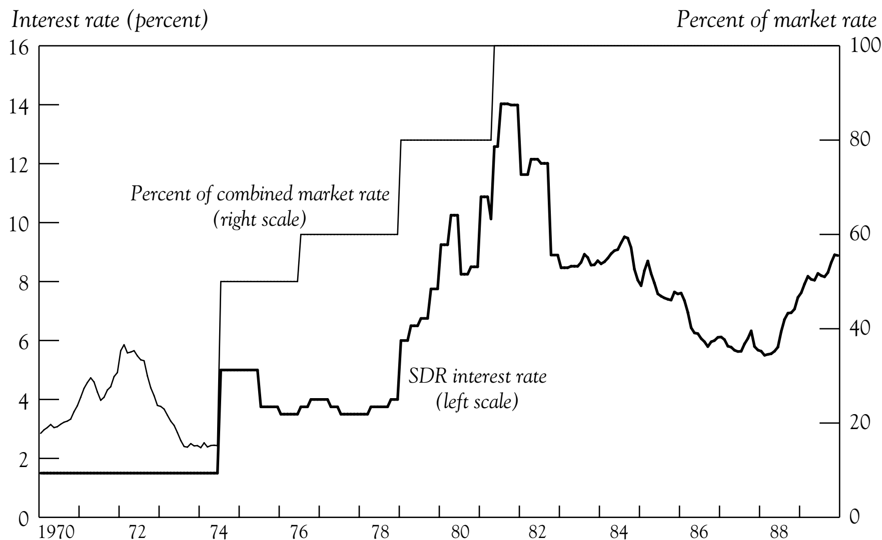
G-5 countries. On that formula, the rate was reduced to 3.75 percent in July 1974 and again to 3.5 percent in January 1976.

Effective in July 1976, the Fund changed this policy again, in three ways. First, the rate was to be set quarterly rather than semiannually. Second, the rate each quarter was to be equal to 60 percent (rather than 50 percent) of the average ("combined") market rate, rounded to the nearest ¼ of 1 percent. Third, the combined market rate was calculated more contemporaneously (based on the average over the six weeks preceding the quarter, rather than over the quarter preceding the semester). Although these changes fell far short of converting the SDR into a market-oriented financial asset, they did represent an initial effort to link the interest rate fairly directly to fluctuations in market rates.

The next step came toward the end of 1978. As of the beginning of 1979, the rate was to be calculated at 80 percent of the combined market rate. Other elements of the calculation were left unchanged, except that the base rate was now to be computed as the average rate over just 15 days prior to the start of the quarter. Ever so cautiously, the Fund was inching toward making the SDR equivalent to a bundle of national short-term securities, but it was still insisting on retaining a discount on the yield, as one component in the Fund's structure of slightly concessional interest rates (de Vries, 1985, pp. 892–95).[72]

[72]At that time, the SDR was a 16-currency basket, while the interest rate was calculated with reference to the five leading currencies. That difference, however, does not account for the discount, since interest rates in the excluded countries were not on average lower than those that were included. As noted in the preceding section, the undefined maturity of the SDR implies that the SDR interest rate and the combined market interest rate are not commensurate.

Figure 18.7. SDR Interest Rate, 1970–89



The final major move was to raise the rate to 100 percent of the combined market rate. The Executive Board took that step in December 1980, to be effective the following May, a few months after the conversion of the SDR into a five-currency basket (see the Appendix). By then, the staff and the Executive Board recognized that experience had not borne out the expectation that the SDR's stable capital value would make it attractive enough without a fully competitive yield. In proposing the increase, the staff acknowledged that raising the rate would impose costs on net users, notably on virtually all low-income countries. They argued, however, that the SDR had to be made fully competitive as an asset if it was to fulfill its potential for strengthening the international monetary system. If it was thought desirable to offset the higher costs for developing countries, that could be done by other means.[73] The G-24 followed up on that notion by trying to push the Fund to create a subsidy account for the use of SDRs by low-income countries (ministerial communiqué, April 1980; in *IMF Survey*, May 5, 1980). No action was ever taken on that proposal, and the idea of offsetting the rise in interest costs was allowed to die.

Appendix: Principal Changes in the Valuation of the SDR

In September 1980, the Executive Board agreed to redefine the SDR as a 5-currency rather than a 16-currency basket, effective in January 1981. (For the previous valuation, see de Vries, 1985, Vol. 3, pp. 556–57.) In December, the Board agreed to set the SDR interest rate equal to the com-

[73]"The Level of SDR Interest Rate in Relation to the Combined Market Rate," EBS/80/252 (November 24, 1980) and minutes of EBM/80/178 (December 8, 1980).

bined market interest rate in the countries issuing those five currencies, effective in May 1981. The initial decision was as follows.

Method of Valuation

1. Effective January 1, 1981, the value of one special drawing right shall be the sum of the values of specified amounts of the currencies listed in 2 below, the amounts of these currencies to be determined on December 31, 1980 in a manner that will ensure that, at the average exchange rates for the three-month period ending on that date, the shares of the currencies in the value of the special drawing right correspond to the weights specified for each currency in 2 below.

2. On the basis of changes in members' exports of goods and services and in official balances of members' currencies held by other members since the previous review of the method of valuation of the SDR conducted in March 1978, that the currencies and weights referred to in 1 above shall be as follows:

Currency	Weight (In per cent)
U.S. dollar	42
Deutsche mark	19
French franc	13
Japanese yen	13
Pound sterling	13

3. The list of the currencies that determine the value of the special drawing right, and the amounts of these currencies, shall be revised with effect on January 1, 1986 and on the first day of each subsequent period of five years in accordance with the following principles, unless the Fund decides otherwise in connection with a revision:

a. The currencies determining the value of the special drawing right shall be the currencies of the five members whose exports of goods and services during the five-year period ending 12 months before the effective date of the revision had the largest value, provided that a currency shall not replace another currency included in the list at the time of the determination unless the value of the exports of goods and services of the issuer of the former currency during the relevant period exceeds that of the issuer of the latter currency by at least one per cent.

b. The amounts of the five currencies referred to in a. above shall be determined on the last working day preceding the effective date of the relevant revision in a manner that will ensure that, at the average exchange rates for the three-month period ending on that date, the shares of these currencies in the value of the special drawing right correspond to percentage weights for these currencies, which shall be established for each currency in accordance with c. below.

c. The percentage weights shall reflect the value of the balances of that currency held at the end of each year by the monetary authorities of other members and the value of the exports of goods and services of the issuer of the currency over the relevant five-year period referred to in a. above, in a manner that would maintain broadly the relative significance of the factors that underlie the percentage weights in paragraph 2 above. The percentage weights shall be rounded to the nearest 1 per cent or as may be convenient.

4. The determination of the amounts of the currencies in accordance with 1 and 3 above shall be made in a manner that will ensure that the value of the special drawing right in terms of currencies on the last working day preceding the five-year period for which the determination is made will be the same under the valuation in effect before and after revision.

Decision No. 6631-(80/145) G/S, adopted September 17, 1980

Implementation of that decision required amending Rule O-1, and the subsequent decision to equate the combined market and SDR interest rates required amending Rule T-1. Rule O-2, which was not amended, is also reproduced here for convenience. For the previous versions of Rules O-1 and T-1, see de Vries (1985), Vol. 3, pp. 474 and 480.

Valuation of the SDR

O-1. The value of the SDR shall be the sum of the values of the following amounts of the following currencies:

U.S. dollar	0.54
Deutsche mark	0.46
French franc	0.74
Japanese yen	34
Pound sterling	0.071

Valuation of Currencies in Terms of the SDR

O-2. (a) The value of the United States dollar in terms of the SDR shall be equal to the reciprocal of the sum of the equivalents in United States dollars of the amounts of the currencies specified in Rule O-1, calculated on the basis of exchange rates established in accordance with procedures decided from time to time by the Fund.

(b) The value of a currency other than the United States dollar in terms of the SDR shall be determined on the basis of the value of the United States dollar in terms of the SDR in accordance with (a) above and an exchange rate for that other currency determined as follows:

(i) for the currency of a member having an exchange market in which the Fund finds that a representative spot rate for the United States dollar can be readily ascertained, that representative rate;

(ii) for the currency of a member having an exchange market in which the Fund finds that a representative spot rate for the United States dollar cannot be readily ascertained but in which a representative spot rate can be readily ascertained for a currency as described in (i), the rate calculated by reference to the representative spot rate for that currency and the rate ascertained pursuant to (i) above for the United States dollar in terms of that currency;

(iii) for the currency of any other member, a rate determined by the Fund.

(c) Procedures to establish exchange rates under (b) above shall be determined by the Fund in consultation with members.

Interest and Charges in Respect of SDRs

T-1. (a) Interest and charges in respect of SDRs shall accrue daily at the rate referred to in (b) below and shall be paid promptly as of the end of each financial year of

the Fund. The accounts of participants shall be credited with the excess of interest due over charges or debited with the excess of charges over the interest due. The accounts of holders that are not participants shall be credited with the interest due.

(b) The rate of interest on holdings of SDRs for each calendar quarter shall be equal to the combined market interest rate as determined in (c) below.

(c) The combined market interest rate shall be the sum of the average yield or rate on each of the respective instruments listed below for the fifteen business days preceding the last two business days of the last month before the calendar quarter for which interest is to be calculated, with each yield or rate multiplied by the number of units of the corresponding currency listed in Rule O-1 and the value in terms of the SDR of a unit of that currency as determined by the Fund under Rule O-2(a) and (b), provided that the combined market interest rate shall be rounded to the two nearest decimal places. The yields and rates for this calculation are:

Market yields for three-month U.S. Treasury bills.
Three-month interbank deposits rate in Germany
Three-month interbank money rate against private paper in France
Discount rate on two-month (private) bills in Japan
Market yields for three-month U.K. Treasury bills.

(d) The Fund will review the rate of interest on holdings of SDRs at the conclusion of each financial year.

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