The Use of SDR Finance for Collectively Agreed Purposes

Introduction

The international debate on international monetary reform, launched by a few academics in 1960 and by the officials in 1963, has proceeded with a logic and consistency unparalleled in other areas of international relations. The SDR agreement, in particular, constitutes a major breakthrough, deemed until recently totally utopian and unattainable, toward a rational management of the international monetary system. It has been rightly hailed as opening the door, for the first time in history:

(1) to a deliberate adjustment of reserve creation to the potential, non-inflationary growth of the world economy;

(2) to the concerted use of needed reserve increases for purposes collectively agreed by the international community.

The Agreement as it now stands, however, still fails to deal adequately with two major problems that could — and currently do — frustrate both of these objectives:

(1) the legacy of the gold-exchange standard of yesteryears, i.e. the role of gold and of reserve currencies — particularly the U.S. dollar — in the reformed system;

(2) an allocation of SDR's serving collectively agreed purposes rather than unilaterally decided national policies, potentially disruptive of equilibrium and/or obnoxious to the countries called upon to finance them through forcible SDR accumulation.

I shall limit myself below to the second of these two issues.

Main Thesis

Let me stress, first of all, what I shall not do. I shall not discuss the special "tied-aid" version of the "link" proposal of Messrs. Karlik and Scitovsky.[1] Nor shall I be arguing for a systematic "link" between reserve creation and development financing.

My main point is, very simply, that any decision of the international community to expand its holdings of fiduciary reserves, in the form of SDR's, inevitably entails, as a by-product, the creation of a lending — or giving away — potential that should, in all logic, be used for purposes collectively agreed and acceptable, rather than for the blind financing of national policies on which such agreement may not exist and which indeed may be deemed at times, as is the case today, to be internationally disruptive, financially, economically, and even politically.

This does not mean, of course, that development financing is the only, or even the best purpose on which such collective agreement could be reached. It is one, however, that has been repeatedly endorsed by the United Nations, the DAC, etc., as requiring resources substantially larger than those now allocated to it. If such supplementary resources become available as a by-product of SDR creation, their use for this purpose should at least be allowed to compete with other alternative objectives for which SDR's could be used.

I would myself certainly list among such alternative objectives the traditional lending operations of the IMF, designed to support agreed policies of monetary stabilization and restoration of balance-of-payments equilibrium, including the re-cycling or offsetting of destabilizing capital movements among major monetary and financial centers. (I would even personally consider — even though it would obviously be premature in the present state of public and official understanding of the issues — the eventual use of SDR's for the partial financing of other agreed international objectives claiming the highest priority in the United Nations, the World Health Organization, etc.).

Any such allocation of SDR finance for agreed objectives would certainly be far more desirable — and viable in the long run — than the present distribution scheme, under which 75 per cent of the SDR's are given automatically to the 26 richest countries in the world, and may be used to support whatever policies, or lack of policies, are responsible for their deficits. SDR allotments to the United States alone ($867 million in 1970) exceed the allotments ($853 million) to the 90 "less developed" member countries of the Fund, and further supplement the huge resources already derived by the United States from the privileged status of the dollar as a reserve currency for central banks and a vehicle currency for private trade and investment.

[1] In *Linking Reserve Creation and Development Assistance, A Staff Study* (April 26, 1969) and *Hearings* (May 28, 1969) of the Subcommittee on International Exchange and Payments of the Joint Economic Committee, Congress of the United States, Washington, D.C., 1969.

Objections

Three major objections have been raised against this common-sense view that *internationally created reserves should be used for internationally agreed objectives.*

The first is that the prospective beneficiaries of SDR financing will press for larger amounts of SDR creation than would be justified by the reserve requirements of feasible non-inflationary growth of the world economy. This argument, however, should not be confined to the less developed countries alone. Who can doubt that the U.S. argument for a large amount of SDR creation, at a time when the international liquidity pool is already flooded with dollars, was influenced, at least in part, by the knowledge that a large share of them (25%) would benefit the U.S. itself and help us finance our deficits and/or reconstitute our depleted level of gross reserves?

The danger of successful LDC lobbying would seem far less threatening since they hold together only 28 per cent of the total voting power, while an 85 per cent majority is required for SDR creation, and since their ability to switch the vote of other countries is relatively minimal.

A second objection, often brandished in earlier days against the "link" proposal, was that reserves should be kept liquid and could not therefore be frozen into long-term lending or investments. Little is heard of it now, after it was brilliantly refuted by Professor Machlup[2] and flouted by the officials themselves when they decided

[2] "The Cloakroom Rule of International Reserves: Reserve Creation and Resources Transfer", *Quarterly Journal of Economics*, Vol. LXXIX August, 1965.

to exempt 70 per cent of SDR spending from any repayment — or "reconstitution" — obligation whatsoever, except in the event of liquidation or withdrawal.

The only argument still widely propounded at this time is that SDR's should not be used to finance persistent deficits and permanent transfers of real resources.

Contrary to a well entrenched mythology, the LDC's are *not* the most persistent deficit countries today. Their gross reserves have indeed risen from year to year, without interruption since 1962, from $8.7 billion to $17.9 billion, as last reported for June, 1970, i.e. an increase of more than 100 per cent, larger by $3 billion over this period than that reported by the Fund for "Industrial Europe". Note, moreover, that this gross reserve increase was not financed by any substantial increase in reserve liabilities. Foreign central banks do not accumulate as reserves the LDC's currencies, and the LDC's use of IMF credit rose by only $200 million over this period. In contrast, reported U.S. and U.K. net reserves fell, during these years, by $13.7 billion, to which should be added a large portion of the $7 billion increase in the discrepancy noted by the IMF between reported foreign exchange assets and the combined U.S. and U.K. liabilities to foreign monetary authorities.

The main answer against the objection that the "link" proposal would entail unnecessary transfers of real resources was given by Professor Machlup in the article quoted above. The fact is that "historically, international reserves have always been earned through the transfer of real resources and, to the industrial countries, the cost of reserves under a plan of distributing new reserves first to less developed countries is no higher than the cost of reserves under the gold standard... When gold is the only international reserve money, some Africans, Australians and Asians (and a few North Americans) must work in the mines to dig the stuff out of the ground. When credit entries in the books of an acceptable organization become substitutes for gold, work on highways, railroads, harbors, power plants, hospitals, and schools of developing countries can take the place of work in the gold mines... the savings in the production of the low-cost substitute must be distributed somehow, and if the producer, in this case the International Reserve Institution, holds a monopoly, the distribution is for the owners of the company to decide. If they are so inclined, they may well let the developing countries have the lion's share".

Under the gold-exchange standard of yesteryears and the *de facto* paper-dollar standard of today, real resources are also transferred by the reserve holders, but to the reserve-currency countries, which are free to use them as they like. In former days, Britain used them to expand its lending and investments mostly in the under-developed countries of the Commonwealth and South America, and the United States to finance postwar reconstruction, development, and military security and assistance. More recently, however, both Britain and the United States have used the resources derived from the system to sustain policies less generally agreed by their creditors, such as questionable internal monetary and fiscal policies, a huge level of military expenditures at home and abroad, a vast expansion of direct investments in the developed — rather than the under-developed — countries, etc., to say nothing of war operations and escalation in South East Asia.

The resources derived by the reserve-currency debtors from this system now total more than $43 billion, and increased by nearly $12 billion last year alone. Is there any conceivable argument for earmarking automatically for the same countries, as is now done, the lion's share of SDR creation?

Professor Johnson agrees with Professor Machlup and with myself that "the logical long-run solution to the international liquidity problem is obviously to convert the International Monetary Fund into a world central bank... operated by international cooperation in the interests of the international economy as a whole...".[3] He goes on, however, to say that, unfortunately, this logical solution is not likely to be achievable in today's world, and considers as more likely alternatives either a gold price increase, or a fullblown paper dollar standard, or a floating exchange-rate standard, accompanied by a larger central banking role for the Fund and some improvements in the adjustment mechanism.

He may — *unfortunately*, as he says himself — be right, but I would like to make two points about this prediction. The first is that I deplore the prevailing tendency of many economic advisers to seem more concerned about being good forecasters than good advisers, and to encourage thereby their advisees to accept second or third best solutions rather than fight for the best ones. This may

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[3] *Hearings* (May 28, 1969) of the Subcommittee on International Exchange Payments, Washington, D.C., 1969, p. 25.

be wise for official advisers, from a career viewpoint, but academic experts and educators should put their main stress on educating officials and public opinion, at the risk of seeing their advice rejected by the politicians as premature, or too hard to follow. Policy is not just the art of the possible. It should be, even more, *the art of making possible tomorrow what seems impossible today.*

My second comment is that, even if we accept Professor Johnson's boundary conditions as to what are *likely* alternatives to the most desirable solution, we should draw a sharper distinction between a "*full-blown paper-dollar standard*" and a "*floating exchange-rate standard*". The former could be, and indeed is at present, the very antithesis of the latter. Exchange-rate readjustments would be far prompter and inescapable if deficits were no longer financed by unlimited acceptance of any national paper currency — particularly the dollar today — as monetary reserves by other countries. Barring, or at least limiting, the accumulation of national currencies as international monetary reserves should be the first step toward a strengthening of the adjustment mechanism. The United States, for instance, would obviously have been unable to sustain, since the end of 1949, such large, persistent and growing deficits if it had not benefited from reserve accumulation of about $41 billion from foreign central ($24 billion) and commercial ($17 billion) banks. It would, like any other country, have been forced to readjust through changes either in its domestic policies or in its exchange rate.

This leaves open, of course, the question whether exchange-rate readjustments should be forced on the persistent reserve losers or the persistent reserve gainers. I can only fall back here upon my "fork" proposal. Ideally,

1. Claims on the IMF, including SDR's, should ultimately become the only reserve instrument — except for limited working balances — available to central banks either to accumulate reserves or to finance deficits.

2. Whichever country gains or loses reserves in excessive amounts compared to some "normal" level, should enter into consultation with the Fund.

3. At this point, further interventions in the market should be subordinated to agreement on appropriate domestic policies and exchange rates, possibly supported in the case of deficit countries by reserve financing —in the form of either SDR's or normal IMF

drawings — and in the case of surplus countries by their continued acceptance of reserve increases in the form of gold-inconvertible claims on the Fund.

4. Failing such agreement, the deficit country should be denied IMF assistance and its reserve losses should make it impossible for it to preserve, through market interventions, its overvalued rate and/or inflationary policies. Conversely, the surplus country should be barred from any further stabilization intervention in the market, in defense of an undervalued rate, and its rate would float upward unless it changed its domestic policies.

Of course, compromise solutions might, instead of barring outright any further market interventions, taper them off in absolute amount, or limit them to the amounts necessary to produce a "desired change" in rates, or to smooth out readjustments to an agreed "crawl", rather than to force abrupt changes reflecting disruptive and excessive speculative movements and expectations.

Put in a nutshell, the fork proposal suggests that the monetary authorities should have a certain leeway — within the "fork" — to protect their exchange rate and domestic price levels against the impact of temporary imbalance. Beyond a certain point, however, they should be barred from exporting indefinitely their inflation or deflation to other countries, through reserve financing, except to the extent that this is agreed by their partners to be a lesser evil than the consequences flowing from too abrupt a readjustment of their domestic policies.

The use of SDR assistance to finance development would only be a facet of these broad guidelines. SDR and IMF reserve creation, in general, should be devoted primarily to the support of stabilization, readjustment policies. But such assistance to the richer countries should be limited in amount, and especially in duration. The main argument for enduring forms of reserve financing should be limited to the less developed countries, the richer ones being called upon, as indeed they have always been in the past, to earn through the transfer of real resources whatever reserves they wish to accumulate in order to enable themselves to avoid premature or unnecessary changes in their domestic policies and/or exchange rates.

The only burden imposed thereby on the persistent surplus countries would be the denial of their right to preserve undervalued exchange rates by gold or foreign exchange accumulation. It should

be noted, however, that such accumulation is just as inflationary, domestically, as the accumulation of SDR's or other claims on the IMF. If they don't like it, they can always avoid it through changes in their domestic policies or in their exchange rates and/or through their refusal to participate in an excessive creation of SDR's.

I am under no illusion, however, that they will easily renounce their present privilege to opt either to finance their reserve accumulation through the acquisition of reserve balances on the U.S., the U.K., or any other potential reserve debtors, or to withdraw such financing at any time through gold conversion of reserves balances accumulated in the past. This privilege, however, surely does not contribute to the strengthening of the adjustment mechanism!

The reform that I have been proposing for the last ten years may still be regarded as unnegotiable today. But I repeat my previous observation: Politics should not be limited to the art of doing what is possible today. It should also encompass — particularly for academic policy advisers — *the art of making possible tomorrow what is still deemed to be impossible today.*

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TABLE 1

GROSS RESERVE INCREASES: 1960-1970
(in billions of U.S. dollars)

	1960-1969 Yearly Average	1970		
		Year	Jan.-June	July-Dec. (pr.)
Gold	0.2	– 1.8	– 0.1	– 1.8
Reserves in IMF	0.2	1.0	0.4	0.6
SDR's	x	3.1	3.2	—
Foreign Exchange:	*1.5*	*11.8*	2.6	*9.3*
United States	0.3	– 2.2	– 1.6	– 0.5
Other Countries	1.3	14.0	4.2	9.8
Total	2.0	*14.1*	*6.1*	*8.0*
United States	– 0.5	– 2.5	– 0.6	– 1.8
Other Countries	2.5	16.6	6.7	9.8

SOURCE: *International Financial Statistics, February,* 1971.

Notes:

1. Unreported estimates of gold and foreign exchange for the United Kingdom and a few non-industrial countries were filled in by using the last estimates reported. Resulting errors are unlikely to total more than a few hundred million dollars.

2. The huge 1970 increase in official foreign exchange holdings reflects primarily an increase in official claims on the U.S. — due in part to a sharp reduction ($5 billion through November) in U.S. short-term liabilities to commercial banks abroad — and in the discrepancy between reported assets and combined U.S. and U.K. liabilities. Reported U.K. liabilities, however, *declined* by about $1.6 billion in the first nine months of the year.

THE U.S. BALANCE OF PAYMENTS, 1960 - SEPT., 1970 — TABLE 2
(Years, or yearly rates seasonally adjusted, in billions of U.S. dollars)

	Average		1964	1968	1969	1970	
	1960-64	1965-67				Jan.-June	July-Sept.
I *Current Account* . . .	5.2	*4.8*	*7.8*	*1.4*	*0.8*	2.5	*2.6*
A. Civilian	7.6	7.5	9.9	4.5	4.1	6.0	6.1
B. Military	−2.4	−2.7	− 2.1	−3.1	− 3.3	− 3.5	− 3.5
II *Exports of U.S. Capital*	*8.6*	*9.3*	*11.3*	9.9	*11.9*	*12.5*	*10.1*
A. Official	3.1	4.0	3.6	4.0	3.8	3.2	3.0
B. Private	4.5	4.6	6.6	5.4	5.2	7.1	5.4
C. Errors and Omissions	1.0	0.7	1.1	0.5	2.8	2.2	1.7
III *Excess of II over I*	*−3.5*	*−4.5*	*− 3.5*	*−8.5*	*−11.1*	*−10.0*	− 7.5
financed by							
A. *Foreign Capital* (−)	*−2.6*	*−4.0*	*− 3.3*	*−9.4*	*−12.3*	− 7.8	*− 5.1*
1. Private	−0.9	−1.7	− 0.5	−6.8	− 4.6	− 3.3	− 4.8
2. Banking	−1.7	−2.3	− 2.8	−2.6	− 7.7	− 4.6	− 0.4
(a) Commercial Banks . . .	−0.5	−1.4	− 1.5	−3.4	− 9.2	3.9	5.5
(b) Central Banks and IMF . .	−1.2	−0.9	− 1.4	0.7	1.5	− 7.6	− 5.0
(c) SDR Allotments . . .	x	x	x	x	x	− 0.9	− 0.9
B. *Gross Reserve Losses* (−) (of which gold)	*−1.0* (−0.8)	*−0.6* (−1.1)	*− 0.2* (− 0.1)	*0.9* (−1.2)	*1.2* (1.0)	*− 2.1* (0.1)	*− 2.3* (− 1.2)
Memo Items:							
1. Liquidity Balance . .	−2.9	−2.1	− 2.8	0.2	− 7.0	− 6.2	− 3.4
2. Net Reserves Balance [lines III A 2 (b) and (c) and III B] .	*−2.1*	*−1.5*	*− 1.6*	*1.6*	2.7	*−10.2*	*− 8.2*

SOURCE: *Survey of Current Business.*

Notes:

1. Capital exports are shown throughout without sign, and imports with *minus* sign.

2. Errors and omissions, whose recent increases are ascribed by the *Survey* to U.S. capital exports to the Euro-dollar market, have been included throughout with U.S. capital exports, in order to simplify the table.

3. For simplicity sake, non-scheduled debt repayments are deducted from gross exports of official capital rather than added to reserve losses. They never exceeded $100 million in the yearly averages shown here.

4. Note the extraordinary stability of exports of U.S. capital (line II) in the face of sharp fluctuations in the current account surplus (line I). Most of the difference (line III) is covered by capital imports from private sources ($6.8 billion in 1968), from commercial banks ($9.2 billion in 1969), or, failing these, from central banks (as in 1970).

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