Part I. Need to Supplement Reserves

1. *Past Developments in the Supply of Reserves*

In Chapter 2 of this year's Annual Report, the Executive Directors have pointed out that world reserves, which consist of official holdings of gold, foreign exchange, and reserve positions in the Fund, have declined by over 50 per cent relative to world trade since the early 1950's; relative to international transactions the decline would have been even steeper. After 1964 reserve growth became much less rapid than in earlier years; indeed, reserves would have shown a decline not merely in relative but in absolute terms, owing mainly to gold hoarding, had it not been for the creation of reserves as a by-product of the use of Fund credit facilities, swap arrangements, and other international credit facilities.

As the Report also indicates, over most of the period any effect of declining reserve ratios in impairing the reserve ease of most countries was offset, if not outweighed, by a marked improvement in the distribution of reserves, in the sense of a shift from countries (notably the United States) where in the early 1950's reserves had been very high to other countries where they had been inadequate. Possibly, also, there was some decline in the magnitude of payments imbalances relative to international transactions, though, even so, the trend of imbalances rose faster than that of global reserves.

Since about 1964, there has been a change in the situation: growth of reserves flattened markedly, the ratio of reserves to trade declined more rapidly, the transfer of reserves from deficit to surplus countries ceased to act as a force tending to equalize reserve ratios, and there was increasing resort to international credit as a means of relieving the tightness of reserves.

2. *Basic Criteria of Reserve Adequacy*

In order to assess the long-term global need, if any, for reserve supplementation, as the Fund must do in order to conform to Article XXIV, Section 1(*a*), it is necessary to arrive at a view, not only as to the probable development of reserves other than special drawing rights, but also as to the long-term development in the need for global reserves. This in turn may be defined as that amount and rate of growth of reserves which is most conducive to the attainment of the objectives described in that provision.

These objectives are contained in the Fund's Purposes, as set forth in Article I, as follows:

(i) To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.

(ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.

(iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.

(iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

(v) To give confidence to members by making the Fund's resources temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.

(vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

The relevant objectives contained herein may be grouped as follows:

(a) expansion of international trade, economic activity, and development;

(b) promotion of multilateral payments and elimination of restrictions;

(c) promotion of exchange stability and orderly exchange rate adjustments; and

(d) correction of payments maladjustments and reduction in payments disequilibria without resort to measures destructive of national or international prosperity.

To these, Article XXIV, Section 1(*a*), adds a further objective, viz.,

(e) the avoidance of economic stagnation and deflation as well as excess demand and inflation in the world.

The objectives at (a) and (e) above fall mainly within the sphere of demand policy, (b) of payments and trade policy, (c) of exchange policy, and (d) of all of these.

Broadly speaking, higher reserves and reserve growth tend to relieve balance of payments difficulties and thus to promote expansion of demand, which may be inflationary, or may avoid contraction, to promote the elimination of restrictions and discrimination in international transactions, and to reduce the need for exchange rate devaluation; lower reserves and reserve growth tend to have the opposite effects. The effects of reserve creation in relation to objective (d) above, which has much in common with the other objectives, are considered separately in the following section.

If world demand were likely to be inadequate, payments and trade restrictions widespread, devaluations unduly frequent and revaluations too rare, it could safely be said that reserves and reserve growth were too low; if demand were likely to be excessive, payments and trade restrictions negligible (so as to offer no scope for reduction), devaluations too long delayed and revaluations too frequent, it could safely be said that reserves and reserve growth were excessive. Unfortunately, it frequently happens that these indicators point in different directions. It is, therefore, necessary to take a view as to what extent in a concrete situation additions to reserves are likely to evoke the various kinds of policy reactions and thus to affect the attainment of the various objectives set forth above. In considering this question account has to be taken of the targets of individual countries as to reserves and reserve accumulation.

In the 1950's and early 1960's there was little doubt as to the adequacy of global reserves. These were years of great expansion in production and international trade and great progress in the liberalization of international transactions and the realization of the purposes of the Fund. If there was any decline in world reserve ease over the period it was from a level that was ample or even excessive, and the consensus of informed opinion was that there was no global inadequacy of reserves.

After about 1964, the signals supplied by the basic criteria of reserve adequacy became conflicting. Judged by the criterion of world demand conditions alone the period from 1965 to the present could scarcely be considered one of reserve inadequacy. World output and international trade expanded rapidly in these years; domestic prices rose rather fast, though international prices were stable; and demand pressures intensified, particularly in North America.

The same holds true to a lesser extent of the criterion of exchange stability. While the exchange rate devaluations which occurred during these years were possibly speeded up by the tightening of the reserve situation, they cannot be said either to have been undertaken prematurely or to have been excessive in amount, though it might have been otherwise had there not been widespread resort to international credit and the associated generation of reserves.

The main indications of reserve inadequacy in these years lie in the increased reliance on restrictions on international transactions and the increased recourse to international financial assistance, bilateral and multilateral, for the purpose of meeting payments deficits and sustaining reserves. Liberalization of trade has continued but its momentum has slackened. Temporary balance of payments restrictions have been imposed on trade and tourism in several major countries. Aid-tying and national preference in the granting of government contracts have been maintained or intensified in many countries. Above all, measures to restrict, attract, or occasionally repel capital flows have been applied or intensified for payments reasons in many countries, large and small. At the same time, there has been a substantially increased use of Fund resources and of other forms of balance of payments assistance, provided notably by the spreading network of swap arrangements and other types of credit arrangements between monetary authorities. These developments, while partly attributable to the persistence of payments disequilibria that could and should be corrected, have almost certainly been exacerbated by a growing shortage of, and increasing desire to obtain, reserves.

When attempting to balance these considerations, I share the view expressed in the 1966 Annual Report and cited in this year's Report, that in view of the great reluctance of countries to subordinate their demand management policies to balance of payments objectives "any shortage of international liquidity is more likely to manifest itself, at least initially, in the form of intensification of restrictions on trade and capital movements, or in increased pressure on exchange rates, than in that of generalized deflationary symptoms in the world economy." Needless to say, this judgment reflects no lack of concern with inflationary conditions. As this year's Annual Report points out: "The removal of inflationary pressures will require the firm determination of member countries to adopt and maintain the fiscal and monetary policies that are necessary to this end."

These considerations suggest that more weight should be laid on the evidence for current inadequacy of reserves and reserve growth provided by the prevalence and growth of restrictions on international transactions and by the increasing resort to arrangements for balance of payments financing than on the evidence for adequate or excessive reserves provided by the current demand situation.

3. *Reserves and the Adjustment Process*

As has already been indicated at page 5 above, one of the purposes which reserve supplementation is to serve, in accordance with Section 1(*a*) of Article XXIV, is to assist in the correction of payments maladjustments and reduction in payments disequilibria without resort to measures destructive of national or international prosperity. In other words, the effect of reserve creation on the adjustment process has to be taken into account on the occasion of all decisions to allocate special drawing rights.

In addition, among the special considerations that are to be taken into account on the occasion of the first decision to allocate special drawing rights are "the attainment of a better balance of payments equilibrium, as well as the likelihood of a better working of the adjustment process in the future."

The relevance of these special considerations to the desirability of a decision to begin allocations of special drawing rights arises in two main ways. In the first place, both the degree of disequilibrium in the world and the future of the adjustment process might be affected more markedly by the prospect of future allocations of special drawing rights set up by the initial activation of the new facility than by subsequent particular decisions to allocate. This would be true, for example, if it were felt that important deficit countries were likely to be induced by such activation to avoid taking desirable action to correct their deficits.

A second type of relationship between the degree of disequilibrium and prospect for adjustment, on the one hand, and the initiation of allocations, on the other, arises from the fact that insofar as deficits are financed by certain forms of international credit they tend to add to world reserves. For example, a drawing by a Fund member in the credit tranches normally gives rise to an addition to world reserves in the form of a reserve position in the Fund held by the member whose currency is drawn. Again, large countries, in addition to their ability to draw on the Fund, often have access to swap arrangements or similar forms of bilateral credit, the use of which again gives rise to reserves. Reserve centers in particular not only enjoy a substantial access to such credit, but may also be able to finance their deficits to some extent through other countries holding additional amounts of their currencies.

The persistence of particular chronic disequilibria or, more generally, the persistence of adverse tendencies in the willingness of deficit countries to adjust, to the extent that it gave rise to the prospect of substantial continued creation of reserves from international credit operations, might provide a reason not only for reducing allocations of special drawing rights but also for postponing the initiation of such allocations.

Some of the most important effects of reserve supplementation on the adjustment process have already been discussed at pages 4 to 7 above. Prima facie, the tendency would be to relieve deficit countries of some of the pressure on their reserves and thus to lessen their need to resort to restrictions on international transactions, deflationary or disinflationary demand policies, and exchange devaluations; and to encourage surplus countries to play a greater part in the adjustment process by expansionary policies and the removal of restrictions. In the abstract, one would expect the effect on deficit countries to be stronger than that on surplus countries, so that the sum of imbalances to be financed might be somewhat increased by reserve creation.

In this connection, it should be borne in mind that the purposes of the Fund call for the correction of payments maladjustments "without resorting to measures destructive of national or international prosperity." Reserve supplementation has to be judged by its effect on the quality as well as on the speed of the adjustment process.

In present circumstances, moreover, it appears unlikely that reserve creation would have any significant effect in increasing the imbalances of those countries which in the past have had the biggest deficits. The United States and the United Kingdom are under such strong pressure to correct their deficits that any relief of this pressure afforded by a general expansion of reserves is likely to be negligible. In the case of the United Kingdom, in particular, the need to repay a large amount of indebtedness in a rather short period of time is likely to compel it to adopt policies that may even exceed the requirements of long-term adjustment. In the United States, the need to contain inflationary pressures would of itself be expected to induce the authorities to pursue demand management policies tending to strengthen the current account of the balance of payments.

In these circumstances, the supplementation of reserves would be most unlikely, on balance, to exercise any adverse effect upon the adjustment process, and indeed if nothing were done to supplement reserves the stabilization efforts now being made by deficit countries might well be frustrated by the defensive measures of others.

I turn, now, to recent trends in payments disequilibria and adjustment policies, and their bearing on the need to supplement reserves and on the desirability of initiating allocations.

From this standpoint, a definite improvement is to be seen, though much remains to be done. Admittedly, international cost and price relationships and current account balances leave much to be desired from the standpoint of a sustainable international equilibrium. Moreover, in some of the principal countries with actually or potentially persistent deficits, such as the United States, the United Kingdom, and France, there has been at some stage a reluctance to apply demand management policies and other adjustment policies with sufficient vigor and flexibility in the light of the balance of payments situation.

More recently, however, strong measures have been taken by these countries in the fields of fiscal, monetary, and exchange rate policy. In spite of the unexpectedly slow response of its economy to corrective measures, the basic position and prospects of the United Kingdom have been greatly improved by the November 1967 devaluation, the application of strong budgetary measures, and latterly the adoption of a more stringent monetary policy. In the United States, also, the measures of fiscal and monetary restraint that have been taken have already led to a slowing down in the rate of growth of output and can reasonably be expected to take effect on the upward trend in prices. In France the first steps have been taken to reverse the expansionary policy previously pursued, and the recent devaluation must be considered an important and timely step in the direction of a better international adjustment. In all these cases, there are signs of the emergence of a better balance in international payments.

There are, of course, a number of instances in the world of the persistence of payments surpluses. These, however, constitute no argument against decisions to allocate special drawing rights or against the initial activation of the new facility, since reserve creation would, if anything, tend to strengthen the incentive of surplus countries to adjust.

A remarkable feature of the balance of payments situation of recent years has been the extent to which abnormalities in current balances of payments have been offset by capital flows, on long term and, save in exchange crises, on short term also. In the United States, in particular, a massive influx on capital account has brought the balance of payments on an official settlements basis into surplus in 1968 and so far in 1969. In consequence the balance of payments situation of the United States has not in recent years given rise to an expansion of world reserves. Rather the supply of dollars to official holders in the outside world has been declining.

Admittedly, the pattern of capital flows that has contributed to over-all payments balance between major countries may not last. In the longer run, the underlying disequilibria, unless corrected, must be expected to find a reflection in over-all payments imbalances. It must be emphasized, however, that, at the present time, it is very difficult to gauge what might be a sustainable pattern of international capital flows and what, therefore, might be the precise magnitude of the underlying payments disequilibria in payments balances. As is pointed out in this year's Annual Report, the big shifts that have occurred in current and capital account balances in recent years, under varying cyclical conditions, make it difficult to derive much guidance on this matter from past experience.

As regards the future of the adjustment process, prediction is, of course, very difficult. As is pointed out above (pages 9-10), countries hitherto in persistent deficit have strong domestic reasons for wishing to emerge from this situation and have adopted policies directed to this end. There is, moreover, a somewhat more widespread appreciation of the desirability of correcting, by means of timely exchange rate adjustments, disequilibria that are unlikely to be removed by other methods of adjustment. So far as short-term adjustment is concerned, there has been a marked development in international cooperation in countering disequilibrating flows, and encouraging equilibrating flows of short-term funds. Finally, in the Fund and elsewhere, international machinery for keeping payments situations under review and suggesting appropriate methods of adjustment of incipient disequilibria as they emerge, is in more continuous and effective operation than at any previous time.

The conclusions which suggest themselves with respect to the relation between reserve creation and the adjustment process as discussed in this section are: that a decision to begin the allocation of special drawing rights at this time would be consistent with Section 1(*b*) of Article XXIV relating to the special considerations with regard to balance of payments equilibrium and the adjustment process; that supplementation of world reserves in an appropriate amount would in present circumstances be likely to contribute to the working of a sound adjustment process; and that considerations with respect to the adjustment process have an important bearing on the amount of special drawing rights that it is appropriate to allocate at this time.

4. *Prospective Need for Reserve Supplementation*

In order to reach a conclusion on whether there is likely to be a need to supplement reserves by the allocation of special drawing rights over the next several years and in order to assess the probable extent of that need, it is necessary to estimate the probable development of reserves over these years in the absence of allocation, and also to take a view as to the reserve development that would be desirable in the interest of the world economy.

As regards the prospective growth of reserves, other than special drawing rights, over the next three to five years, from 1970 onwards, perhaps $500 million per annum might be allowed for the accrual of official gold holdings, reserve creation through the General Account of the Fund (other than that arising from transactions with the reserve centers), and various minor sources of reserve creation. As for the accrual of U.S. dollars to official holders and developments with respect to credits between monetary authorities in such a form as to create reserves, a range of assumptions is possible. One assumption would imply maintenance of payments balance by the United States, no creation of reserves in the form of U.S. dollars, attainment of a substantial surplus by the United Kingdom, and net repayment over a five-year period of some $5 billion of international credits (including Fund purchases) extended in recent years. On this assumption, reserves instead of rising by $0.5 billion per annum might fall by $0.5 billion per annum.

Another assumption would allow for the possibility that the next three to five years might on the average show a deficit for U.S. payments (on the official settlements basis), and that, while there would not be a repetition of the large expansion of reserve credits that occurred in recent years, there would be no substantial net reduction in the total amount of such credits outstanding. On this assumption there would be no reserve destruction, and a possible rise in official holdings of U.S. dollars of some $0.5 billion to $1 billion, making an over-all reserve increase of $1 billion to $1.5 billion per annum.

For two reasons it appears to be advisable to adopt for present purposes the latter of the two assumptions (i.e., the assumption that results in an estimate of future reserve growth amounting to $1 billion to $1.5 billion per annum). In the first place, to do so would better correspond to the need for a cautious approach to the first activation of the Special Drawing Account. Secondly, as regards possible reserve destruction, any creation of offsetting amounts of special drawing rights may be delayed until there is clear evidence of such destruction.

It has been suggested above that symptoms of reserve inadequacy had begun to appear before the end of the period from 1964 through 1968. During the first half of the present year, owing to the mopping up of official holdings of dollars by the payments surplus of the United States, reserves have declined, not merely in relation to trade, but (by $1 billion) in absolute terms. An increase of $1 billion to $1.5 billion per annum in global reserves from the above-mentioned sources over the next several years, even if it should materialize, would not suffice to remove the danger of undue competition for reserves. Some countries need to raise the level of their reserves by amounts which, in the aggregate, are substantial; most of the others wish to see a continuation of the increases which in any case barely keep pace with the growth of their trade, and few indeed are prepared to see their reserves decline to any significant extent.

While it is clear that some supplementation of reserves is required, the problem is to estimate how much. Given the distribution of reserves, reserve ease can be thought of as dependent on two factors: the level of reserves in relation to imports (or other suitable indication of normal reserve needs) and the rate of reserve growth. The latter factor is closely related to the excess of balance of payments surpluses over deficits in the world. As is pointed out in this year's Annual Report, the fact that reserve ease may have been less than adequate in 1968 does not rule out the possibility that, if reserves were to increase in the future at a rate corresponding to a normal growth in the need for reserves, this of itself might go far toward raising reserve ease to a satisfactory level.

There are a great many different ways, none of them very satisfactory, of setting about the measurement of this normal growth in the need for reserves. An approach based on the rate of growth of world trade, using for this purpose the growth of imports over the 1952-68 period, could lead to an estimate that the long-term trend in required reserves would increase at a rate of 7 per cent per annum. Another approach might be to extrapolate an unweighted average of the ratios of reserve increases to imports over a past period on the grounds that for most countries, apart from the larger ones, actual reserve increases would not diverge from desired reserve increases in any systematic way accounted for by the constraint imposed by global reserve availabilities. The extrapolation of an unweighted average for 60 countries of the ratios of annual reserve increases to the level of imports over the 1954-68 period would yield a proportionate rate of reserve increase of 5 per cent per annum. Another possibility would be to estimate the exponential trend in the growth of balance of payments disequilibria (deficits plus surpluses) though this is subject to considerable variation in the short run. An extrapolation of this trend calculation over the 1954-68 period would yield a rate of growth of required reserves of over 4 per cent per annum.

These and other calculations of the trend growth of reserve needs, each of which, of course, is highly tentative in character, provide a set of estimates for annual increases in reserve needs over the next three to five years that fall within a range of approximately \$3.5 billion to approximately \$6 billion a year. Most estimates lie between \$4 billion and \$5 billion a year.

These estimates of the trend growth in the need for reserves, together with the estimate previously given of a potential growth of \$1 billion to \$1.5 billion in reserves other than special drawing rights, suggest a central, most probable, estimate of the need to supplement the reserves of Fund members by allocation of special drawing rights over the next three to five years of approximately \$3 billion to \$3.5 billion per annum.

Consultations have established that there is broad support among participants for the conclusion that there is a global need to supplement reserves, and for the allocation of special drawing rights in accordance with the proposal set forth in the concluding section of this Report.