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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

Special Drawing Rights: Paper Gold In Action

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
September 1970

INTELLIGENCE MEMORANDUM

Special Drawing Rights: Paper Gold In Action

Introduction

Throughout the 1960s, many of the world's economists, monetary officials, and politicians were increasingly preoccupied with the growing need for greater international liquidity. Their efforts culminated in the creation of Special Drawing Rights (SDRs) or "paper gold," which through a simple bookkeeping entry at the International Monetary Fund (IMF) provide a new type of liquidity as permanent as gold itself.

This memorandum, prepared to coincide with the forthcoming IMF annual meeting, reviews major developments leading to the first SDR allocation on 1 January 1970, examines trends in the use of SDRs, and makes some observations regarding their future.

Background

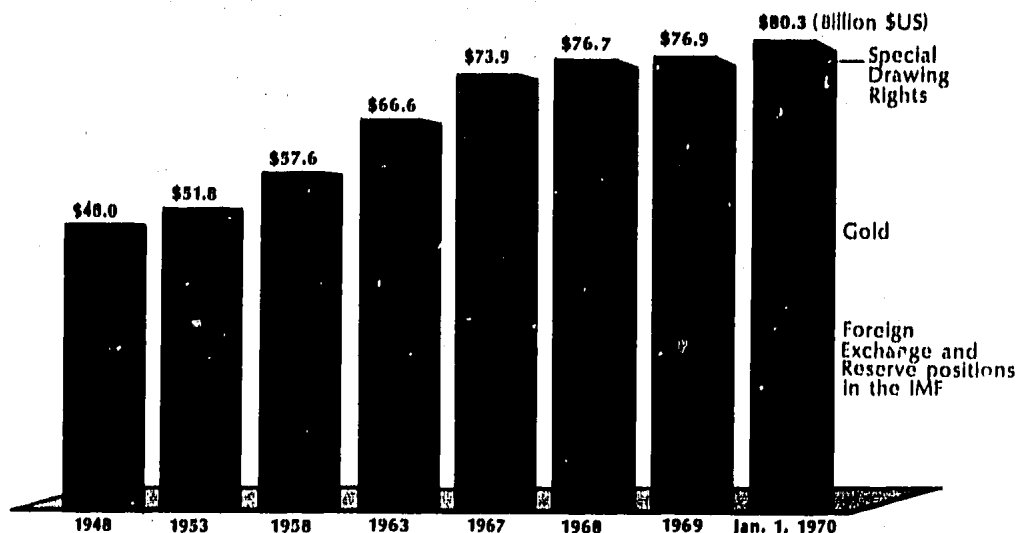
1. SDRs were created to insure continued growth of international liquidity. In the postwar period as a whole, world reserves of gold and foreign exchange (principally US dollars and pounds sterling) increased slightly more than 2% a year (see the chart). World trade and other international transactions grew far faster than reserves. In 1954, world reserves were

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It was prepared by the Office of Economic Research.*

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COMPOSITION OF WORLD RESERVES*



*Excluding institutional (International Monetary Fund, Bank for International Settlements) gold holdings.

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equal to 67% of total world imports. By 1969, the ratio had fallen to 30% (see Table 1).*

2. In spite of their slow growth, world reserves were considered adequate until the early 1960s. Reserves outside the US grew considerably faster than 2%, and through the 1950s the US had reserves to spare. Moreover, official reserves were supplemented by various forms of international credit -- often referred to as "conditional liquidity."**

* Because merchandise trade accounts for only a small portion of international transactions, this ratio is considered a less than satisfactory indicator. Its widespread use, however, stems from the fact that data on world imports, unlike those of many other current account items and capital flows, are easily obtainable.

** The basic difference between conditional liquidity and reserve assets such as gold -- that is, unconditional liquidity -- is the same as between credit and money. The most common forms of conditional liquidity are the IMF credit tranches and central bank swap arrangements like those the Federal Reserve has concluded with the Bank for International Settlements in Basel and 14 central banks worldwide. Faced with payments difficulties, a country can often borrow short-term foreign exchange under one or both of these options.

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3. By the mid-1960s, however, the earlier pattern of reserve creation could no longer be sustained. Gold production began to level off, while an increasing part of overall production went into private uses as official gold holdings fell. With sterling a weak currency, the only available means of increasing reserves abroad was through continued deficits in the US balance of payments. But the United States no longer had excess gold reserves, and other countries had become reluctant to accept large additions to their dollar holdings.

4. At the 1967 IMF annual meeting held in Rio de Janeiro, member nations reached a historic agreement to create a new form of unconditional liquidity, a facility based on Special Drawing Rights in the IMF, which would assure future increases in world reserves. In the period following the Rio Conference, the agreement was ratified by parliaments of 60% of the IMF member nations having 80% of weighted voting power, and then formalized through the deposit with the IMF of instruments of participation by members having 85% of the weighted voting power. The first annual allocation, totaling \$9.5 billion over three years, was made on 1 January 1970.*

5. The initial allocation of more than \$3.4 billion in SDRs immediately raised the average reserve-import ratio by about one and one-half percentage points (see Table 1). This amount is less than the \$3.5 billion originally agreed upon because 11 countries declined to accept the new facility (see paragraph 11). More noteworthy, however, was the fact that with the addition of the new facility gold, for the first time in history, accounted for less than half of total world reserves (see the chart).

6. SDRs in their final form represent a series of compromises. Early discussions revealed strong

* SDRs are expressed in terms of a unit of value equivalent to 0.888671 gram of fine gold. This is also the gold content of the US dollar at its present par value.

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concern about the form the new facility should take. Consequently, the SDR is both money and a form of credit. A country can use the entire amount of its SDR allocation in any manner it sees fit,* but to prevent SDRs from being consistently and indiscriminately used in favor of gold or foreign exchange, the IMF's Articles of Agreement require a country to maintain in its reserves an average daily SDR balance over the first five-year period equal to 30% of its net cumulative allocation. Furthermore, the amount of SDRs allocated -- \$3.5 billion in 1970 and set at \$3 billion for each of 1971 and 1972 -- was a compromise between the United States' proposal of \$5 billion per year and the European estimates of a need not exceeding \$2 billion annually.**

7. Opponents of SDRs argued that the plan contained inherent weaknesses. In particular, some believed that SDRs would enable deficit countries such as the United States to avoid the painful measures necessary to bring payments back into equilibrium, while at the same time allowing them to continue exporting their inflation. These fears have thus far been largely unfounded, primarily owing to the relative calm pervading world financial markets since the changes in parities of the French franc and the Deutschmark in August and October 1969, respectively, and the subsequent normalization of gold sales to monetary authorities by South Africa.***

* In January 1970 the two major Middle East antagonists, the UAR and Israel, used their entire first year's SDR quotas. Both have been accused in so doing of furthering hostilities. Nevertheless, from a legal point of view the only stipulation with regard to these transactions is that, between now and the end of 1974, these two countries repurchase -- "reconstitute" in IMF jargon -- enough SDRs to raise their overall average SDR balance during the period to a level equal to 30% of their allocations.

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Trends in the Use of SDRs

8. After eight months of operation the United States -- having used only \$20 million of its initial allocation of \$867 million -- has become the largest net recipient of SDRs (see Table 2). To be sure, by year's end this will most likely change as more SDRs are used to redeem a portion of the dollars held by foreign central banks -- that is, those in excess of their requirements. Still, while many of the world's money managers try to cope with inflationary pressures, there is little evidence to indicate that the introduction of SDRs has seriously impeded their efforts.

9. The net use of SDRs has been less than anticipated, reflecting the relative stability of the international monetary system and, to a lesser extent, the increasing availability of dollars resulting from the large US payments deficit in 1970. (Table 3 contains a list of the countries whose SDR net transfers during the first eight months of 1970 exceeded \$5 million.) At the end of August 1970, participants' net transfers of SDRs for balance-of-payments or reserve purposes totaled \$525 million. Of this amount, \$253 million were transferred to the IMF General Account* for repayment of credit or service charges. Another \$272 million in SDRs were exchanged for currency, almost entirely under the designation system.**

10. More than half of the Fund's 116 members have already participated in SDR transactions. A total of 22 countries are presently net recipients

* Subsequent to the allocation of SDRs on 1 January 1970, operations of the Fund have been conducted under the auspices of two accounts. All former operations of the Fund, including sales of currencies to members, are handled through the General Account. SDR transactions among member countries are administered through a new account, the Special Drawing Account.

** Certain countries are designated each quarter to accept SDRs on the basis of their reserve strength or balance-of-payments position. The transferring countries receive in exchange currencies "convertible in fact," currencies of those countries whose signatures have in most cases been affixed to Article VIII of the Fund [Footnote continued on p. 6].

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while those transferring SDRs number 42, including 17 that have used all or virtually all of their first SDR allocation. As was to be expected, the less developed members, including Greece and Turkey, have made the greatest use of SDRs. These presently account for nearly 60% of the total. The United Kingdom is responsible for another 23%.

11. Of the remaining inactive 52 countries, 41 are participants in the scheme but have yet to transfer or receive SDRs, 10 have declined to participate in the plan, and one only recently joined the Fund. The 10 members not participating include Ethiopia, Iraq, Kuwait, Lebanon, Libya, Nepal, Portugal, Saudi Arabia, Singapore, and Thailand. Although a participant, the Republic of China did not wish SDRs to be allotted to it in the first period. The Yemen Arab Republic, which became a member of the Fund and the Special Drawing Account in May, will also receive its initial SDR allocation in the second period.

Outlook

12. SDRs are now a permanent and increasing part of the world financial system. In less than two years, SDRs will account for about 10% of total world liquidity. And before the end of the three-year introductory period, in late 1972, Fund members will again decide upon the level of a second period of SDR allocations. If the present rate of about \$3 billion annually were sustained through the 1970s, SDRs could account for more than one-fourth of world reserves by 1980. SDRs not only should insure a continued growth of world liquidity but also should be a stabilizing influence on the international monetary system. Unlike reserve currencies, SDRs cannot be extinguished by being exchanged for gold -- they can only be traded among central banks. And unlike gold, there are no private uses for SDRs that compete with their use as an international currency.

13. Nevertheless, SDRs are not soon likely to supplant the dollar in the international monetary system. Foreign central banks need working balances, which are presently denominated largely in dollars.

Agreement, which confirms their willingness to renounce the use of exchange restrictions on current payments.

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Moreover, the private demand for dollars will probably continue to increase, as has been demonstrated by the growth of the Eurodollar market. To be sure, excess dollar holdings of foreign central banks can now be used to purchase SDRs where formerly the only alternative to holding dollars was to demand gold from the United States and risk a monetary crisis. In years to come, the decision to hold excess dollars over SDRs will be based largely on the belief that the risk is less than the interest rate differential, at present about 7%.*

14. As confidence in the new facility increases, the role of SDRs should expand. For example, there has been much discussion about using SDRs as a form of aid to the less developed countries. A certain percentage of individual country allocations could be placed at the disposal of the International Development Agency (IDA), the "soft loan" window of the World Bank. While a form of SDR aid is likely to be discussed during the forthcoming IMF Annual Meeting, this is not likely to become a reality for at least several years.

* The IMF currently pays interest on SDRs in excess of allocations at the rate of 1-1/2% per year, payable in SDRs. These payments are made in SDRs obtained from countries whose present holdings are below allocation. A charge of 1-1/2% is correspondingly applied against the shortfall.

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Table 1

Ratio of Reserves to Imports
Selected Years 1954-70

	Percent				
	1954	1959	1964	1969	1 January 1970
World total <u>a/</u>	67.2	53.6	43.9	30.3	31.6
Developed countries	71.7	56.7	46.9	29.9	31.1
Of which:					
United States	195.6	114.7	82.2	44.0	46.3
Common Market countries	41.7	48.4	48.9	27.6	28.4
EFTA countries	40.0	35.4	32.5	27.4	28.6
Japan	30.8	36.7	26.8	25.4	26.3
Less developed countries	55.7	44.6	28.2	32.0	33.8

a. Excluding Communist countries except Yugoslavia.

Table 2

Major Recipients of Special Drawing Rights
1 January-31 August 1970

Country	Initial Allocation (Million US \$)	SDR Holdings as of 31 August 1970	
		Million US \$	Percentage of Initial Allocation
United States	866.9	961.2	111
West Germany	201.6	250.1	124
Netherlands	87.4	112.4	129
Belgium	70.9	93.9	132
Japan	121.8	142.5	117
Canada	124.3	144.7	116
Austria	29.4	38.2	130
South Africa	33.6	39.1	116
Australia	84.0	89.0	106
Venezuela	42.0	47.5	113

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Table 3

Major Users of Special Drawing Rights
1 January-31 August 1970

Country	Net Amount Transferred (Million US \$)	SDR Holdings as of 31 August 1970	
		Million US \$	Percentage of Initial Allocation
United Kingdom	122.7	287.2	70
India	47.4	78.6	62
Indonesia	34.8	0	0
Italy	29.4	75.6	72
United Arab Republic	25.1	0.1	a/
Colombia	20.9	0.1	a/
Pakistan	20.2	11.4	36
Iran	20.0	1.0	5
Yugoslavia	19.1	6.1	24
Philippines	18.5	0	0
Turkey	18.0	0.1	a/
Greece	16.8	0	0
Israel	15.1	0	0
Morocco	14.4	0.7	5
Ceylon	13.1	0	0
Denmark	10.0	17.4	64
Sudan	9.4	0.1	2
Uruguay	8.8	0.4	4
Burma	8.1	0	0
Syrian Arab Republic	6.4	0	0
Ghana	6.0	5.6	48
Tunisia	5.9	0	0
Dominican Republic	5.4	0	0

a. Less than 1%.

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