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ON LINKING RESERVE CREATION AND DEVELOPMENT ASSISTANCE

A STAFF STUDY

PREPARED FOR USE OF THE

SUBCOMMITTEE ON INTERNATIONAL EXCHANGE AND PAYMENTS

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

APRIL 1969

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LETTERS OF TRANSMITTAL

APRIL 14, 1969.

To the Members of the Joint Economic Committee:

Transmitted herewith for the use of the members of the Joint Economic Committee and other Members of Congress is a staff document prepared for the Subcommittee on International Exchange and Payments, entitled "On Linking Reserve Creation and Development Assistance."

The views expressed in this document do not necessarily represent the views of members of the committee or of persons on the committee staff, other than the author.

WRIGHT PATMAN,
Chairman, Joint Economic Committee.

APRIL 11, 1969.

Hon. WRIGHT PATMAN,
Chairman, Joint Economic Committee,
Congress of the United States.

DEAR MR. CHAIRMAN: Transmitted herewith is a study prepared by John R. Karlik, staff economist, entitled "On Linking Reserve Creation and Development Assistance." He argues that such a link is desirable to insure an adequate supply of international liquidity and to increase economic assistance to developing nations.

This study was prepared for the members of the Subcommittee on International Exchange and Payments as background material for our forthcoming hearings on the various linkage proposals. Our publication of this study, of course, in no way commits us to support this particular proposal, and others will undoubtedly be discussed during the hearings.

HENRY S. REUSS,
Chairman, Subcommittee on International Exchange and Payments.

APRIL 10, 1969.

Hon. HENRY S. REUSS,
Chairman, Subcommittee on International Exchange and Payments,
Joint Economic Committee, U.S. Congress.

DEAR MR. CHAIRMAN: Transmitted herewith is a study prepared by John R. Karlik, staff international economist, entitled "On Linking Reserve Creation and Development Assistance." The study argues that a special issue of SDR's be made available for purchase by IMF members desiring additional reserves. The proceeds of these purchases would then be distributed to developing countries for their expenditure.

JOHN R. STARK,
Executive Director, Joint Economic Committee.

April 9, 1969.

Mr. John R. Stark,
Executive Director, Joint Economic Committee.

Dear Mr. Stark: Attached is a study I have prepared for the Subcommittee on International Exchange and Payments entitled "On Linking Reserve Creation and Development Assistance." Ratification of the Special Drawing Rights amendment to the IMF Articles of Agreement will give that organization the capability to create internationally acceptable reserve-assets. My study suggests that, at least in part, the creation of reserves be used to finance larger transfers of real resources to developing countries.

As my discussion points out, the idea of using reserve creation to finance development assistance is not a new one. But, so far as I know, my argument for an explicit link is original. Most previous arguments have observed that the quantity of assistance extended from industrial to developing nations is inadequate and that—on humanitarian grounds—a link would be a convenient way to increase such assistance.

By contrast, my argument is based on the stipulations of the SDR amendment and on the mechanics of the international monetary system. For reasons outlined in the study, I anticipate that the quantity of additional reserves supplied through the pending SDR facility will be insufficient. Insufficiency would tend to increase the risk of global deflation or monetary instability. This inadequacy can be eliminated, I believe, with minimal interference to the international monetary system by distributing a supplemental increment of SDR's through a mechanism that increases assistance to developing countries. Thus, the primary objective of my proposal is to insure an adequate supply of reserves; increased aid for development is an associated benefit, but one essential to the smooth functioning of the distribution process.

For their valuable comments on an earlier draft, I would like to express my indebtedness to Drs. Edward M. Bernstein and Grant Taplin, and to Profs. Roger Lawrence, Benjamin J. Cohen, and Robert Triffin. Of course, neither any of these individuals nor the members of the Joint Economic Committee should be held responsible for whatever logical fallacies remain. I alone must answer for such errors.

Sincerely,

John R. Karlik,
International Economist.

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ON LINKING RESERVE CREATION AND DEVELOPMENT ASSISTANCE

BY

JOHN R. KARLIK

International Economist

Joint Economic Committee

Introduction

For some time academic economists and officials of governments and international organizations have considered the possibility of linking reserve creation by the International Monetary Fund (IMF) with assistance to developing nations. The prospective ratification and activation of the Special Drawing Rights (SDR) amendment to the IMF Articles of Agreement will make multilateral reserve creation an accomplished fact. A link with development assistance may therefore be reconsidered as a useful extension of this new facility.

According to the proponents of a link, reserve creation, in addition to expanding the supply of international liquidity, also offers the opportunity to finance additional transfers of real resources to impoverished countries. The most prominent advocates of such a link are probably Maxwell Stamp and Robert Triffin.[1] On the other hand, Harry Johnson and others have offered reasoned opposition.[2] As for official attitudes, it is known that some Western European governments have quite staunchly resisted any explicit link between reserve creation and development assistance, and none of the "Anglo-Saxon" nations has elected to push strongly for such an arrangement.

Two possible mechanisms for effecting real transfers have been considered by the advocates.[3] First, multilaterally guaranteed reserve-assets might be issued to one of the organizations, such as the World Bank, specializing in the financing of development projects. That insti-

[1] Sir Maxwell Stamp, "The Stamp Plan—1962 Version" in *World Monetary Reform*, edited by Herbert G. Grubel (Stanford: Stanford University Press, 1963), pp. 80–89; Robert Triffin, *Our International Monetary System: Yesterday, Today, and Tomorrow* (New York: Random House, 1968), pp. 136–139. See also the Report of a Group of UNCTAD Experts, *International Monetary Issues and the Developing Countries* (New York: United Nations, 1965), Sales No.: 66.II.D.2, pp. 26–31, and Benjamin J. Cohen, *Adjustment Costs and the Distribution of New Reserves*, Princeton Studies in International Finance, No. 18 (Princeton: International Finance Section, 1966).

[2] See Johnson's comments on the Stamp Plan in *World Monetary Reform, op cit.*, pp. 380–81 and his review of Triffin's *Our International Monetary System* in Book World, August 11, 1968. Note also Triffin's comments on the Stamp Plan in *World Monetary Reform, op. cit.*, pp. 429–30, 433. Both Johnson and Triffin raise the issue of acceptability or "backing"; on this question, see Fritz Machlup, *Remaking the International Monetary System: The Rio Agreement and Beyond* (Baltimore: Johns Hopkins Press, 1968), pp. 64–66 and "The Cloakroom Rule of International Reserves: Reserve Creation and Resources Transfer," *Quarterly Journal of Economics*, LXXIX (August, 1965), p. 343.

[3] In his speech to the Board of Governors at the 1968 annual meeting, Emilio Colombo of Italy suggested that industrial countries "use the part of their reserves corresponding to a portion of their special drawing rights allocations for the replenishment of IDA or for subscription to World Bank bonds"; see *Summary Proceedings Annual Meeting, 1968* (Washington: IMF, 1968), p. 81. This mechanism, however, would depend upon voluntary contributions and not an explicit link between reserve creation and development assistance in the distribution of new reserves.

tution would then sell these reserve-assets to governments in return for their own currency or acceptable foreign exchange, and the funds so obtained would be loaned to developing countries. Expenditure of the funds for imports would complete the transfer process. Alternatively, the reserve-assets could be distributed directly to the developing countries themselves, which would then use these instruments to finance import surpluses.

The most common objection to any link between reserve creation and aid to developing countries rests on a distinction between the objectives of these two activities. The goal of multilateral reserve creation is to maintain an adequate global stock of reserves through the distribution of additional liquidity whenever necessary. The global stock of reserves may be considered just adequate when the aggregate surpluses of nations holding more reserves than they desire is equal to the aggregate deficiences of countries with fewer reserves than they would prefer to hold.[4] By contrast, the goal of assistance to developing nations is to help them grow more rapidly. Although the poorer countries of the world have asked for yearly transfers equivalent to one percent of the total annual gross national product of the industrialized nations, there is no explicit level of transfers that is necessarily appropriate in any objective sense.

Opponents of any link between these two goals have generally pointed out that the objectives are distinct, that there is no direct interrelationship between them, and, therefore, that each problem should be solved independently according to its particular facets. Such a distinction between objectives and the means used to attain them is normally a sound analytical and practical device. Occasionally, however, two problems can be solved more easily if considered together rather than independently. The linking of separable issues is perhaps most commonly used as a political tactic, but occasionally examples also occur in the area of economic policy. For instance, both domestic monopolies and persistent external surpluses can be attacked through the removal of tariff barriers, even though there may be no causal link between the two problems.

Abstract of an Argument To Link Reserve Creation and Development Assistance

The following outline describes a set of circumstances under which the task of providing an adequate amount of international liquidity would be simplified if reserve creation were linked with a facility providing financial assistance to developing nations. Some of the necessary conditions already exist, and the others can be expected to come about in the future. The subsequent analysis offers evidence to support each step in the outline.

1. The potential for net additions to the global stock of reserves through gold purchases by monetary authorities and through the acquisition of U.S. dollar assets is limited.

[4] This definition of reserve adequacy at a particular instant seems widely accepted today, although this writer at least is uncertain who initially formulated the definition as it appears above. Also popular are various "dynamic" definitions similar to the one used herein and apparently leading to the same outcome, viz., the growth rate of the global reserve stock is appropriate when throughout the world as a whole the growth of purchasing power is equivalent to the expansion of productive potential and, therefore, when there is no net tendency for either inflation or deflation. An example of a similar "dynamic" definition appears in Machlup, *op. cit.*, pp. 42–45.

2. At some future time the preponderance of reserve increases will therefore result from the multilateral creation of mutually acceptable reserve-assets, such as Special Drawing Rights.

3. But several European nations have a conservative outlook regarding multilateral reserve creation, and the SDR amendment to the IMF Articles of Agreement requires that any distribution of SDR's be approved by nations holding 85 percent of the voting power in the Fund. Thus, the supply of multilaterally created reserve-assets will most likely be insufficient. The following discussion argues that countries holding at least 63 percent of the voting power in the Fund will probably find SDR distributions inadequate.

4. This inadequacy could be reflected in two ways: first, an increase in pressures from central banks for reserve acquisitions in the form of gold purchases or additions to their dollar holdings; second, a general deflationary tendency throughout the world and a slowdown in the growth of international trade.

5. But there is no reason to permit a lag in the expansion of trade or to risk the stability of the international monetary system by introducing measures to increase the availability of gold or dollar reserves. A preferable solution would make available a limited quantity of additional SDR's that nations experiencing reserve deficiencies could buy at their own discretion with the foreign exchange proceeds of payments surpluses. From the point of view of nations fearing excessive multilateral reserve creation, this method of providing additional reserves would have several advantages over larger general distributions of SDR's.

6. The proceeds from the sale of these reserves could then be loaned to developing countries to finance imports and enable more rapid economic growth. Through this mechanism real transfers from industrial nations would help prevent the emergence of payments deficits.

7. To summarize, international monetary stability would be maintained, and transfers of real resources from industrial to developing nations would be effected. An adequate supply of reserves *and* completion of the transfer cycle would insure against any unnecessary deflation or slowdown in the expansion of world trade.

Limitations on Traditional Sources of Reserve-Assets

During the postwar era, most net additions to the global stock of reserves have been either in the form of gold supplied by producer nations or in the form of dollar-denominated assets representing the counterpart of U.S. payments deficits. Even before the March 17, 1968, Washington agreement—in which the representatives of the active Gold Pool nations asserted that purchases of gold from the free market were "no longer necessary"—the undependability of year-to-year increases in gold reserves was widely recognized and well documented. Although the level of production remained virtually unchanged in 1966 and 1967, during both years gold purchases by speculators and hoarders resulted in net declines in the global stock of monetary gold reserves. During most of 1968, South Africa—the largest supplier—withheld gold from the free market to maintain the price or even drive it higher.

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As long as the major industrial nations continue to observe the March 1968 Washington agreement, any significant increase in the stock of monetary gold reserves is impossible. But even if for some unforeseen reason the agreement does break down, and if South Africa resumes the previous level of sales, annual increases in worldwide gold reserves will still be subject to the vagaries of speculative demand. Thus, under any circumstances, the supply of monetary gold will remain unreliable and unsatisfactory as a basis for an orderly expansion of the stock of global reserves.

The extent to which dollar reserves can continue to increase without seriously endangering international monetary stability is also uncertain. Because of this uncertainty, both European and American officials have advised caution and virtual elimination of U.S. official settlements deficits at the earliest possible date. No one can accurately predict the level of United States liabilities to foreign monetary authorities that would precipitate a crisis substantially curtailing the acceptability of the dollar as a reserve-asset. The level is probably higher than even most informed persons would guess, and to some extent it also depends on the rate at which the U.S. runs deficits. But the network of international monetary cooperation, although resilient, is not invulnerable, and some absolute limit or maximum tolerable rate of increase in liabilities to official foreigners must exist. A disturbance like that of early 1968 suggests that at the time, the limit was in fact being approached. Because of the potentially disastrous consequences of loss of the dollar's acceptability as a reserve-asset, responsible officials can only seek to preserve a margin of safety and to curtail or eliminate U.S. payments deficits as soon as possible.

The Need for Multilateral Reserve Creation

Discussions of the appropriate rate of increase in the global stock of reserves generally recommend an annual growth of from about 2 to 4 percent, or from approximately $1.5 to $3 billion each year. Currently the increase in gold reserves is virtually nil, and even with a return to the former system, available supplies of monetary gold could not be depended upon to furnish more than a half to a quarter of this amount. Nor could repeated U.S. payments deficits bring steady reserve increases of this size without eventually endangering the reserve-asset status of the dollar and the stability of the international monetary system. Therefore, at some time in the future multilateral reserve creation will become more important than any other single source of supply in the continued expansion of international liquidity.

The Ability of the IMF To Supply Reserves

Given the major role the International Monetary Fund will be called upon to play in assuring an adequate supply of international liquidity, its ability to do so—and the suitability of the SDR amendment in particular—is a critical element in fostering the orderly growth of the international monetary system. Since the pending amendment requires that any distribution of Special Drawing Rights have the approval of countries holding at least 85 percent of the voting power in the Fund, an analysis of the prospective ability of the IMF to create reserves

must begin with a consideration of the likely voting behavior of member nations. For purposes of clarity, the decisions of a single nation are examined first.

The economic interests of a single IMF member dictate that any addition to its desired stock of reserves be acquired initially through a distribution of SDR's rather than through payments surpluses vis-a-vis the outside world. The distribution of SDR's is analogous to a decision by, say, the stockholders and depositers in an isolated country bank to vote themselves an increase in the checking account balance of each—no initial transfer of real resources is required. On the other hand, if a nation is to increase its reserves via a payments surplus, it must do so through the net exports of goods and services or through net sales of equity or debt instruments to foreigners. By comparison with the traditional forms of acquiring reserves, the acquisition of SDR's is costless. Subsequent to acquisition, the respective benefits and costs of using SDR's to finance temporary balance-of-payments deficits and of later reconstituting a depleted reserve stock are precisely the same as the benefits and costs of using any other type of reserve-asset in the same way.[5] Thus, it is in the interest of each IMF member to obtain the largest possible proportion of desired reserve gains in the form of Special Drawing Rights, since this method of obtaining reserves entails no acquisition cost.

The pending amendment also specifies that SDR's are to be distributed in proportion to the quotas of the Fund members participating in the allocation. Thus, given a proposal to distribute, say, an aggregate amount of $1 billion SDR's, each member will be able to estimate its portion of this distribution and whether the amount allocated to it is larger or smaller than the desired increase in its reserve stock. Similarly, given its quota, the nation's officials can compute the distribution that would bring an allocation equivalent to the desired increase in reserves.

Presumably a nation's Governor to the IMF would approve any proposed distribution equal to or smaller than the hypothetical distribution required to yield the desired expansion of reserves. A proposal less than the desired hypothetical level would be approved because half a basket of a desired free good is preferable to none. But a proposal in excess of the desired level would be rejected—at least in this simplistic formulation—since these additional reserve gains would offer no desired benefit and would bring additional but avoidable risks of involuntary resource transfers to foreigners. To the extent that SDR distributions are larger, the probability increases that a given country will unexpectedly find itself in surplus with developing nations or industrial countries using Special Drawing Rights to finance incoming real transfers and investments abroad. Moreover, as the size of a nation's allocation grows, its obligation to accept SDR's—under the agreement—increases threefold.

A country that elects not to participate in the initial SDR distribution avoids any commitment to accept SDR's from other nations running payments deficits, but it also forgoes the benefit of obtaining

[5] For a more detailed discussion of these costs and benefits, see John R. Karlik, "The Costs and Benefits of Being a Reserve-Currency Country: A Theoretical Approach Applied to the United States" in *The Open Economy: Essays on International Trade and Finance*, edited by Peter B. Kenen and Roger Lawrence (New York: Columbia University Press, 1968), pp. 314–18.

reserves at no cost. If it participates in the first allocation but rejects a subsequent one, however, the nation will still be required to accept SDR's as long as its total holdings are less than three times its past allocations. Thus, subsequent rejections may not offer the same protection against involuntary reserve acquisitions, although similar benefits are forgone.

When contemplating rejection of an SDR distribution because of its excessive size, a highly sophisticated analyst might compare the expected real cost of achieving desired reserve gains through payments surpluses (the consequences of rejection) against the expected real cost of involuntarily accepting excess SDR's from deficit nations (the consequences of acceptance). He would presumably then choose the course that seemed to entail lower costs. For a variety of reasons that will be discussed further, the calculations required to formulate these expectations explicitly and to compare them are probably too complex and dubious in their accuracy to have a practical impact on the decisions of officials. For this reason, the following analysis pursues the implications of the simpler model that has been introduced. In this model, decisions are based on a straightforward comparison of the size of desired increases in a nation's reserves and its share of a proposed allocation of SDR's.

If every IMF member votes upon the size of proposed SDR distributions in accordance with this simplistic formulation, what is the consequent implication regarding the adequacy of multilaterally created reserves? In canvassing the members, the Managing Director of the Fund will presumably question them concerning the size of the distributions they would find acceptable and unacceptable. He might begin with a comparatively modest figure and then move upwards until, in the opinion of the member under questioning, the distribution would be too large. One might also presume that the Managing Director will strive for the largest possible distribution that will obtain the required majority approval, since he is interested in assuring the adequacy of the global reserve stock and in "expanding" the activities of the Fund.

The proposed size of the distribution might thus be moved upwards until, at most, nations holding 14-plus percent of the voting power in the Fund disapprove because they consider the proposal to be excessive. The desired distributions of the remaining members, i.e., those approving the proposal, will then range upwards. If there is a country precisely on the margin, then the distribution actually selected will equal its desired distribution. Suppose the United States, the country with the largest proportionate voting power (21.6 percent of the total), is that marginal country. Then nations with up to 15 percent of the voting power in the Fund will oppose the suggested distribution because they find it too large, and nations with *at least* 63 percent (100 − [15 + 22]) of the voting power will consider it too small. Despite their negative votes, the former 15 percent can elect whether or not to participate in the distribution. The portion of this minority that does choose to participate will receive some undesired reserves; the remaining portion will receive no SDR's. But at least 63 percent of effective majority will prefer a larger distribution. Therefore, the strong probability is that globally the SDR distribution will be inadequate.

The outcome would be the same if instead the Managing Director initiated the discussions with individual members by proposing a dis-

tribution of SDR's that was larger than would be generally acceptable and lowered to the size of the distribution until the required 85 percent majority was obtained. Nations with a maximum of 15 percent of the voting power would consider the distribution excessive, and other countries with at least 63 percent of the votes would find the distribution too small. This conclusion also stands, if contrary to the preceding analysis, IMF members expect to run balance-of-payments surpluses and acquire dollar or gold reserves. Their desired allotments of SDR's would merely be reduced by the amount of anticipated external surpluses. Changes might occur in the particular countries that consider a given distribution to be excessive or in the size of the acceptable distribution. But 15 percent at most would consider the distribution too large, and at least 63 percent would find it inadequate.

The foregoing model of the voting behavior of individual IMF members is a simple one that would no longer remain credible if pushed too far, and the above discussion has perhaps pressed the model to its tolerable limits. Alternative models can of course be constructed. They would be more sophisticated and complex in that national monetary authorities would attempt to predict the redistribution of SDR's that will result from balance-of-payments surpluses and deficits after an initial distribution. If the central bank or treasury of every Fund member made such a prediction, if all of these projections were consistent with one another, and if they all proved to be accurate regarding the pattern of future surpluses and deficits, then the member nations would theoretically be able to agree upon the size of a total SDR distribution that would precisely satisfy the desires of each national authority. But even given this ideal state of affairs, temporary reserve excesses and deficiencies would presumably occur during the interim when the redistribution was taking place.

The relevant question is not whether it is possible to design a model satisfying the appropriate equilibrium conditions, but how member states will arrive at their voting decisions, and whether in the aggregate these decisions will tend to produce a general excess or deficiency of reserve-assets. National monetary authorities will presumably calculate the appropriate size of an SDR distribution in terms of their own perceived interests. But a complete model that included the impact of redistribution of SDR's would probably lack the credibility necessary to warrant designing it and estimating the relevant parameters. Therefore, monetary authorities will most likely make their decisions in terms of a simple model like the one outlined above or through an ad hoc cut-and-try approach. The latter would imply a relatively modest initial SDR distribution with larger subsequent allocations if no dire consequences follow the initial experiment. But in either case there is a reasonable likelihood that the total supply of additional reserves will be inadequate—that throughout the world the aggregate of perceived reserve deficiencies will exceed the total of perceived reserve excesses.

The Signs of Reserve Inadequacy

If the supply of additional reserve-assets did prove to be inadequate, then under the existing fixed exchange rate system this condition would be evidenced either as pressure to increase the supply of reserves from traditional sources or as a worldwide deflationary tendency accom-

panied by a slowdown in the expansion of world trade.[6] The supply of reserves from traditional sources could be expanded through abrogation of the March 1968 Washington agreement and a general increase in the price of gold or through deflation and devaluation vis-a-vis the United States.

To review once again the already too familiar arguments against a general rise in the price of gold hardly seems necessary. The importance of preserving the March Washington agreement, however, is a more recent issue. Although resumption of limited official purchases of gold offered on the free market might be possible without the reintroduction of a rigid floor price, any renewal of official purchasing would be a step in the direction of a floor. To avoid a return to the fixed $35 per ounce minimum in the private market, official purchasing would have to be restricted to special circumstances. Purchases effected under these circumstances would almost certainly be too small to have a noticeable impact on the total supply of international liquidity. On the other hand, reintroduction of a fully guaranteed floor price, without any restriction on official purchases, would once again eliminate the risk of substantial losses by speculators. The absence of this risk would tend to increase speculative demand for gold and to drive the free market price higher. In turn, the danger of widespread conversion of dollars into gold would also rise.

The alternative to a net expansion of gold reserves would be the continued growth of official dollar holdings. But net additions to dollar reserves require U.S. payments deficits, and with further deficits, the acceptability of the dollar as a reserve-asset tends to deteriorate. If foreign nations were to insist on achieving the surpluses necessary to realize their expected reserve gains,[7] the risk of a calamitous international monetary crisis would continue to rise.

Perhaps the most likely outcome would entail some combination of additional U.S. payments deficits and general deflation. The increase in dollar liabilities to official foreigners would probably not be sufficient to satisfy foreign desires for reserve gains. Consequently, some degree of deflation would probably result in part from a monetary and fiscal tug of war between this country, on one hand, to curtail U.S. deficits, and European nations, on the other, to achieve the desired expansion of reserves.

A New Source of Earned Reserves

The introduction of a new source of earned reserves to substitute for additional gold or dollar assets and to fill any deficiencies remaining after the distribution of SDR's would avoid both deflationary tendencies and the dangers of monetary instability. An appropriate way to furnish this new source of reserves would be to permit a multinational organization to sell, in return for convertible currencies, a reserve-asset that is fully guaranteed and accepted by all IMF members as a

[6] Ad hoc expedients, such as swap arrangements among central banks, can temporarily defer the choice between permanently expanding the stock of reserves and suffering deflation. But these expedients cannot satisfy the long-term need for additional liquidity, as the agreement to create SDRs indicates. The introduction of substantial exchange rate flexibility could, of course, reduce the need for reserves. But the prospects for general acceptance of this degree of flexibility appear to be slim.

[7] On the consequences of this type of conflict between U.S. and foreign objectives, see Machlup, *op. cit.*, pp. 70–72, and Milton Gilbert, *The Gold-Dollar System: Conditions of Equilibrium and the Price of Gold*, Essays in International Finance, No. 70 (Princeton: International Finance Section, 1968), pp. 24–28.

means of international settlement. These assets could be purchased voluntarily by Fund members with foreign exchange earned through balance-of-payments surpluses.

At this stage in the evolution of the international monetary system, however, no asset issued by a multilateral organization can be free from doubts concerning its future value. Few countries would be willing to accept such assets without limitation. The SDR agreement, for example, requires Fund members participating in general distributions to accept only three times their individual allocations of SDR's. It seems unlikely that in the foreseeable future any multinational organization could issue a reserve-asset carrying broader guarantees or having wider acceptability than SDR's. Moreover, issuance of another type of fiduciary reserve would contribute to the multiplication of different types of reserve-assets that is already a source of concern. The most expedient course, therefore would apparently be to provide a special issue of SDR's that Fund members desiring additional reserves could purchase at their own volition with the foreign exchange proceeds of earlier payments surpluses. To the extent that a member utilized this facility and purchased additional reserves, its total obligation to accept SDR's would increase by the same amount.

The Proposed Modification Contrasted With Larger General Distributions of SDR's

Since IMF members holding only 15 percent of the total voting power were able to secure the prerogative to veto general SDR distributions they consider excessive, the same groups could probably also block acceptance of the proposed extension. Why should this group accede to the extension if they oppose larger general distributions of SDR's?

Nations opposing an expanded general distribution of SDR's would obviously not be suffering from any actual reserve shortage and would probably not be concerned about any foreseeable lack of reserves for financing their own deficits. Their concern, to be serious, would have to be rooted in the likelihood of damage to the international monetary system either from an increase in the official value of gold or from the continued accumulation of dollar reserves. Therefore, conservative Fund members could be expected to agree to supplementary distributions of reserves only as a reflection of their own apprehensions regarding the global consequences of reserve inadequacy.

From the conservative point of view the proposed reform would have several advantages over enlarging general SDR distributions to avoid the consequences of a potential reserve scarcity. Therefore, given an acknowledged but modest degree of concern, the conservatives might agree to the suggested reform despite their opposition to larger general distributions.

In order to compare the suggested change with an enlarged general allocation of SDR's, it is necessary to investigate briefly the mechanism in each case through which additional reserves would be distributed. For purposes of making a comparison between the alternatives, a hypothetical five-country world will be utilized. This world consists of three non-reserve-currency (or peripheral) industrialized nations, the United States, and a developing country.[8] Initially each nation has

[8] The hypothetical developing country in this model may be thought of as a collection of all the less developed nations.

zero balance of payments and is assumed to be satisfied with the quantity of reserves it holds. A portion of these reserve stocks will consist of SDR's received under general distributions approved by the required 85 percent majority.

Suppose the first peripheral nation (P_1) decides to acquire an additional amount of reserves equivalent to Q. If this demand were to be satisfied under the SDR amendment as it now stands, IMF members would be required to approve an additional distribution amounting to Q. A portion of Q would be allocated to each participating nation according to its quota (in this example all countries are assumed to participate), and the obligation of each nation to accept SDR's would increase by three times the amount of additional SDR's received. Country P_1 would receive its allocation, but in order to fully realize its desires, it would then have to run payments surpluses with the rest of the world sufficient to acquire reserves equivalent to the remainder of the distribution. Thus, at the conclusion of the process, P_1 would have achieved an increase in its reserves of Q. While the quantity of reserves held by the rest of the world would remain unchanged, the composition of national reserve stocks might be altered.

Starting with the same initial conditions, under the proposed reform P_1 would initially evidence the desire to increase its reserves by Q through the adoption of policies that would generate the desired payments surplus. Suppose that the other four nations finance their consequent deficits in dollars. The surplus country would then use these dollars to purchase additional SDR's, and the dollars would in turn be loaned to the developing country. Extension of the loan would complete the first round in the process.

The second round would begin when the developing country spent the borrowed dollars. Each of the four industrialized nations would presumably contribute to the total of real transfers intended to speed development, and each would therefore earn a portion of the dollars channeled through the multilateral lender. If the surplus of the United States in the second round were precisely equal to its deficit with P_1 during the first, then the global increase in reserves would exactly equal Q. The entire increase would then occur in the form of SDR's, and dollar reserves would remain unchanged. By contrast, if the proposed reform were adopted and U.S. deficits with industrial nations generally exceeded U.S. surpluses with developing countries, the quantity of outstanding dollar reserves would tend to grow. But if initial U.S. deficits were smaller than later surpluses, the global stock of dollar reserves would gradually diminish.

Because of its likely second-round surplus, P_1 would probably acquire slightly more reserves than initially intended, and some redistribution of reserves among the three peripheral nations might occur subsequently. Similarly, the United States might adjust its policies to achieve zero external balance over the entire process. These subsequent adjustments in reserve composition and size can be considered the third and final stage in the process. With no further increase in desired reserves, a state of equilibrium would be reestablished when the reserves of P_2 and P_3 had returned to the initial levels and each nation was content with the composition of its reserve stock, whether changed or not.

On the basis of this hypothetical exercise, the proposed reform has at least four advantages from the point of view of conservative IMF

members. On the other hand, these conservative advantages may be disadvantages from the viewpoint of developing countries and some other industrial nations.

First, the proposed reform would entail no expansion in the obligations of the conservatives to accept SDR's, while a larger general distribution would produce an increase in these commitments. One of the chief motivations for nations with abundant reserves to limit distribution of Special Drawing Rights under the existing amendment is that by doing so, they will also reduce their obligation to accept SDR's. When, under the proposed reform, a reserve-scarce nation purchased Special Drawing Rights, its obligation to accept additional SDR's would be increased by the amount of its purchases, but the obligations of other Fund members would be unaffected.[9]

Second, actual willingness to accept and hold SDR's would tend to grow simultaneously with use of the proposed facility. By contrast, larger general distributions of SDR's might increase the risk that some Fund members would prefer to hold these additional reserves in another form. When a Fund member bought SDR's, that nation would presumably intend to hold these assets as part of its desired reserve stock, which could be expected to grow with the passage of time. Its actual holdings would fluctuate with cyclical payments surpluses and deficits, but any transitory decline in SDR holdings would probably be reconstituted through later surpluses. Therefore, the Special Drawing Rights earned through the proposed reform would most likely be held willingly. In any event, the obligations of purchasers to accept SDR's would be increased by the amount of their purchases.

Third, to the extent that reserve-scarce nations did purchase SDR's, this action would evidence an actual reserve inadequacy rather than a scarcity calculated according to a projection formulated in previous years. From the point of view of conservative Fund members, the need to decide upon future distributions of SDR's five years into the future is probably one of the most undesirable aspects of the existing agreement. The proposed reform would entail the distribution of additional SDR's only as the need for them developed and as reserve-scarce nations elected to purchase them. If general distributions proved to be sufficient, the proposed facility would not be utilized. It would be utilized only to the extent that general distributions proved to be inadequate and as the inadequacy became evident.

Fourth, the need to earn additional SDR's through payments surpluses would tend to check their distribution. General distributions of SDR's under the existing amendment will be based on what nations say their reserve needs will be in the future; the willingness to earn reserves through payments surpluses is a far more substantial demonstration of a perceived need. Conservative Fund members fear the unrestrained creation of fiduciary reserve-assets. The requirement that need be demonstrated through net external earnings should ease these fears.

[9] Use of the suggested facility to purchase SDR's might increase the likelihood that a deficit country desiring to exchange SDR s for the currency of a particular Fund member would not be able to do so. The quantity of SDR's outstanding would tend to be increased relative to the obligations of nations with sufficient reserves and strong external positions to accept these assets. Whether any problem of this type actually occurred would depend upon the distribution of surpluses and deficits among Fund members and how these payments imbalances were financed.

The Link With Development Financing

The International Monetary Fund could sell supplementary issues of SDR's itself, or it could authorize some other multinational organization to do so. If there is to be a link between multilateral reserve creation and development finance, the World Bank would be the logical agent, since it is the one with the most widespread global commitments and capabilities.

But the desirability of such a link has not been explicitly demonstrated; instead, the above discussion emphasized the desirability of an additional source of earned international liquidity. Normally pleas for assistance to developing nations are couched in terms of equity and humanitarianism, and these motivations can hardly be deprecated. However the following case rests not on humanitarianism but on the operation of the international transfer mechanism.[10] The merit of a link between reserve creation and financial assistance for economic development would be the effectiveness of such a tie in permitting reserve-scarce nations to earn additional reserves without creating enduring payments deficits or reserve losses for other countries.

The hypothetical example offered above to illustrate how additional SDR's would be distributed showed that over the entire three-stage process, the United States and peripheral industrial nations with sufficient reserves (countries P_2 and P_3 in the example) could maintain zero balance of payments and suffer no increase or decrease in their own reserve stocks or in their liabilities to official foreigners. Yet the proposed facility would have the flexibility to allow nations desiring additional reserves to acquire them. Consequently, the distribution mechanism would be approximately neutral in terms of expansionary or deflationary consequences. Nations with adequate reserves would not need to introduce deflationary policies to maintain their stocks, and competition for outstanding reserves would be avoided. Moreover, the United States could assure the reserve-asset value of the dollar by maintaining zero external balance without imposing deflationary burdens on the rest of the world.

While the IMF might be authorized by its members to issue the additional increment of SDR's, the receipts from their sale should most appropriately be channeled through the World Bank to developing countries. Nations in need of capital goods imports to stimulate growth would be the recipients most likely to spend the borrowed funds in industrialized countries; therefore, developing countries would constitute the most effective available link in completing the real transfer cycle. To the extent that initial surpluses by reserve-scarce nations (such as P_1 in the example) exceeded subsequent deficits by developing countries, other industrial countries (P_2, P_3 and the United States) would suffer net external deficits as the result of the mechanism for distributing additional SDR's. For this reason it is important that the receipts from sales of additional SDR's be loaned to a group of countries which will largely spend these funds rather than hold them as additional reserves. Because developing countries

[10] At least one other economic argument has been advanced for a link between reserve creation and development assistance. Cohen, *op. cit.*, has suggested that since—according to his analysis—less developed countries bear a disproportionate share of the adjustment costs from eliminating international payments disequilibria, the major portion of new reserves should be allocated to these countries.

have the highest propensity to spend externally of any easily segregated group of states, the World Bank should channel the proceeds from SDR's sales to these nations.

The increase in transfers of real resources to developing nations resulting from the proposed reform would probably be modest. Not only is activation of the suggested reform voluntary—therefore no use whatsoever is a possibility—but Fund members might prefer to obtain most of their SDR's through general distributions and enjoy the benefits of a zero reserve-acquisitions cost. Thus, to expect a massive increase in real transfers via the proposed mechanism would be unrealistic.

Activation of the Proposed Facility by Reserve-Scarce Nations

The initiative in activating the proposed reform would lie with nations experiencing a shortage of reserves, since it is these countries that would purchase SDR's with the proceeds of external surpluses. However, reserve-scarce nations might be reluctant to activate the facility or might be slow in recognizing the need to do so. The effectiveness of the reform would then be curtailed.

If initial reserve acquisitions were in the form of dollar obligations, reserve-scarce nations might prefer to hold these assets and obtain a higher interest return than available on SDR's. Alternatively, if deficit countries financed their net external expenditures in SDR's, a reserve-scarce nation (such as P_1 in the above example) would obtain this form of asset initially without any increase in its obligation to accept more of the same. Swapping the SDR's received initially for foreign exchange and then purchasing additional SDR's would increase the global quantity of outstanding reserves, but would seem to do nothing for the nation acquiring reserves other than increasing its obligation to accept Special Drawing Rights.

In the face of a global shortage of reserves, however, a reserve-scarce nation could not expect to realize its desires without activating the proposed reform. If, as in the foregoing example, the global supply of reserves were just sufficient and if each country was satisfied with the size of its stock, then—without the proposed facility—any increase in desired reserves would set off a chain of competitive reactions. Each nation would attempt to maintain its desired level of reserves, but at least one country would always be dissatisfied. The only way to reestablish equilibrium would be to increase the quantity of reserves available globally.

In actual practice nations do not have such well-defined objectives or react so mechanistically. But if the global supply of reserves were inadequate, and if nations with a majority of the voting power in the IMF desired greater additions to their reserves than provided through general SDR distributions (as would be likely if the supply of gold and dollar reserves were permanently reduced to a low level), then no country could expect to realize a sustained increase in its reserve holdings without activating the proposed reform. Without activation, gains would be temporary and would be followed by losses reflecting the reactions of other countries. When the officials of a reserve-scarce nation recognized this condition, they would activate the proposed facil-

ity. During periods of generally recognized reserve scarcity, activation might be accepted as the norm of international economic cooperation.[11]

The Benefits of the Proposed Reform Summarized

The foregoing discussion proposed a special issue of SDR's that can be purchased voluntarily by IMF members, since the supply of SDR's offered through general distributions is likely to be inadequate. The proceeds of SDR sales would then be loaned to developing countries. The characteristics of the suggested reform that could make it acceptable to conservative IMF members would also tend to make it less valuable to developing nations. At best, the additional real transfers to less developed countries financed through this reform would be modest, and at worst the additional real transfers might be nil. But if any reform in this direction is to be adopted it must be acceptable to the conservatives as well as the developing nations.

The alternatives to expanding the supply of SDR's—deflation, an increase in the official price of gold, or continued accumulation of U.S. liabilities to official foreigners—would threaten economic growth or international monetary stability. It is vitally important, therefore, to take a step—however small—in the direction of a reform that will (*a*) provide a reserve-asset that countries can earn voluntarily instead of gold or dollars, (*b*) facilitate completion of the transfer cycle, to permit reserve creation without payments deficits, and (*c*) foster economic development.

[11] Like all international monetary reforms, this one is proposed with a tongue-in-cheek attitude. But in the more distant future, most SDR's could be issued through the proposed mechanism rather than through general distributions. From the point of view of conservative Fund members, as well as developing countries, such a procedure could have substantial advantages.

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