

The interest of developing countries in securing an effective regime of exchange rate adjustment is essentially indirect. Together with the smaller industrial countries, the developing countries already have effective freedom of action in adjusting their own exchange rates. Their interests in this aspect of the reform lie primarily in the avoidance of both excessive fluctuations in the currencies of the main financial centers and trading countries, and of undue rigidities. As has been amply demonstrated in recent years, such rigidities impede the ability of the developed countries to maintain open import markets, and they induce restrictions on flow of capital and aid, as well as building up crises for the future. The prime interest of the developing countries in the exchange rate regime is therefore that it should operate smoothly, and be well safeguarded against breakdown.

#### IV THE RESERVE REGIME

The interest of the less developed countries in future arrangements for reserve settlements and reserve holding is direct, substantial and many sided. These countries have a special interest in the development of a reserve system on a deliberative and organized international basis. They have a special interest in regular allocations of Special Drawing Rights from a number of standpoints:

- they have traditionally had disproportionately low holdings of gold;
- they have a potentially high need for reserves;
- they feel an increasing need to avoid dependence on a single reserve centre;
- they suffer from the absence of an international reserve asset with a stable valuation base;
- and the developing countries are of course the potential beneficiaries of a link between international reserve creation and development aid, a facility which is a wholly appropriate feature of an international reserve system.

These considerations are developed further below. What also needs to be emphasized is that a fully fledged SDR system can be expected to emerge only in so far as it provides a basis for attaining effective regulation over global monetary reserves. This is the rationale of a full SDR system and its only sound foundation. Such regulation necessitates in turn the acceptance, by countries participating in the system, of commitments to limit their holdings of reserves in forms other than SDRs. For in the absence of such limitations, there can be no assurance or expectation that regulation of the supply of SDRs will regulate the level of world reserves as a whole. One may recall the experience of the SDR system in its first phase, 1970-72, when SDR allocations were overwhelmed by an explosion of foreign exchange reserves in the form of U.S. dollars and other currencies held in national centres and in Euro-currency markets. This experience

provides a clear forewarning of the need to integrate the SDR system with the practices of countries in the holding of their reserves as a whole.

### *Gold*

The logic of events is gradually transforming the effective character of official holdings of gold. They are being transformed from their original function of readily useable reserves to the different function of long-term assets, having an essentially investment character rather than monetary character. This evolution should in time receive formal recognition. Meanwhile, gold retains a monetary status in form but not in substance. The present arrangements under which leading central banks have agreed to avoid either sales or purchases in private gold markets have the disadvantage of freezing official gold holdings in both their monetary use and in their use as investment or commodity assets. This has led to strong pressure to permit countries, in effect, to liquefy their gold holdings by sales to the market. This suggestion has attracted growing support. Its implementation would yield both immediate practical benefits, by deflating speculative expectations in the gold market, as well as by absorbing private liquidity in the form of currency balances. More important would be the long-term benefits in the recognition of the changed character and function of official gold holdings. The very large and now clearly excessive holdings of gold in the I.M.F. provide a convenient source of substantial market sales from the official sector. By contrast, use of the free market gold price as a basis for gold settlements between monetary authorities, as has been suggested in some quarters, would constitute a backward step. It would involve a *de facto* increase in the official gold price, albeit by haphazard amounts that could introduce a new element of speculation in official reserve management. It is very doubtful whether such action would be consistent with an increasing role for SDRs. Such action would not be a complement to a move to an SDR standard, but rather an alternative, albeit of a rather dubious kind.

### *Foreign Exchange and SDRs*

Provided that a firm commitment to a predominant reserve role for the SDR is made, the measures required to accommodate official gold holdings need be neither complex nor troublesome. The far larger problem in the regulation of global reserves is posed by present and potential reserves held by countries in foreign exchange. Developing countries, and many others, have been inclined to resist suggestions that their foreign exchange reserves should be subject to certain agreed limits. They have placed considerable importance on maintaining freedom of action over their reserve holdings. These

reactions are a natural response to the difficulties in which countries have found themselves in recent years in managing their reserves. The depreciations in exchange value of the traditional reserve currencies, U.S. dollars and pounds sterling, have imposed significant exchange losses on developing countries and others with proportionately large foreign exchange holdings. These countries have been able to avoid or limit further losses only by diversifying reserves into stronger currencies and by taking advantage of higher interest rates available in Euro-markets.

These responses are fully understandable and entirely rational for individual countries in the absence of an acceptable alternative that would show them equal advantage. So long as no such alternative exists – which is the actual situation at present – it is unrealistic to expect the movement toward diversification of foreign exchange reserves to be checked. But it would be equally unwise for the small countries that have most to gain from a collective reserve system to weaken the chance of this being established, by reluctance to accept the individual commitments necessary for the success of the collective enterprise. Thus it is important for developing countries to distinguish between the losses they would incur in giving up freedom to hold reserves in the form they choose in *present circumstances*, with the very different balance of advantage resulting from an effective switch from their present foreign exchange holdings which have to be earned or borrowed, to reserves in the form of SDRs made available on a more favourable basis.

In the absence of an effective international agreement by all countries concerned, to keep strict limits on official holdings of foreign exchange, it would be difficult to be confident that SDRs would acquire a major role in world reserves, and that an assured basis for regular allocations of SDRs would be achieved. Expressions of collective intent that the reserve system should move progressively on to an SDR basis are not a substitute for the commitments that individual countries have to make in order to provide the necessary conditions for this desirable development.

The chief such commitments concern the limitation of official holdings of foreign exchange and undertakings to convert excess holdings into SDRs. One possible form of such commitments is negotiation of permissible working balances, either country by country or according to some formula. But it might be both more effective and more feasible to eliminate the need for official working balances altogether. This could be done by putting the mechanism of exchange support on an overdraft basis, with necessary balances being supplied by creditor central banks under credit lines, and the balances being settled at regular (e.g. monthly) clearings. Such a mechanism would involve a bigger break in habits of reserve managers than would limitations on working balances; but a psychological break of this kind may be

needed if the big step of moving to an SDR reserve system is to be accomplished.

### *Swaps in the IMF?*

A system of this kind could be associated with a streamlining of credit facilities in what is now the General Account of the Fund. One possibility would be to grant a new facility to all Fund member countries, to draw up to their whole quota for the purpose of offsetting payments outflows that were judged to be both temporary and reversible. Such drawings would be without policy conditionality. Repayment might be within a maximum of say one year, and the interest rate set in relation to rates in major money markets. All Fund members, including developing countries, would thereby be provided with facilities comparable to those currently enjoyed by major countries through central bank swap arrangements. A new IMF facility of this kind would also provide countries with a substitute, on advantageous terms, for the balances they have traditionally held in reserve centres; a further substitute for these balances would be provided by the additional allocations of SDRs that would become available as global reserve growth in other forms was brought under control.

### *Consolidation*

Control over accumulation of new reserve currency balances would also need to be flanked by consolidation of the large existing balances held in reserve centres. Consideration has been given to the opening of a special SDR "substitution account" for this purpose. Fears have been expressed by some developing countries that the great expansion in the size of SDR issues that would result from substitution of SDRs for existing foreign exchange balances might prejudice the supply of new SDRs through allocations. Yet substitution of SDRs should help to reinforce the provisions necessary to regulate the growth of foreign exchange reserves, so that these fears seem to be misplaced. Far the biggest discernible threat to future SDR allocations is that uncontrolled growth in reserves in other forms will leave no need and no room for additional SDRs. By helping to contain this threat, consolidation of reserve currency balances into SDRs should therefore strengthen the basis for future SDR allocations.

### *SDR Interest Rate and Valuation*

A switch of reserves from foreign exchange to SDRs appears unattractive to many countries in present conditions because of the loss in interest earnings that would be involved. This is a particularly

important consideration for developing countries. It has therefore been generally accepted that expansion in the role of the SDR would necessitate an improvement in its attractiveness as a reserve asset. This improvement should probably extend both to the interest rate and to the basis of valuation – e.g., whether the SDR should be valued in terms of some sort of weighted average of major currencies.

The current interest rate of  $1\frac{1}{2}$  per cent paid on accumulations of SDRs above allocations, and payable on net use, bears no relation to current market conditions. It is in fact based historically on the rate established in the negotiation of the IMF's General Arrangements to Borrow in 1961. The U.S. Treasury bill rate had then averaged about  $2\frac{1}{2}$  per cent in the preceding four years; in the past four years it has averaged about  $5\frac{1}{2}$  per cent.

An improvement, and clarification, is also needed in the valuation of the SDR. The current valuation defined in weight of gold has proved unsatisfactory and is currently impeding the use of SDRs in settlements. The value of the SDR is tied to the official valuation of gold, which has become an arbitrary and disputed magnitude. It reflects, on one interpretation, the haphazard extent to which changes in relationships between currencies happen to take the form of a formal devaluation of the U.S. dollar rather than appreciation in the parity or the market exchange rates of other currencies. On another interpretation, it reflects the par value of the currencies of other countries which claim to have "captured" the gold price through the (better) maintenance of their par value obligations.

In order to avoid arbitrariness or uncertainty of this kind in the value of the SDR in terms of currencies, it is probably necessary to base the SDR valuation on some weighted index of all currencies. If the SDR was given a constant value in terms of currencies as a whole, its worth would maintain a middle position between the weakest currency and the strongest. Because such a position might make the SDR appear unattractive vis a vis the strong currencies, if these held their place for substantial periods of time, it might be preferable to give extra weight to strong currencies in compilation of the index of SDR valuation, so that the SDR showed some long-term appreciation against currencies as a whole. The SDR interest rate could then safely be kept significantly below the average rate in world markets, though almost certainly not so far below as currently prevails with the rate of  $1\frac{1}{2}$  per cent.

A "hardening" in the characteristics of the SDR through either its valuation base or its interest rate has generally been resisted by developing countries. These countries tend on balance to be net users of SDRs, and expect to continue in that position, so that they would incur additional burdens from an increase in the SDR interest rate or appreciation in its currency value. Considered in isolation, this policy

position against a hardening of the SDR is well founded, and the developing countries will be well advised to maintain it.

But it is equally important to recognize that maintenance of a "soft" SDR is very much a second best or third best way of protecting the position of the developing countries. Many individual developing countries have creditor positions on SDR account, and these include some of the poorest countries; equally, the largest net users of SDRs have been rich industrial countries. Moreover, the softer the terms of the SDR, the less is the likelihood of the SDR developing a major role with an assured basis for allocations, in which the developing countries have an important interest.

#### *The Link with Development Aid*

The most efficient way of protecting and improving the position of developing countries through the SDR mechanism is the direct way – by establishing a link between allocation of SDRs and the flow of resources for use in development aid. Such a link is both feasible technically and fully justifiable in principle.

This justification has sometimes been disputed on the ground that creation of reserves should be kept separate from transfer of real resources. But such separation would introduce a new principle into reserve creation. Resource transfer has been involved in both the acquisition of gold from countries with gold mines and in the acquisition of foreign exchange from countries with reserve currency printing presses. It is a clear advantage of reserve creation through an instrument such as SDRs that it saves the real resources that are involved in gold mining, and avoids the potential instability and eventual overburdening of the position of national currencies that are involved in the growth of foreign exchange reserves.

In these ways, a fully fledged SDR scheme offers a collective benefit for the world as a whole. It is fully appropriate for the international community to take the deliberate decision to use this collective saving yielded by the common enterprise for a collective purpose. Since all the developed countries are agreed in principle on the collective purpose of increasing the supply of development aid, it is entirely rational and sound that a part of the collective saving from international reserve creation should be used to that end.

A development link for SDRs should therefore not be seen as a dubious intrusion into the scheme or a practical political necessity to obtain the support of the developing countries. In its implementation of an agreed collective purpose, the development link broadens the rationale of the SDR scheme itself. It is therefore encouraging that support for such a link is now widespread.

There remains the question of the appropriate form of the link – a question almost as controversial as the propriety of the link itself. Among individual developing countries, there is a natural instinct to prefer a link directly through their own SDR allocations, rather than through the intermediary of one or more international development institutions. In negotiations over these questions, care must be taken to preserve the principle on which a preferential allocation of SDRs to developing countries can be soundly based – namely, the global collective interest in adding to the resources of countries that need them most and are willing and able to put them to constructive developmental use. A formula that simply added a supplement to the SDR allocations of all developing countries and distributed it to them *pro rata* according to IMF quota would not be consistent with this principle. It would involve unavoidable anomalies as between countries on the border of eligibility, and these anomalies would be likely to increase over time, as the original classification of eligible countries became less suited to changing circumstances. In addition, the weak connection between such a formula and development needs and potential would not be lost on the industrial countries. These countries would on that account be likely to have fewer inhibitions in keeping the funds channelled through such a link to a minimum.

A link that was in keeping with its underlying rationale might take either of two forms, or possibly a combination between them. In both cases it is assumed that a part of the SDR allocation would continue to be allocated to all participants according to quota:

- (1) Allocation of the aid SDRs to the World Bank group and the regional development banks, on the lines that have been frequently discussed.
- (2) Allocation of the aid SDRs directly to developing countries according to a new formula varying positively with population and negatively with per capita income. Thus the smallest countries with very low income per head would have their special need recognised; and more advanced developing countries that have not in the past been considered eligible for concessionary development finance would receive support at a reduced per capita rate, and would have the size of their population taken into account in determining the amount of their special allocation. Distribution on this basis would transfer to the international sphere the general principle of the negative income tax, which is finding growing favour in a number of industrial countries in the combating of domestic poverty. Use of per capita income as a criterion for allocation would also introduce a reasonably smooth progression into the extent of eligibility, avoiding an arbitrary cut off for countries placed outside the eligible group.

A form of the link that has been discussed by the developing countries in their Group of 24 would to some extent combine the two principles outlined above. Under this scheme, allocation of aid SDRs would be direct to countries, in proportion to quota; but the least developed

countries would receive an additional special allocation; and release of all aid SDRs would be subject to confirmation by the International Development Association that the funds would be used for sound development purposes.

## V ORGANISATIONAL ISSUES

The discussions and negotiations on international monetary reform that have taken place in the past year have been carried out by the specially created Committee of Twenty, meeting at both ministerial level and deputies level. A final judgment of the success of this organisational innovation must await the outcome of the reform exercise. But there is no doubt that the formation of the committee has filled an important gap in the previous administrative structure of the IMF.

From the IMF's earliest beginnings, knowledgeable observers have believed that its influence would be enhanced if officials with immediate responsibility for policy in their own countries could be associated more closely with the direction of the Fund. This was the basis for the strong conviction held by Maynard Keynes that the Executive Directors of the Fund should not be professionalized as full time residents. Keynes envisaged that they should be high officials in their own administrations attending periodic meetings of the Fund executive board, meetings which would thereby concern themselves with the main general lines of policy. In the event this solution was rejected – though one or two countries tried initially to carry out its spirit in selecting their own appointees. The Fund's executive board consists of full time directors and alternates; it meets very frequently, and is concerned with matters of detailed administration.

The limitations of this arrangement became more marked with the growth in the Fund's membership, which made the Board of Governors of well over one hundred persons an essentially ceremonial and validating authority. A gap developed between the Executive Board, knowledgeable and expert on technicalities but somewhat remote from the centre of influence in national administrations, and the unwieldy Board of Governors consisting of finance ministers and central bank governors.

The formation in 1961 of the Group of Ten, consisting of ministers and high national officials of the major industrial countries, was in part a response to this vacuum. The Group of Ten had manifest advantages in compactness of size and in authority of its participants: but it was indefensible in its composition, excluding as it did all primary producing countries; and it had no formal place in the Fund structure. This exclusive association inevitably provoked in time the formation of other groupings to give voice to the excluded countries, and probably in-