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STREAMLINING THE FINANCIAL STRUCTURE OF THE INTERNATIONAL MONETARY FUND

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The author of this Essay, Jacques J. Polak, began his association with the International Monetary Fund in 1947. He was Director of Research from 1958 to 1980, Economic Counsellor from 1966 to 1980, and Executive Director from 1981 to 1986. He is the author of many publications, including *An International Economic System* (Chicago, 1953) and two previous contributions to the International Finance Section, *The Changing Nature of IMF Conditionality* (1991), and a symposium article, "The Articles of Agreement of the IMF and the Liberalization of Capital Movements" (1998).

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STREAMLINING THE FINANCIAL STRUCTURE OF THE INTERNATIONAL MONETARY FUND

1 Introduction

In recent years, considerable progress has been made toward enhancing the transparency of the International Monetary Fund (IMF). Most of the secrecy has been lifted from the policies it pursues, the reasons behind these policies, and the conditions the Fund imposes for members' access to its credit facilities. The IMF's findings in its consultations with members under Article IV of the Articles of Agreement are, for most members, published in a regular series of Public Information Notices, and a pilot project has been started to publish the consultation reports themselves. The Fund also publishes the Letters of Intent in which members seeking credit from the Fund spell out their policy undertakings. Delays imposed on access to the minutes of board meetings and other source material have been greatly reduced.

Despite the achievement of a welcome degree of transparency with respect to the Fund's aims and policies, however, the Fund's financial operations are still shrouded in clouds of specialized terminology. The financial world has changed radically since 1944—the year of the Bretton Woods conference—and again since the 1960s, when the special drawing right (SDR) was created. Yet the Fund's financial structure has been only partly adjusted to its new surroundings. Significant additions to this structure were brought about by the first and second amendments to the Articles of Agreement, as well as by decisions of the Fund's executive directors. Further changes would follow from the proposed fourth amendment, which provides for a special one-time allocation of SDRs, structured to eliminate "inequities" arising from previous allocations (see the Appendix for brief descriptions of these amendments). Very little, however, was removed. The anomalies of the resulting patchwork are most obvious in the survival of Articles VI and VII, which, among other patently dated provisions, proscribe the use of Fund credit "to meet a large or sustained outflow of capital" and authorize a system of collective discrimination against a currency that the Fund has declared to be "scarce." It can be argued—although not wholly convincingly—that these particular oddities have proved harmless to the effective functioning of the Fund. Whatever the merit of this view, it does not apply to other surviving anomalies that bear more directly on the Fund's operations. The cumulative weight of the Fund's jerry-built structure of financial provisions has meant that almost nobody outside, and, indeed, few inside, the Fund understand how the organization works, because relatively simple economic relations are buried under increasingly opaque layers of language. To cite one example, the Fund must be the only financial organization in the world for which the balance sheet (see Box 1) contains no information whatever on the magnitudes of its outstanding credits or of its liquid liabilities. More seriously, the Fund's outdated financial structure has been a handicap in its financial operations, including the periodic process of reaching agreement about quota increases, about decisions on which currencies to use in its transactions, about the role of the SDR, and about the distribution over the membership of the cost of its administrative expenditures.

Thus, it is not sufficient simply to bring openness to the Fund's policies and decisions; it is equally necessary to make the financial activities of the Fund understandable, to adjust its financial techniques to the realities of today's world, and, through these adjustments, to make the Fund a financially more effective institution.

Many of the weaknesses of the Fund's present financial structure can be attributed to two of its characteristic features. The first, the design of the Fund as a "mixed bag of currencies," formed an essential part of the original Bretton Woods agreement. The other, the construction of a completely separate department to extend unconditional liquidity to the membership in general, was believed to be equally essential twenty-five years later for agreement on the novel SDR scheme. Both features have become redundant, increasingly awkward, and, by now, counterproductive to the efficient functioning of the Fund. The achievement of a sensible financial structure for the Fund will require the elimination of these two features. Once that is done, a number of other improvements will become more readily available, and the entire structure (including its specification in the Articles of Agreement) will be greatly simplified.

The changes proposed in this essay will require an extensive amendment affecting, perhaps, as many provisions as the first or the second amendment did. But this new amendment can be expected to raise far fewer issues than these earlier changes raised. This is so for two reasons: (1) the great majority of the changes required will follow readily from the basic decisions to recast the Fund without holdings of the currencies of all members and to merge the SDR Department with the General Department, and (2) many of the changes will be simple deletions.

BOX 1

THE BALANCE SHEET OF THE FUND

The Fund does not publish a consolidated balance sheet of its two departments, the General Department and the SDR Department. The balance sheet of the General Department as of April 30, 1999 (the end of fiscal year 1999), is reproduced below as published by the Fund, with some smaller items (including the Special Disbursement Account) combined as "Other assets" and "Other liabilities."

GENERAL DEPARTMENT BALANCE SHEET, APRIL 30, 1999

(*In billions of SDRs*)

Assets	
Currencies (including securities substituted for currencies)	205.0
SDR holdings	3.6
Gold holdings	3.6
Other assets	2.6
Total assets	214.8
Quotas, Reserves, Liabilities, and Resources	
Quotas	208.0
Reserves (including Special Contingent Accounts)	4.6
Other liabilities	2.3
Total Quotas, Reserves, Liabilities, and Resources	214.8

The entry "Currencies" (SDR205 billion) combines four heterogeneous elements: (1) only about SDR80 billion represents "usable currencies;" the remainder of the currencies item consists of three categories of "nonusable currencies"; (2) IOUs for the Fund's outstanding credit (SDR61 billion), which the Fund does not use in transactions with other members, even in the rare cases where these currencies have become strong; (3) an amount equal to the quotas of the members using Fund credit (SDR44 billion), none of which could become usable until the credits had been repaid, plus the quotas of countries not indebted to the Fund but with outstanding credits to the Structural Adjustment Facility (SAF) or Enhanced Structural Adjustment Facility (ESAF) (SDR3 billion); and (4) the balance—potentially usable currencies—namely, the currencies of members that are not indebted to the Fund or to the SAF or ESAF but whose positions the Fund has judged to be too weak for inclusion in its operational budget (SDR17 billion).

SOURCE: IMF, *Annual Report 1999*, and IMF staff.

The benefits of the amendment effort will extend well beyond providing transparency with regard to the finances of the Fund and relieving future generations of executive directors, Fund staff members, and officials in treasuries and central banks around the world of the need to master the Fund's obscure terminology. The amendment will also produce a number of substantive improvements in the Fund's financial structure. In particular, it will:

- give members that provide resources to the Fund an asset they have been shown to prefer, namely, SDRs, instead of the increases in their reserve tranche positions (RTPs) that they currently receive.
- by providing SDRs, make it possible to extend the range of countries able to provide resources to the Fund and, thereby, to increase by about 15 percent the amount of credit the Fund can provide, given total quotas.
- introduce an equitable system for members to share in the cost of running the Fund, namely, in proportion to quotas.
- make it possible for the Fund to charge a higher interest rate (instead of the current lower rate) for the use of unconditional and potentially permanent credit (in the form of net use of SDRs) than it charges for conditional credit having a specific repayment requirement. The additional source of income could be used to augment the resources available to subsidize conditional credit to low-income countries.

Part 2 of this essay develops the reasons for replacing the "currencies technique" currently used in the operations of the Fund's General Department with an alternative technique introduced by the first amendment for the transfer of SDRs. Part 3 shows that this choice of technique logically leads to a merger of the two departmental accounts and that the time for such a merger has come. It also discusses certain aspects of the resulting "merged" Fund. Part 4 focuses on the special language that entered the Articles of Agreement along with the currencies technique, language that has become increasingly awkward—indeed, nearly incomprehensible—because that technique has outlived its usefulness. Part 5 concludes the discussion with a broad outline of the amendment to the Articles of Agreement that will be necessary to achieve the streamlined Fund this essay advocates. An Appendix summarizes previous amendments.

2 Alternative Transfer Techniques in the IMF

The essential contribution of the financial activities of both the General and the SDR Accounts of the Fund is that they reinforce the foreign-exchange reserves of a qualifying member. The reinforcement is brought about by the transfer to that member of reserve currencies owned by other members. To achieve this result, the Fund uses three different techniques. Sections 2-1 and 2-2 describe the two techniques that have most in common, labeled here as the "currencies technique" and the "SDR designation technique." Section 2-3 compares the relative merits of these two techniques. The third technique, based on SDR transactions by agreement, is described in Section 2-4.

2-1 The Currencies Technique

The proposals that the U.S. Treasury developed in the early 1940s for an International Stabilization Fund were based on its experience with currency swaps under the Tripartite Agreement and, bilaterally, with a number of Latin American countries (Horsefield, 1969, pp. 6–8). These proposals envisaged the Fund as a "mixed bag of contributed currencies" and Fund transactions, not as credits, but as exchanges of one currency for another. By contrast, the Keynes plan saw the Fund as akin to a bank, which would create international money ("bancor") by extending credits to member countries that experienced payments deficits. United States opposition to this feature of the Keynes plan was based more on substantive than technical considerations: the United States feared that, under the economic conditions expected for the early postwar years, it might well end up with a creditor position close to the sum of the debtor positions of most other countries. Under the alternative technique proposed in the White plan, however, the United States would not be obliged to provide an amount larger than its quota to finance the balance-of-payments deficits of other countries. Of this, it would pay 25 percent in gold and the balance in dollars. At U.S. insistence, this was the technique adopted at Bretton Woods. To make this system effective in a world of convertible and floating currencies, it was significantly changed in the first and second amendments, and it was further modified in important ways by decisions of the executive board. In its present form, the currencies technique consists of the following steps:

(1) A member "pays in" its quota, 25 percent in SDRs (until 1978, in gold) and 75 percent in its own currency or, at its option, in securities payable on demand in that currency.

(2) In order to maintain the value of its currency holdings in terms of SDRs, the Fund continually adjusts the amounts of each currency held (for the U.S. dollar, almost every day) and periodically settles these adjustments with each member by repaying or receiving balances of the member's currency. Under the par value regime, when currencies were

kept within narrow spreads around par values, these adjustments occurred only on the rare occasions that par values were changed.

(3) Technically, a member does not receive credit from the Fund. Instead, it *buys* from the Fund the currencies of other members (or SDRs), *paying* the equivalent in its own currency. Similarly, it does not "repay credit" but "repurchases" the Fund's excess holdings of its currency with SDRs or other members' currencies. Nowadays, the Fund specifies which currencies a member should ask to buy or should use in repurchase. Originally, however, the member specified the currency it wanted to buy, for which it had to represent that it was "presently needed for making *in that currency* payments which are consistent with the provisions of this Agreement" (emphasis added). Until the second amendment, moreover, repurchases were to be made in gold and individual convertible currencies according to the member's holdings, and increases in its holdings, of each of these reserve assets.

(4) Because most of the currencies bought under (3), even if technically convertible, are not useful or convenient to the borrower, the issuer is obliged to convert them into a "freely usable currency" (that is, any of the four currencies that make up the SDR basket: the dollar, euro, pound, and yen) and, in practice, to deliver the reserve currency that the borrower wants—usually U.S. dollars.

(5) The implicit cumulative limit on the sale by the Fund of any creditor's currency is the amount the member has subscribed, unless it has lent additional amounts to the Fund.

(6) As a result of the sale by the Fund of an amount of a creditor's currency, the creditor member receives an RTP in the Fund of an equivalent amount. Since the first amendment (de facto, since a 1952 decision of the executive board), the member may draw down its RTP with no questions asked and no policy conditions imposed.

2-2 *The SDR Designation Technique*

The long drawn-out discussions that preceded the introduction of the SDR brought about a general awareness among the technicians and policymakers involved that there was no point in having countries contribute currencies to the Fund as the counterpart of the SDRs allocated—or, as that discovery was described at the time, that SDRs did not need "backing" by an equivalent amount of currencies.[1] Accordingly,

[1] Fritz Machlup (1968, pp. 64–66) praised this discovery as a major intellectual breakthrough.

the first amendment provided a simple technique for the exchange of SDRs into an equivalent amount of currency. It stated that:

(1) a member is entitled to use its SDRs to buy reserve currencies from other members. Those members, and the amounts to be delivered by each, are specified by the Fund in a process called "designation."[2]

(2) a member's obligation to provide currency under designation is limited to twice the amount of SDRs it has been allocated, its net cumulative allocation (NCA).

At this point, it should be noted that because the General Account receives large amounts of SDRs—in quota contributions, charges, and repayments of credit—the Fund often provides drawing members with SDRs instead of currencies, which the recipient member can then turn into reserve currencies through the designation process.

2-3 Comparison of the Currencies and SDR Designation Techniques

The currencies and SDR designation techniques have much in common—indeed, the SDR technique was largely inspired by the currencies technique—but there are four important differences:

- To put it mildly, the currency technique lacks transparency. It hides the fact that all the to-and-fro with currency balances involved in this technique serves no purpose at all. The true obligation of a creditor member is to deliver on demand its fair share of the total credit that the Fund has voted for a debtor member. Steps (1) to (4) of the currency technique achieve no more than step (1) of the SDR technique. The statutory limit (step 2) of the SDR technique is no less effective than the implicit limit (step 5) of the currencies technique.
- The "assets" received by the member providing foreign-exchange reserves under the two techniques do not receive equal remuneration. Holders of RTPs participate in sharing the burden imposed on the Fund by the failure of some debtors to pay charges on time, whereas the strict separation between the Fund's two accounts makes it impossible to extend this burden-sharing to the holders of SDRs by lowering the interest rate they receive.
- In spite of the Fund's best efforts to treat the RTP as an "asset," it remains nothing but a preferential drawing right, whereas the SDR—in spite of its name—is a true asset. The RTP can only be used by a

[2] The technique is described here as applying to *members*, even though the Articles dealing with the SDR Department spell out the rights and obligations of *participants* in that account. The distinction has become irrelevant now that all members of the Fund are also participants in the SDR Account.

drawing on the Fund; unlike the SDR, it cannot be transferred from one member to another in a bilateral exchange for currency. (This point was missed in the Maastricht Treaty, which assumed [in Article 30.5] that it would be possible for the European Central Bank to pool the RTPs of its members). Although members' use of their reserve tranches, except in combination with credit tranche drawings, has been extremely rare, at least in the last twenty years (Polak 1996, p. 230), any such use has to be financed from the same resources that meet requests for conditional credit. Periodically, in the months just before an increase in quotas, these resources tend to run low. As we have seen in recent years, the Fund's pronouncements on RTPs then become embarrassingly ambivalent. The Fund (1998, p. 44) proclaims that "there must never be any doubt about the IMF's ability to finance such [reserve tranche] drawings." At the same time, it presses the case for an increase in quotas by pointing out that its "liquidity ratio" (its holdings of available usable currencies as a percentage of the sum of RTPs and loan claims) is approaching—or has reached—an uncomfortably low level by historical standards.

• Under the SDR technique, members supply reserve currencies that they hold (or in the case of a reserve center, that their central bank creates) in exchange for SDRs. Such exchanges are typical central-bank transactions that do not require a budgetary provision. Even if (as in the United States) the initial currency sale is executed by the government, the SDRs obtained can be monetized at the central bank. By contrast, the currencies technique requires each member to deliver up front—in currency balances or securities—the maximum amount of its currency that it may ultimately be asked to provide under its present quota. With the ultimate beneficiaries of Fund credit consisting nowadays almost exclusively of developing and transition economies, it is not surprising that some legislatures consider their national contributions to be similar to foreign aid and therefore to require budgetary appropriations.[3]

2-4 The Third Technique: SDR Transactions by Agreement

The Articles of Agreement permit members to exchange SDRs for currency by agreement. For members that want to reduce their holdings of SDRs, this is an alternative to designation, but for members

[3] The Fund's own publicity is not particularly helpful on this issue when it describes quota subscriptions as "membership fees" (Driscoll, 1998, p. 16).

that want to acquire SDRs, it is the only technique available.[4] Since 1987, transactions by agreement have become the standard technique for transferring SDRs among members, and the SDR designation mechanism has ceased to be used, although quarterly designation plans are still devised on a contingency basis. Transactions by agreement are facilitated by standing arrangements between the Fund and a dozen members, each of which is prepared to buy or sell SDRs up to a specified amount. These amounts add up to a total (net) of SDR2.5 billion. In effect, the Fund acts as a broker in a protomarket for SDRs against reserve currencies, but under the constraint that all transactions in this market take place at the official exchange rate of the SDR for the currency involved. As a consequence of this constraint, the market does not always clear at once. The gaps between the demand for SDRs (to pay charges to the Fund and repay credits) and the supply (Fund credit to borrowing members paid out as SDRs rather than currencies) have only rarely, however, led to significant delays.

2-5 *The Choice of a Transfer Technique for Conditional Credit*

To ensure the prompt execution of sometimes massive reserve transfers to a country receiving conditional Fund credit requires a technique for mandatory designation by the Fund of the members that are to provide reserves and the amount to be provided by each. The comparison in Section 2-3 of the Fund's two mandatory techniques has shown that the technique currently forming part of the SDR Account is clearly superior. This judgment seems to be confirmed by the contrast between the sensitivity members show to their inclusion in the operational budget—as revealed by the frequent adjustments in the rules governing that budget (see Section 3-3 below)—and the evident indifference of at least a dozen members toward modest increases or decreases in their holdings of SDRs (Section 2-4).

More direct evidence on members' views about holding SDRs, as contrasted with RTPs, is provided by their actual choices in the few circumstances in which they may choose between the two. A member may opt to receive remuneration either in SDRs or "in its own currency," that is, as an enlargement of its RTP. In the last five years, all but two of the nearly 100 members that received remuneration, accounting for less than

[4] The Articles provide for "reverse designation" (the obligation to sell SDRs for currency) only in the event that a member needs SDRs for reconstitution—which is no longer relevant—or to pay charges and assessments, and then only if the Fund itself cannot make the required amount of SDRs available.

1 percent of the total amount of remuneration, have chosen payment in SDRs. Most recently, all members of the General Arrangements to Borrow (GAB) opted to receive interest payments on their loans in SDRs rather than in their own currencies. The same choice was made by the great majority of the lenders under the New Arrangements to Borrow (NAB).

In order to bring the transfer of reserves required for the execution of conditional drawings under a technique similar to the SDR designation technique, it would be necessary:

(1) to eliminate the entire "currency veil" from the Articles of Agreement; there would be no payments for quota increases and no "purchases" of currencies. The obligation to provide reserve currencies for Fund transactions would be made direct and explicit (as it is already under the SDR designation technique), instead of indirect, through the conversion of currency balances; and

(2) to supply the member providing a reserve currency under (1) with an equivalent *asset position* in the Fund, rather than with the RTP it currently receives, which is a *reduction of its debit position* (that is, the Fund's holdings of its currency).

This asset would have to have four characteristics: (1) Its value would be maintained in SDRs; (2) it could be used to pay the Fund; (3) it could be transferred to other members and other holders; and (4) it would earn the SDR interest rate. An asset of this kind would so closely resemble the present SDR that simplicity would require making it identical with the SDR. This would imply widening the definition of the SDR (see Box 2) to include SDR-denominated assets in the Fund originating both from allocations and from Fund credit transactions.

Under the strategy described here, the Fund would not only cease holding currencies; it would also stop holding SDRs. But this change would merely remove an anomaly: no central bank carries its own bank notes as an asset on its balance sheet. Only in a Fund split into two parts—reminiscent of the old split of the Bank of England into an Issue Department and a Banking Department—is it possible for one half of the institution to hold assets issued by the other half. It follows that if members pay SDRs to the Fund—an option discussed in the next section—those SDRs will be automatically canceled.

Box 3 describes how these changes could be applied to past transactions, essentially by reversing members' past payments for quotas. As a result of this notional transaction, quotas would move from the balance sheet itself to a *pro memoria* entry at the bottom of the balance sheet. They could, of course, be restored to the liabilities side of the balance sheet if the necessary contra entries were also added. In any event,

BOX 2

THE EVOLUTION OF THE SDR

When the SDR was introduced, the membership was still sharply divided about its nature and function. This explains why the Articles of Agreement do not contain a definition of the SDR. Instead, Article XV merely authorizes the Fund to allocate SDRs "to meet the need, as and when it arises, for a supplement to existing reserve assets." The value of the SDR was defined as a weight of gold equal to that of the U.S. dollar at that time.

The Articles still have no definition for the SDR, but the Fund's *Annual Reports* provide, not one, but two definitions. Following are the lead sentences of two successive paragraphs in the Fund's *Annual Report 1998* (p. 93):

- "The SDR is an international reserve asset created by the IMF under the First Amendment of its Articles of Agreement to supplement existing reserve assets," and
- "The SDR is the unit of account for IMF operations and transactions."

The first definition of the SDR applies to the asset—the term is no longer controversial—described in the entire block of Articles added by the first amendment (Articles XV through XXV), as well as in the objective expressed in Article VIII, Section 7, of "making the SDR the principal reserve asset in the international monetary system." The second definition arose from the abandonment of gold as the linchpin of the system in the period from 1971 to 1973, a change that made it necessary for the Fund to address two critical problems: (1) how to replace gold as the unit of account for its assets and liabilities, as well as its operations and transactions, for which the SDR was now the natural candidate, and (2) how to find an alternative basis for the valuation of the SDR, for which the basket of currencies was the only acceptable option, although it took the Fund until 1981 before the basket was slimmed down to five currencies.

Although the SDR functions well as a unit of account and a store of value, it serves as a means of payment almost exclusively between members and the Fund, and there is little reason to expect this to change. It would therefore not be useful for the Fund to extend credit and accept repayment of credit in the form of SDRs (as I proposed in an earlier paper on this subject [Polak, 1979]), because the recipients of SDRs would still need to use designation to turn them into reserve currencies, and perhaps reverse designation to acquire SDRs in exchange for reserve currencies. If the Fund's credit operations must provide debtor countries with reserve currencies, they should do so directly, as suggested in Section 2-5.

quotas would retain all the functions they now have, as limits on a member's commitments, guidelines for designation, access to Fund credit and voting rights, and as the yardstick for the allocation of SDRs.

2-6 *The Choice of a Mechanism for the Exchange of SDRs for Currencies*

At present, most of the demand for the conversion of SDRs into currencies arises when the Fund sells SDRs in lieu of currencies. This

BOX 3

TRANSITION FROM THE CURRENCIES TECHNIQUE
TO THE SDR DESIGNATION TECHNIQUE

The transposition of outstanding Fund transactions from the currencies technique to the SDR designation technique can be construed as the Fund's repaying all past inpayments of quotas, using the following assets:

- For each net debtor country, an amount of its currency equal to its quota; in addition, the Fund would cancel its remaining holdings of the member's currency, because there would be other adequate evidence of the member's debt to the Fund.
- For each net creditor country, all of the Fund's holdings of the member's currency, and the balance in newly created SDRs (after use of the present SDR holdings of SDR3.6 billion).

The balance sheet would then read as follows:

ADJUSTED GENERAL DEPARTMENT BALANCE SHEET, APRIL 30, 1999
(*In billions of SDRs*)

Assets		Liabilities	
Fund credit	60.7	SDRs (created in lieu of RTPs)	60.0
Gold holdings	3.6	Reserves, etc.	4.6
Other assets	2.6	Other liabilities	2.3
Total assets	66.9	Total liabilities	66.9
Memorandum: Quotas = 208.0			

demand will disappear when the Fund ceases to hold SDRs. If, moreover, there is an assured market in which SDRs are traded for currencies, there will be no further need for a mandatory designation mechanism for the conversion of SDRs. The current voluntary system brokered by the Fund provides a market in a rudimentary form. That system could usefully continue, but without being supported by designation on a standby basis, and it cannot be assumed that the system would always provide market clearance. Three changes to the system might therefore be considered:

(1) The rule that exchanges must take place at the official value of the SDR as calculated every day by the Fund could be abolished. In a world where reserve currencies float with respect to each other, and the calculated value of the SDR basket floats in terms of both a country's domestic currency and its main reserve currency, there is no reason to expect that the price at which a country buys or sells SDRs will be precisely determined by a formula.

(2) To support the market exchange rate for the SDR at, or extremely close to, its official rate, members could be given the option to make payments (charges, repayments) either in SDRs or in reserve currencies. The current rule that charges must be paid in SDRs is the main reason why demand occasionally exceeds supply in the Fund-operated proto-market for SDRs. When members pay SDRs to the Fund, these SDRs will, of course, automatically be canceled.

(3) The extremely narrow definition of potential "other holders" of SDRs could be removed, so that commercial banks could also become other holders. The 85 percent majority that Article XVII, Section 3, imposes for the selection of an "other holder" should provide sufficient protection against the admission of any undeserving institution to this exclusive group. There is no evidence that commercial banks are particularly anxious to become other holders, but a few of them might want to offer their central-bank clients the extra service of making a market in SDRs, without themselves necessarily becoming important holders of SDRs.

3 Merger of the General Department and the SDR Department

3-1 The Case for Merger

If SDRs are created and withdrawn not only by "allocation" and "cancellation," but also by the extension and repayment of conditional Fund credit, merger of the Fund's two accounts becomes inevitable. Developments in the Fund since the introduction of the SDR have, in any event, removed much of the rationale for the original rigid separation between the two accounts. One of the reasons for that separation was the fear of associating the existing Fund too closely with a new-fangled set of accounts that would create, "*ex nihilo*," as the saying went, something akin to international money. Those concerned about this aspect of the SDR Account insisted on separate membership ("participants" vs "members"), separate decisionmaking, and separate financing of operational expenses, as well as limitations on the use of SDRs in transactions with and by the General Department. Over the past thirty years, and even though the original enthusiasm for the SDR mechanism has cooled markedly, these particular concerns appear to have largely evaporated. Since 1980, all members of the Fund have been participants in the SDR Account, and a large proportion of the turnover in SDRs is connected with the transactions and operations of the General Resources Account. Separate cost accounting has turned out to be meaningless in practice: a large part of the Fund's annual meeting in Madrid (1994) was devoted to the question of a new SDR allocation, but none of the costs of that meeting were allocated to the SDR Account. Perhaps most important, the nature of the SDR has significantly changed (see Box 2 above).

After merger of the two departments, the Fund's balance sheet would appear as follows, reflecting the combination of the balance sheet shown in Box 3 with the quasi-balance sheet that the Fund publishes for the SDR Account:[5]

Balance Sheet of an Integrated Fund, April 30, 1999
(*In billions of SDRs*)

Fund credit	60.7	SDRs: members	77.4
SDR allocations	18.0	SDRs: others	0.6
Gold holdings	3.6	Reserves, etc.	4.6
Other assets	2.6	Other liabilities	2.3
Total assets	84.9	Total liabilities	84.9
Memorandum: Quotas = 208.0			

3-2 *Members' Commitments to Give Credit in a Merged Fund*

Under the current Articles of Agreement, the limit on a member's obligation to extend credit through the Fund is determined separately for each department. In the General Department, that limit equals the member's quota; in the SDR Department, it equals twice the member's NCA. Furthermore, two measures indicate the extent to which the Fund can still call on a member under these two obligations: the Fund's holdings of its currency in the General Department; and the member's holdings of SDRs, compared to three times its cumulative allocation, in the SDR Department.

In the merged Fund proposed here, there is only one obligation: to participate in the Fund's conditional lending. And there is only one indicator: the member's holdings of SDRs. To what new "holding limit" should these holdings be compared to determine the remaining size of the member's obligation to provide financing for Fund transactions? The answer to this question follows from the quota-based character of the Fund, which implies that a member's contribution to the Fund's conditional lending should not exceed its quota, except insofar as it has lent additional resources to the Fund.

[5] SDR holdings of the General Resources Account (SDR3.6 billion) are subtracted from SDR allocations.

Thus, the holding limit should be set at a member's quota *plus* its own allocation of SDRs *plus* an allowance (which can only be an approximation) for the amount of SDRs that the average creditor member might acquire through voluntary purchases from other members. The following rough calculation suggests a remarkably small size for this allowance, far below the formal obligation of 200 percent of NCA set out in the existing Articles of Agreement.[6] Since the last SDR allocation, in 1981, the combined SDR holdings of the industrial and oil-exporting countries, all of which would be expected to qualify for designation under the rules set out in the next section, have never exceeded SDR 18.5 billion, or 115 percent of their combined cumulative allocations of SDR 16.1 billion. Thus, setting a holding limit at a member's quota *plus* 1.20 or 1.25 times its NAC would ensure that a member's maximum contribution to the Fund's conditional credit would not, at least not significantly, exceed its quota. Indeed, with current allocations, setting the holding limit simply as a member's quota *plus* its cumulative allocation would make only a small dent in the Fund's usable resources—far smaller than the 10 percent of quotas of the members currently considered as having "usable" currencies (SDR 14 billion as of April 30, 1999) that the Fund deducts from its holdings of usable currencies to compute its "available usable resources."[7]

3-3 *Rules for Designation After Merger of the Accounts*

Once a member receives SDRs instead of an RTP in exchange for the reserve currency it delivers to finance a Fund transaction, it should no longer need to be protected by the highly detailed (and, in recent years, frequently refined) procedures to determine whether its balance-of-payments and reserve position is sufficiently strong for it to be included in the designation plan.[8] A simple rule should suffice, such as one stating

[6] It should be stressed that this is the formal obligation. In fact, even members that hold no SDRs in excess of their own allocations are not, at present, included in the Fund's (contingent) designation plans, because a substantial number of members strong enough to be subject to designation are also large net users of SDRs. Until the below-allocation holdings of these latter members have been filled up, designation will not reach members in a neutral SDR position.

[7] According to the liquidity table posted on the Fund's external web site, this deduction represents "minimum working balances required for the IMF to be able to make payments that must be made in specified currencies" (. . . /external/np/tre/liquid/1999/0899.HTM). But could not *any* "freely convertible currency" be converted into whatever specified currency the IMF would have to pay?

[8] In its *Annual Report 1997* (p. 126), the Fund reported that it weighed the following four variables to conclude whether a member was in a sufficiently strong position to be included

that a member is sufficiently strong if it is not indebted to the Fund or to the SAF or ESAF. After all, quite a few indebted countries maintain reserve tranche positions, and any member that is uncomfortable in being designated to hold somewhat more SDRs in its reserves, and thus somewhat fewer dollars, may sell the SDRs it has received. At present, nondebtor countries have aggregate quotas of about SDR 161 billion. Of these, the Fund currently uses the currencies of countries with quotas of SDR 140 billion, leaving nondebtor countries with SDR 21 billion in quotas excused from participation in the operational budget.[9] Their inclusion would stretch the Fund's potential for providing conditional credit correspondingly. It would also, incidentally, increase transparency. The list of "usable currencies" is, at present, not published for fear that removal of a country from the list, even though it has not borrowed from the Fund, might signal a serious weakening in its position.[10]

3-4 Charges, Remuneration, and Interest on Fund Positions After Merger of the Accounts

Charges. The proposed streamlining of the Fund's finances has no necessary substantive implications for the existing provisions on charges. Charges on the Fund's outstanding conditional credit and, for all members, on their NCAs, could remain as they are at present.

The merger of the two accounts, however, would lift the "balanced budget constraint" of the SDR Department that has made it necessary for the debit and credit interest rates in that department to be equal. The odd consequence of this constraint has been that the Fund charges

in the operational budget or the designation plan: "(1) recent and prospective movements in gross reserves, (2) balance of payments developments, (3) the relationship of gross reserves to a member's imports and to its Fund quota, and (4) developments in exchange markets." Shortly afterward, the executive directors apparently found it necessary to add additional refinements, supplementing the four criteria mentioned "by a small set of additional indicators bearing on a member's financial strength, including in particular indicators of short-term external debt and debt service" (IMF, *Annual Report 1998*, p. 84, box 15).

[9] The difference between SDR 21 billion for the quotas of this group of countries and the figure of SDR 17 billion in Box 1 for the Fund's holdings of potentially usable currencies reflects the reserve tranche positions of debtor countries, together with possible errors of rounding.

[10] Although the Fund does not divulge its list of "sufficiently strong" currencies, it did publish the names of the NAB participants that lent to the Fund in 1998 (in connection with the large transaction in favor of Brazil), a list that would normally be guided by the same criteria. At least one member sought protection against the risk that the list of countries in the operational budget would become known by insisting that it be included in the budget, even though the staff's criteria suggested that it did not qualify.

only the SDR interest rate on members' use of the unconditional and timeless credit currently offered by the SDR Department, whereas in the General Department, it charges about 25 basis points more than that rate, plus a one-time 0.5 percent service charge, for conditional credit subject to precise repayment conditions. Once the constraint is lifted by a merger of the two accounts, the Fund will have a broader set of options to cover its operational costs. The introduction of a charge on the shortfall of a member's holdings of SDRs below its net cumulative allocation would enhance the equity of the entire interest-rate structure of the Fund and provide some incentive for members to avoid net use of SDRs when their payments position does not require it. In recent years, the collective SDR debit position of all "net users" of SDRs has been about SDR 8 billion, and that amount is likely to rise substantially once the allocation under the fourth amendment occurs. A charge on the use of SDR credit of perhaps 50 or 100 basis points could make an important addition to the Fund's operational income and reduce *pro tanto* the need for recourse to other measures to finance interest-rate subsidies to low-income countries.

Interest and remuneration. Remuneration of RTPs would, of course, be replaced by interest payments on SDR holdings, but the current problems with remuneration would still require a solution. There is a long tradition in the Fund, going back to the original Articles of Agreement, that a member should receive remuneration or similar income payments only on that part of its reserve tranche that exceeds 25 percent of its quota. This 25 percent originally represented the part of the quota paid in gold, on which the member had earned no interest and on which the Fund could earn no income as long as it kept the contribution in the form of gold. It fit into this logic that, when the second amendment abolished gold payments for quota increases, the unremunerated amount could be frozen at 25 percent of each member's quota at that time (and could perhaps be reduced further if the Fund sold more gold). That was what the executive directors meant to say in a new provision on remuneration.[11] The revised Article V, Section 9, that resulted, however, wraps this intent in such convoluted language that the Fund as an institution seems unable to read the provision in the way intended. That is one of the Fund's language problems discussed in Part 4 of this essay.

In any event, developments since 1978 have changed opinions about what would be an equitable remuneration formula. As the Fund built up

[11] This was well understood at the time, see Polak, 1979, n. 20.

its reserves in the years after 1978, to a level about equal to its gold holdings (which had been reduced by the gold-sales policy of the 1976–80 period), the rationale for not remunerating a portion of RTPs shifted from the need to finance the gold stock to the need to cover the Fund's administrative expenses. From that perspective, the provisions of Article V, Section 9, suffer from a triple inequity. First, only members that have RTPs contribute. Debtor members and those in a neutral position make no contribution. Second, creditor members with RTPs smaller than those defined by the formula make only a partial contribution. At current SDR interest rates of about 3.2 percent a year, the Fund loses approximately SDR 50 million a year in income from these two groups of members. Third, contributions are shared among the creditors in proportion to a wholly outdated set of quotas, with unremunerated reserve tranches ranging from more than 6 percent of its current quota for the United Kingdom to less than 0.5 percent for Saudi Arabia.

These inequities were recognized by the Fund's Interim Committee, and the executive directors, in their *Annual Report 1995* (p. 144), indicated a measure of agreement that the Fund's administrative costs should be shared by all members in proportion to quotas, even though this would require an amendment to the Articles of Agreement. It is clear that the directors did not intend to implement this strategy by simply assessing all members a contribution equal to a (flexible) percentage of quota. Being anxious to avoid to the largest extent possible the need for members to vote annual contributions to the IMF's operational budget, they proposed maintaining primary reliance on a nonremunerated fraction of the reserve tranche, with compensating charges imposed on members that did not maintain a sufficiently large reserve tranche. Transposed to a Fund in which reserve tranches are merged into holdings of SDRs, a provision on the rate of interest to be paid on these holdings could read as follows:

• Members would be expected to maintain a minimum average balance of SDRs to be set annually by the executive board and expressed as a percentage of current quotas.[12]

• A member's SDR holdings in excess of the minimum balance would earn interest at the SDR interest rate. A member whose holdings

[12] The main argument for a flexible percentage, rather than one set by the Articles, as at present, would seem to lie not so much in the variability of the Fund's administrative budget, which moves on a slow trend in dollars, as in the fact that the availability on an interest-free basis of resources equal to a given percentage of quotas (that is, a *stock amount in SDRs*) yields the Fund *a flow in dollars* that varies with the SDR-dollar exchange rate and the SDR interest rate.

fell short of the minimum balance would be charged interest on the shortfall, at the SDR interest rate.

Thus, a member with a balance between zero and the stipulated minimum would make its contribution in part by forgoing interest on its balance, and in part by paying the charge on the shortfall of the balance it held.[13]

4 A Farewell to Cherokee?

4-1 The Fund's Special Language

In addition to defining the financial structure of the Fund, the currencies technique also provided an insider language to describe many of the Fund's features. Thus, a member paid charges on "the average daily balances of its currency held by the Fund in excess of its quota" (translation: *on the amount of its credit from the Fund*), and its entitlement to remuneration (in the original Articles, to a preferential share in the Fund's profits) was calculated on the amount by which the Fund's holdings of its currency were below 75 percent of its quota (translation: *on its creditor position minus 25 percent of its quota*).

The special language irritated many, among them Lord Keynes, who sneeringly referred to it as "Cherokee" (Horsefield, 1969, vol. 1, p. 57).[14] And, whatever may have been its merits in 1944, it lost its rationale as a result of two little-known policy decisions taken by the Fund in 1981–82. The first decision allowed a member to draw in the credit tranches without first using up any RTP it might have; the second allowed a member indebted to the Fund to choose whether any payment it made to the Fund (for example, the SDR component of a quota payment) should reduce its debt or should enlarge its RTP (*Annual Report 1981*, pp. 162–163; *Annual Report 1982*, pp. 127–128). These

[13] This may have been the intent of the somewhat opaque suggestion for an amendment mentioned in the *Annual Report 1995* (p. 144): "If a member were to have utilized part or all of its reserve tranche, balances equal to the proportion of the reserve tranche used that would be unremunerated would become subject to charges."

[14] Even before Bretton Woods, the American technicians conversed in this "currency language," rather than in one more readily understandable. Thus: "when the Fund's holdings [of a member's currency] have reached 200 percent of the quota [translation: *when a member has borrowed its full quota from the Fund*], it is generally an indication that there is a fundamental disequilibrium in the country's international position that calls for remedial action" (reply to question 23 in *Questions and Answers on the International Monetary Fund*, June 10, 1944, reprinted in Horsefield, 1969, vol. 3, p. 164.

decisions made a member's financial relation to the Fund more flexible—in fact, made it similar to the relation it might have with a commercial bank, where it could have a deposit account and one or more debit accounts at the same time. But they also deprived the standard Fund concept—the difference between a member's quota and the Fund's holdings of its currency—of any useful meaning and made nearly incomprehensible the provisions in the Articles that still employ this concept, in particular Article V, Sections 8(b) and 9, on periodic charges and remuneration, respectively. I consider these two provisions in order.

4-2 Periodic Charges

The second amendment, which recognized that a member might make certain drawings (at the time, those under the so-called "floating" compensatory financing and buffer-stock facilities) while keeping its RTP intact, could have made the level of outstanding drawings as the base for periodic charges. Instead, it stuck to the form of the holdings-of-currency approach while abandoning it in effect. Article V, Section 8(b), now defines the base for periodic charges as balances that "(i)... have been acquired under a policy that has been the subject of an exclusion under Article XXX(c)"—that is, outstanding drawings that may be made without prior use of the reserve tranche—and balances that "(ii) . . . exceed the amount of the member's quota after excluding any balances referred to in (i) above"—that is, all other outstanding drawings. Grasping the meaning of this provision is not facilitated by the fact that the conjunction "and" between the first and the second categories of drawings is found only in the commentary (IMF, 1976, p. 35); the text of the Article reads "or." But because the 1981 decision referred to above puts all balances in the first category, the issue of the correct conjunction has, fortunately, become moot.

4-3 Remuneration

As mentioned in Section 3-4 above, the intention of Article V, Section 9, was to set a member's unremunerated reserve tranche at 25 percent of its quota on April 1, 1968. But the Article is drafted as a string of circumlocutions and, as currently read by the Fund, never arrives at its destination.[15] Indeed, it takes a considerable effort—first to translate

[15] I recall that the provision was drafted under severe time pressure late in the preparation of the second amendment. This pressure must also account for the odd placement of the two sentences defining the *rate* of remuneration (at the end of subsection [a], interrupting the definition of the *base* for remuneration), rather than as a separate subsection, as in Article V, Section 8.

certain obscure passages and then to convert them into elementary algebra—to retrieve the original intention from the text of the provision. In the text reproduced below, each passage to be explained is highlighted and is followed by a reference to an explanatory note. The variables to be used in the algebra have been inserted in the text in square brackets and are defined as follows: RA = the remunerated amount of the member's reserve tranche; Q = the member's current quota; Q′ = the member's quota on April 1, 1978, the date of the second amendment; H = the Fund's average daily holdings of the member's currency; and D = the member's outstanding drawings.

Section 9. *Remuneration*

(a) The Fund shall pay remuneration on the amount [RA] by which the average percentage of quota prescribed under *(b)* or *(c)* below exceeds the Fund's average daily balances of a member's currency held in the General Resources Account [H] other than balances acquired under a policy that has been the subject of an exclusion under Article XXX*(c)* [Note 1]. The rate of remuneration, which shall be determined by the Fund by a seventy percent majority of the total voting power, shall be the same for all members and shall be not more than, nor less than four-fifths of, the rate of interest under Article XX, Section 3. In establishing the rate of remuneration, the Fund shall take into account the rates of charge under Article V, Section 8*(b)*.

(b) The percentage of quota applying for the purposes of *(a)* above shall be:

(i) for each member that became a member before the second amendment of this Agreement, a percentage of quota corresponding to seventy-five percent of its quota on the date of the second Amendment of this Agreement [0.75Q′], and for each member that became a member after the date of the second amendment of this Agreement, a percentage of quota calculated by dividing the total of the amounts corresponding to the percentages of quota that apply to the other members on the date on which the member became a member by the total of quotas of the other members on the same date [Note 2]; plus

(ii) the amounts it has paid to the Fund in currency or special drawing rights under Article III, Section 3*(a)* since the date applicable under *(b)*(i) above [Note 3]; and minus

(iii) the amounts it has received from the Fund in currency or special drawing rights under Article III, Section (3)*(c)* since the date applicable under *(b)*(i) above [Note 4].

(c) The Fund, by a seventy percent majority of the total voting power, may raise the latest percentage of quota applying for the purpose of *(a)* above to each member to:

(i) a percentage, not in excess of one hundred percent, that shall be determined for each member on the basis of the same criteria for all members, or

(ii) one hundred percent for all members [Note 5].

(d) Remuneration shall be paid in special drawing rights, provided that either the Fund or the member may decide that the payment to the member shall be made in its own currency.

Note 1: Since a board decision of April 22, 1981, this expression means the amount of the member's outstanding drawings [D].

Note 2: A country that joined the Fund after April 1, 1978, is given a notional 1978 quota, calculated as its initial quota reduced by the average increase since April 1, 1978, in the quotas of all countries that were members at the time it joined.

Note 3: This is equivalent to the member's quota increase(s) since April 1, 1978, or [Q – Q′].

Note 4: This is equivalent to a reduction in the member's quota, which happened only once in the Fund's history: in 1948, Honduras asked for a reduction in its quota, which was restored to the original amount four years later.

Note 5: This subsection gives the executive board the power to reward the full reserve tranche with remuneration, or, as the commentary (IMF, 1976, p. 39) puts it hopefully, "that eventually the same level as is applicable for other purposes under the amended Articles may apply to remuneration," adding, with perhaps less than perfect foresight, "the reason why the level of quota is not adopted at once is that such a solution would impose too heavy a financial burden on the Fund for an indeterminate period ahead."

Translated into elementary algebra, and following the order of presentation in the Article, its message becomes

$$RA = -(H - D) + 0.75Q' + (Q - Q'), \text{ or}$$

$$RA = Q - (H - D) - 0.25Q'.$$

Because $Q - (H - D)$, if positive, equals the member's RTP, it follows that

$$RA = RTP - 0.25Q',$$

or that the remunerated reserve tranche equals the total reserve tranche *minus* 25 percent of the member's quota (or notional quota) as of April 1, 1978. But the Fund as an institution seems unable to translate the implied mathematics back into simple English.[16] The

[16] The difficulties in understanding Article V, Section 9, are enhanced by the confusion in the text between percentages of quota and amounts equal to percentages of quota. The same confusion is found in the Fund's Treasurer's Department pamphlet describing the financial organization of the Fund (IMF, 1998, p. 32): "For countries that became members after April 1, 1978, the norm is the weighted average of the norms

official commentary on Article V, Section 9 (IMF, 1976, pp. 37–40), should have clarified the point but failed to do so. The Fund's financial statements provide numbers for the unremunerated reserve tranche of pre–1978 members that check out as 25 percent of their quotas on April 1, 1978, but no Fund *Annual Report* contains a statement to this effect.

The forgoing analysis of what are perhaps the two most awkward provisions of the Articles of Agreement suggests that, in addition to its other benefits, the abandonment of the currencies approach in the Articles will also spell the end of "Cherokee" in the Fund. Its demise should be welcomed.

5 Concluding Observations

The streamlined version of an integrated IMF sketched in this essay would be simpler to understand and could more efficiently serve the agreed upon purposes of the financial structure of the institution. The elimination of both the "currency veil" and the, by now, artificial separation of the Fund into two departments would make this structure much more transparent. Large chunks of the Articles of Agreement would disappear, including (in the order of the Articles' Table of Contents) those dealing with: the payment of quota subscriptions and substitution of securities for currency in Article III; purchases and sales of SDRs by the Fund, remuneration, computations, and maintenance of value in Article V; all of Article XVI (General Department and Special Drawing Rights Department); the Fund as a holder of SDRs (Article XVII, Section 2); parts of Article XIX (Operations and Transactions in SDRs); assessments for the costs of the SDR Department (Article XX, Section 4); all of Article XXI (Administration of the General Department and the SDR Department), and all of Articles XXIII, XXIV, and XXV (Suspension of Operations and Transactions in SDRs, Termination of Participation, and Liquidation of the SDR Department) and the corresponding Schedules H and I.[17] A number of esoteric terms would disappear, including "reserve tranche," "reserve position in the Fund," "remuneration," and "operational budget." "Designation," however, would remain.

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applicable to all other members on the date that the member joined the IMF [clearly, a percentage] plus any increase in its quota after that date [clearly, an amount]."

[17] The occasion of a major amendment might, of course, also be used to eliminate other provisions that have long outlived their usefulness, such as most of Articles VI (Capital Transfers) and VII (Scarce Currencies), or even their validity, such as Schedules F and G, which apply to the first basic period (1970 to 1972) only.

In addition, experience has proved the redundancy of most of the four pages taken up by Article XVIII, which deals with decisionmaking on SDR allocations. The single effective key to allocation has been the requirement for an 85 percent majority of the votes in the board of governors. A simple provision, patterned on that for quota increases, should largely suffice. The new provision could specify that allocations should either be proportional to quotas (as in Article XVIII) or lead to NCAs proportional to quotas (as in the proposed fourth amendment). The provision should also preserve the essential preconditions for allocation laid down in Article XVIII, namely, the existence of a "long-term global need . . . to supplement existing reserve assets," the promotion of the Fund's purposes, and the avoidance of "economic stagnation and deflation as well as excess demand and inflation in the world."

The improvements to the financial structure of the Fund that would follow from the streamlining proposed in this essay would involve the one-time cost of a major amendment, and even though it would be much less fundamental than the first or the second amendments, it would still require a significant effort on the part of the Fund staff and executive board. Although this effort can, at some cost, be postponed, it will have to be made at some time in the future. The pressure to modernize the financial structure of the Fund will inexorably increase over time.

Appendix: Amendments to the Articles of Agreement of the IMF

The Articles of Agreement have been amended three times. A fourth amendment was approved by the board of governors in 1997 but has not yet been ratified by the required majorities of the membership.

The *first* amendment (1969) established the SDR Account in the Fund, provided for the allocation of SDRs, and improved the characteristics of the gold tranche as a reserve asset.

The *second* amendment (1978) dealt mostly with the reform of the international monetary system, including exchange arrangements and Fund surveillance, a reduction in the role of gold and the disposition of part of the Fund's holdings of gold, and the possible establishment of the Council as a new organ of the Fund. It also made many changes in the characteristics, and expanded the possible uses, of the SDR, including use by members in quota payments.

The *third* amendment (1990) provided for the suspension of voting and related rights of members that do not fulfill their obligations under the Articles of Agreement.

The *fourth* amendment (approved by the board of governors in 1997 but not yet effective) addresses what has become known as the "equity issue" with respect to the allocation of SDRs, namely, the wide differences among members' ratios of SDR allocations to quotas. The thirty-nine members that joined after 1981—notably many of the economies in transition—have received no allocation at all, and other members have "opted out" of allocations, or had only very small quotas when the allocations were made. The distribution among the membership of the allocations under the fourth amendment was designed to remedy these perceived inequities by bringing each member's cumulative allocation to the same percentage (29.3 percent) of its quota on September 17, 1997. The new allocation, which will double the total of SDRs outstanding to SDR 42.8 billion, requires an amendment for two reasons: the existing Articles of Agreement stipulate (1) that allocations, and not cumulative allocations, should be proportional to quotas, and, more fundamentally, (2) that allocations should meet "the long-term global need . . . to supplement existing reserve assets," a condition that most industrial-country members believe has not been met.

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