Substitution in the International Monetary System

by Sir Joseph Gold*

I. THE CONCEPT

Plans for substitution have been a persistent phenomenon in international monetary affairs for many years. An examination of the history of projects for substitution is of more than antiquarian interest. It will help not only to explain a project that recently has been under close examination but also to draw attention to a range of problems of the international monetary system.

"Substitution" is not a term of art, and the word has been applied to a broad range of proposals. The plans that have been advocated or put into effect have varied in structure and objective. An element in the concept that is common to all plans is that countries transfer an asset that they hold in their monetary reserves in return for another asset to be included in their reserves. For convenience, assets transferred for substitution will be called deposited assets.

A plan for substitution may relate to part or the full amount of the holdings of one or more or all of existing reserve assets. There is no universally accepted legal definition of a reserve asset. For practical purposes, a reserve asset can be defined as an asset held by the monetary authorities of a country, or by their fiscal agencies, with which, at their will, they can support the exchange value of the country's currency, or an asset with which they can obtain such assets without legal impediment or undue cost. Some reserve assets are issued by the monetary authorities of a country, others are issued by an international organization or arise as a result of its financial activities, and one is dug out of the ground or washed out of streams. The main reserve assets at the present time are: the currencies that are held in reserves, among which the U.S. dollar predominates; special drawing rights (SDRs) that the International Monetary Fund (Fund) allocates to its member states (members) that participate in its Special Drawing Rights Department; the rights of members to make unconditional use of the Fund's general resources and to call for early repayment of loans they have made to the Fund; the European Currency Units (ECUs) that are issued in accordance with the arrangements constituting the European Monetary System; and gold.

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Another common element in the concept of substitution is that substitution is intended to bring about an improvement in international monetary arrangements. The idea of substitution has persisted because of the perception of new or uneradicated defects in the international monetary system. The improvements in the system that are sought are manifold, but they can be classified as contributions toward the solution of one or more of three related problems that were described as follows in a report issued in 1964 as a result of the deliberations of an international study group of thirty-two economists:

(1) the problem of payments adjustment, deriving from the need for correcting persistent imbalances in the payments positions of individual countries;
(2) the problem of international liquidity, connected with the need for long-term adaptation of the total volume of world reserves to the full potentialities of noninflationary economic growth; and
(3) the problem of confidence in reserve media, implied in the need for avoiding sudden switches between different reserve media.¹

Improvement is sought by withdrawing the deposited assets from use or from the normal use that could be made of them by the depositor in the absence of substitution. The advocates of some plans see the improvement as resulting primarily from the withdrawal, because they wish to eliminate some or all holdings of the asset from reserves. The advocates of other plans see the improvement primarily in the injection of an asset into reserves that is made possible by the withdrawal of another asset. Finally, some plans are supported because the improvement is seen to reside in a combination of the withdrawal of one asset and the replacement of it by another. Under some plans, however, the depositor may be able, in some circumstances, to reacquire assets that it has deposited. Furthermore, sometimes the depository may make specified uses of deposited assets.

Substitution is often thought of as the substitution of an asset issued by the Fund or by another international entity for an asset issued by a country. It will be seen, however, that plans have been advanced for the substitution of another asset for gold, which is not issued by anyone, and for SDRs, which are allocated by the Fund.

The rights and obligations attached to an asset issued by an international entity are not the same under all plans. For example, as noted already, the asset may or may not entitle the holder to require the issuer, in specified circumstances, to encash the asset with deposited assets. The

issuer may be required to redeem the asset only on liquidation of the plan or on the withdrawal of a participant from it, or on other occasions as well. Substitution, however, can be permanent and make no provision for liquidation, withdrawal, or encashment by the issuer. To this extent, the issued asset would resemble gold in the sense that gold is not the obligation of anyone.

To say that the international issuer of an asset provided in substitution has no obligation to a holder of the asset to redeem or encash it is not the same as saying that the other participants in the plan or the issuer of the asset have no obligations of any kind toward the holder. SDRs are not allocated by the Fund in substitution for other assets, but they may be cited to illustrate some of the characteristics of assets issued in exchange for deposited assets. SDRs are claims against the Fund that it must redeem only on the liquidation of the Fund or the Special Drawing Rights Department or on the withdrawal of a member from the Fund or the termination of a member's participation in the Department, but other participating members and the Fund are bound by a number of obligations toward a participant. For example, the Fund, if requested by a participant wishing to transfer SDRs, must designate another participant to receive the transfer, and the designated participant must accept the SDRs and provide currency for them at the prescribed rate of exchange.

Substitution can be distinguished from certain other operations to which it has some resemblance. Funding involves the exchange of an asset for a reserve asset, but the new asset is a longer-term and illiquid or less liquid asset. The terms for funding may be of such a character that the holders of the new asset will not regard it as a reserve asset. In that event, funding reduces global reserves in contrast to substitution, which does not reduce global reserves but changes the composition of them. Funding need not, but substitution normally does, involve the performance of functions by an entity other than the original obligor. These distinctions do not imply that funding cannot be an improvement of the international monetary system. On the contrary, funding was proposed during the discussions conducted in 1972-1974 by the Committee of the Fund's Board of Governors on Reform of the International Monetary System and Related Issues (the Committee of Twenty) and by its associated bodies. Funding was considered as a way of eliminating the dangers to a reformed system that were foreseen because of the "overhang" of existing balances of reserve currency that had been accumulated as a result of past activities. Funding seemed feasible because the bulk of these balances were concentrated in the reserves of a few holders.²

There will be much discussion of the overhang and substitution later in this paper, but at this point it is relevant to note the successful efforts at funding by the United Kingdom when, in 1977, it sought to persuade official holders to reduce their sterling holdings to working balances by offering negotiable bonds with maturities of five, seven, and ten years. The bonds were denominated in four non-sterling currencies and were issued on market-related terms. The Fund had approved a stand-by arrangement for the United Kingdom, which was regarded by a group of central banks and the Bank for International Settlements as a safeguard that enabled them to provide stand-by financial support for the effort to reduce official sterling balances. The international community considered the project as one that would improve the international monetary system because fluctuations in official sterling balances had been disruptive for both the system and British economic policy.

Substitution must be distinguished also from arrangements under which a country receives a reserve asset in return for its own currency. The proposal of a CRU (Composite, or Collective, Reserve Unit), first proposed by Mr. E.M. Bernstein and the subject then of many variants, was intended to solve the problem of a shortage of global reserves by the creation of a new reserve asset. The CRU would be defined as a unit of value equivalent to one U.S. dollar of fixed gold content. Each of the countries of the Group of Ten and Switzerland would deposit with the Fund as trustee a determined amount of its own currency, would maintain the value of its deposit in terms of gold, and would be credited with an equivalent amount of CRUs. Each CRU would be deemed to consist of quantities of the currencies in proportion to the amounts that the countries had deposited. The amounts to be deposited would be based on some norm, such as quotas in the Fund for the members of the Group of Ten, that reflected their relative importance in international payments. Mr. Bernstein also dealt with the idea that only seventy-five percent of the unit of value of the CRU might be composed of the eleven currencies, with the remaining twenty-five percent consisting of an obligation of the Fund payable in gold or currencies. The Fund would receive an amount of CRUs based on this proportion, which it would be able to use in its activities.4

4 The ten countries are Belgium, Canada, France, the Federal Republic of Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States.

The CRU would have been an addition to global reserves because participants in the plan would have received this asset in return for their own currencies and not in substitution for their reserve assets. The SDR is similar to the CRU as an addition to global reserves. The SDR is indeed described in the Fund's Articles as "a supplement to existing reserve assets," and can be allocated only if there is a "long-term global need . . . to supplement existing reserve assets." A difference between the CRU, which has not come into existence, and the SDR is that a member receiving an allocation of SDRs does not deposit its own currency (or reserve assets) as a counterpart or "backing" for the SDRs.

Certain other transactions that have some resemblance to substitution must be distinguished from it. If SDRs are transferred and the transferee provides a currency from its reserves that is added to the reserves of the transferor, the exchange, like substitution, does not affect the total of global reserves. Transactions in SDRs, however, are regarded as part of the ordinary mechanism of the international monetary system and not as modifications of it. Substitution is advocated in order to change the system by improving it.

A further difference between substitution and other international transactions that resemble substitution up to a point is that it is often foreseen that substitution would be undertaken on a single occasion or on a few discrete occasions. The object of this limitation would be to prevent speculative use of substitution, which might be possible if it were an everyday operation of the international monetary system.

On the basis of the discussion so far it would be possible to define substitution, somewhat narrowly, as an operation by which on a single occasion, or on a few occasions, the Fund or another international entity would issue a reserve asset to participants in the plan in exchange for one or more reserve assets held by them, which are then withdrawn from the normal use that could be made of them in the absence of substitution, in order to bring about an improvement in the international monetary system. Substitution in accordance with this definition would change the composition of global reserves but would not affect the total of them.

Such words as "substitution" or "exchange" should not convey the impression that deposited assets are extinguished or that an obligor is discharged from the obligations attached to them. The assets may retain their original form or be transformed, for example by investment, but they are not destroyed. Normally, two changes occur in relation to deposited assets. One change is that during substitution the obligor has new obligations in place of its original obligations. The converse of this change is that during substitution the original holder of deposited assets has new

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*Art. XV, § 1.*

*Art. XVIII, § 1(a).*
rights in place of its original rights. If there is no original obligor because gold is the subject of substitution, only the converse proposition will apply. The second change is that the deposited assets are in the charge of a new holder. The legal arrangement under which they are held may vary, and it may even provide for the retention of ownership by the original holder. It is not possible, however, to make inflexible statements about these or other characteristics of substitution because of the diversity of the plans that have been advanced.

For this last reason, the definition of substitution offered above will not be observed resolutely in the rest of this paper. It will be useful to discuss certain plans that are not wholly compatible with the definition because some of their aspects provide useful contrasts to substitution as defined above or because these plans have led to proposals that come within the ambit of the definition. Even so, the paper will not attempt to examine all of the many plans and variants of them that are consistent with the definition or that have some affinity with it.

The paper will deal with the following topics. The idea of the centralization of monetary reserves in Keynes' Clearing Union will be noted. Professor Triffin's pioneering plan, or more properly plans, for the elimination of currency from reserves will be described, and will be followed by a discussion of Mutual Currency Accounts and Mr. Bernstein's plan for the substitution of a new asset for almost all other reserve assets. The next topic will be the work of the Committee of Twenty on a Substitution Account that would be the instrument for the restoration of official convertibility in the form of "asset settlement" and for protecting it against the "overhang." That topic will be followed, logically, by a discussion of the efforts to provide for a Substitution Account during the drafting of the Second Amendment of the Fund's Articles, but to serve purposes different from, and narrower than, those discussed by the Committee of Twenty. If the work of the Committee demonstrated complexities of principle in introducing asset settlement with SDRs through a Substitution Account, the work of the Executive Board during the drafting of the Second Amendment demonstrated the technical complexities of issuing SDRs through a Substitution Account. (This distinction between principle and technique is a rough one, and is not meant to suggest that the categories can be defined so as to be automatically exclusive of each other.) No express provision was made for substitution in the Second Amendment. The idea of substitution was kept alive by the suggestion that allocation of SDRs could be resumed if members transferred part of their holdings of reserve currency to a Substitution Account, but the Fund was able to make allocations without substitution. In the next episode of the serial, substitution was considered as a means of providing members with the opportunity to diversify their reserve holdings without destabilizing the exchange markets or fostering the growth of a multicurrency reserve system. Meanwhile, the European Monetary System has
come into being under arrangements that call for the substitution of ECU for a portion of participants' holdings of gold and U.S. dollars.

The final topic, before some concluding observations, will be the latest discussions, in which the rationale for substitution is promotion of the evolution of the international monetary system by helping to make the SDR the principal reserve asset of the system.

II. Keynes' Clearing Union

A discussion of substitution, as of most aspects of the international monetary system of the last forty years, can begin with Keynes' Proposals for an International Clearing Union. The purpose of his plan was to give members the time and the external resources that would enable them to stabilize their currencies by adjusting their balances of payments, within a framework of the control of global reserves by a central international organization. The issue of reserve assets ("bancor") by the central organization, and not substitution, was the crucial feature of the plan. This feature is often referred to as an example of the "centralization of reserves," and in this respect the Clearing Union has an affinity with certain plans for substitution.

Each member would have a quota, which would be adjusted from time to time. Settlements between members could be made in bancor, with each member entitled to an overdraft in bancor up to the limit of its quota. A member would be able to hold gold but not more than working balances of another member's currency except with the approval of that other member. This provision meant that it would be possible for countries to reach agreements under which substantial amounts of currency could be held in reserves. Bancor or gold would be used to make settlements if they were not made in reserve currency, but the hope was implied that normally they would be made in bancor. A member would be able to obtain bancor by paying gold to the Clearing Union, which was an element of substitution, but a member was not required to deposit gold, or entitled to obtain it from the Clearing Union for bancor. The Clearing Union, however, would be able to distribute any gold it obtained among members in proportion to their credit balances in excess of a specified proportion of their quotas, which would have the effect of reducing their holdings of bancor and reversing substitution.8 Keynes was not an ally of

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gold but was content not to spend powder and shot in attacking it. Later
planners, it will be seen, would eliminate gold from reserves by
substitution.

The plan for a Clearing Union was not the model on which the nego-
tiators of the Articles of Agreement constructed the Fund. The United
States preferred a plan that limited the amount of credit each member
would be required to extend to its subscription and rejected the idea of
the creation of reserve assets, which could place vast obligations on coun-
tries in surplus to accumulate bancor and could expose them to enormous
inflationary pressures. Not until the First Amendment became effective, a
quarter-century after the Bretton Woods Conference, did the Fund re-
ceive authority to create SDRs as a new reserve asset.

III. PROFESSOR TRIFFIN’S PLANS

Professor Robert Triffin, in his book Gold and the Dollar Crisis pub-
lished in 1960, drew attention to a fault in the international monetary
system that could have seismic consequences. Growth in the volume of
global reserves, he pointed out, was determined mainly by the supply of
gold, which was insufficient, and the haphazard and dangerous deficits in
the balances of payments of reserve currency countries. He was particu-
larly disturbed by the risk, in the short-run, of a contraction of global
reserves as a result of demands for the conversion of official holdings of
U.S. dollars into gold. These demands might grow as the ratio of the gold
holdings of the United States to the holdings of U.S. dollars in reserves
diminished and bred fears of the inability of the United States to meet
demands for conversion. An objective of his plan, therefore, was to re-
place official holdings of currency with an asset that was superior to gold,
and to encourage—even to require to some extent—the replacement of
gold also. Substitution for Professor Triffin was a means of avoiding the
risk implicit in the Clearing Union that settlements might still be made
in reserve currencies, with expansionary effects that might be com-
pounded by the creation of bancor. His plan probably provoked more de-
bate and counter-proposals than any other past proposal for substitution.
Certainly, his plan and Mr. Bernstein’s were the most thorough of all
those that were advanced in the past.

Professor Triffin proposed the restructuring of the Fund and the cre-
ation of a new type of reserve asset by it, for which he borrowed the name

9 ROBERT TRIFFIN, GOLD AND THE DOLLAR CRISIS: THE FUTURE OF CONVERSION 100
(New Haven, 1961).

10 Robert Triffin, The Coexistence of Three Types of Reserve Assets, BANCA NAZIONALE
DEL LAVORO Q. REV., No. 81, 125 (June 1967).
bancor from Keynes as a tribute to him.\textsuperscript{11} Quotas in, and subscriptions to, the Fund would be abolished. The assets of the Fund would consist of gold and the balances of currencies deposited with it in return for bancor. Members would hold only gold and bancor, except perhaps for small working balances of some currencies.

Each member would be required to make an initial minimum deposit with the Fund of a determined proportion of its gross reserves. These reserves were defined as outstanding net creditor claims on the Fund, gold, and holdings of foreign exchange in liquid and semi-liquid form. A member would have to maintain a deposit in these reserves equivalent to the prescribed minimum proportion of its gross reserves, including bancor, at all times. Members would receive bancor in return for their deposits. An initial proportion of twenty percent was suggested, but it could be adjusted from time to time, although this action might be unnecessary because voluntary deposits of gold would be permissible. Even if the minimum proportion was not increased, the resources of the Fund would increase with the growth of global reserves.

The obligatory deposit would be made with the accumulated net creditor claims on the Fund that members held at the time of the restructuring of the Fund in accordance with the plan. The substitution of bancor for these claims would take place automatically. The rest of the deposit by these members, and the full deposit by other members, would be made with gold or with their liquid or semi-liquid holdings of foreign exchange, which, for the most part, would be balances of reserve currency. Members could decide in what form they would make the minimum deposit, apart from the automatic substitution of bancor for net creditor claims on the Fund. Members might prefer to deposit balances of reserve currency, but they would be forced to deposit gold if they held no currency or an inadequate amount of it in their reserves. The United States, for example, would have to deposit gold because it did not hold currency in its reserves.

The obligatory deposit of a determined proportion of gross reserves was not the only substitution that had to take place. In addition, at all times members would have to deposit with the Fund, in return for bancor, the rest of their holdings of foreign exchange, except, possibly, for moderate working balances of currencies that were actively traded. Modification of the minimum proportion of gross reserves that had to be deposited, the obligation to deposit remaining balances of reserve currency, and the voluntary deposit of gold could achieve the centralization of a growing proportion of global reserves over time.

Bancor would be defined in terms of gold. The issuer of a currency held by the Fund would be bound to maintain its value in terms of gold.

\textsuperscript{11} History, supra note 8.
This feature of the plan was intended to be attractive to the holders of reserve currency, but the critics of this and of other plans that have included a similar feature have always argued that the issuers of reserve currencies would refuse to give this guarantee.

The holders of bancor would receive interest on their holdings. This feature of the plan was intended to be attractive to the holders of gold. Interest would be paid for the income derived by the Fund from its loans and investments as described later.

Members would be required to accept transfers of bancor without limit in settlement of their balances of payments. A member making a settlement could transfer gold or bancor, or both, for this purpose. If a settlement was to be made in currency, the Fund would stand ready to provide it in return for bancor, which would then be credited to the bancor account of the issuer of the currency. Similarly, the Fund would provide currency needed as working balances for intervention in the exchange market. If necessary, the Fund would be able to meet members' needs for a currency by obtaining it from the issuer with gold. The convertibility of bancor into any currency, and in effect therefore of the balances of reserve currency for which bancor had been substituted, was ensured.

A member holding more bancor than corresponded to the minimum compulsory deposit of reserves would be entitled to obtain gold for any part of the excess by requiring the Fund to convert bancor into gold. The issuer of each deposited currency would amortize deposited balances with gold or bancor over time, subject to the power of the Fund to accelerate the process or to delay it in the general interest. Amortization would have the effect of terminating the investments that had been made in the reserve currency countries in the form of balances of their currencies held by other members, and would permit the Fund to use the proceeds of amortization to make investments, either directly or through international organizations, in countries that needed capital imports. To the extent that investment was redirected, the effect would be to transform the assets of the Fund from obligations of the issuers of reserve currency into claims against other obligors. This change in the Fund's portfolio of assets was criticized as a possible weakening of the backing of bancor, even though the value of the new obligations would be guaranteed in terms

12 In a later article, Professor Triffin proposed that members should be required to hold no more than 60 percent of their reserves in gold and at least 40 percent in currency in order to prevent undesirably large conversions of reserve currency into gold. Robert Triffin, The International Monetary System, Moorgate and Wall Str. 44 (Summer 1965). See also Triffin, supra note 10, at 129.

13 But for a somewhat different approach, see Triffin, The International Monetary System, supra note 12, at 44-45.
of gold. If members concluded that the backing had been weakened, they might prefer to hold gold rather than bancor.

Professor Triffin concluded that there would not be a run on the Fund's gold and that the Fund would be able to meet all demands on it for gold. Nevertheless, Professor Triffin made various suggestions in the course of time for protecting the Fund against excessive demands for gold. One suggestion was that the conversion of bancor into gold could be limited to bancor received by a depositor in return for a currency that the issuer itself had undertaken to convert into gold. This suggestion would have confined the convertibility of bancor into gold to bancor received for deposits of U.S. dollars. Other suggestions were that the Fund should be empowered to issue gold certificates that would be encashable in gold or bancor, which was equivalent to a power to borrow gold, or to raise the obligatory minimum deposit, or to raise the obligation in relation to the portion of reserves that exceeded a certain norm.

The Fund would be able to increase the total reserves of members by creating new deposits of bancor in such amounts as it deemed desirable in the general interest. It could create bancor by either or both of two techniques, loans and investments. The Fund would be able to make loans of bancor to members, on their initiative, on terms similar to those on which the Fund had given balance of payments assistance before it had been restructured. The Fund would be able to take the initiative to make investments by purchasing the securities of a government, with its consent, or the securities of such international development organizations as the World Bank, in return for bancor. The value of these securities would be guaranteed by the issuers in terms of gold. Critics of the plan were worried that exercise of the Fund's power to expand global reserves could produce inflation, although Professor Triffin suggested criteria for limiting the creation of bancor in order to avoid this development.

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15 Robert Triffin, The International Monetary System, supra note 12, at 33-34.
Professor Triffin did not deal in 1960 with questions of the ownership of the deposited assets. This aspect of substitution has preoccupied a number of planners. In a later article, however, in which he discussed safeguards against the dangers of excessive conversions into gold, he pointed out that these conversions might be caused by the blocking of bancor in time of war. He suggested, therefore, that a member might request the Fund to deposit within the member’s territory a proportion of the Fund’s gold determined by the ratio of the member’s holdings of bancor to total holdings of the asset.\textsuperscript{16}

In the years following 1960 when it became clear that prompt agreement would not be reached on the problems of the international monetary system that were being examined, Professor Triffin issued a number of variations on his original theme in which he concentrated increasingly on avoiding the contraction of global reserves through conversions of holdings of reserve currency into gold. The modified plans, however, could be readily adapted at a later stage to take care of the need for an expansion of global reserves. The difficulties of solving the problem of the contraction of existing reserves seemed less forbidding than the difficulties that would be raised by obligations associated with the expansion of reserves by the issue of a new reserve asset.

In 1966, for example, Professor Triffin proposed what he called a Gold Conversion Account (GCA), to be established originally by the eight countries that were the main holders of gold (Belgium, France, Germany, Italy, the Netherlands, Switzerland, the United Kingdom, and the United States) and administered by them with the Fund or the Bank for International Settlements as Agent. The objective of the plan, once again, was to deter conversions of balances of reserve currency into gold by offering a more attractive asset than gold without sacrificing the liquid character of the balances. Each participant would deposit in the GCA the balances of reserve currency it had accumulated before the GCA was established, retaining only the amounts it needed as working balances for intervention or for the repayment of debt to the issuer of the currency held. Initial and subsequent deposits would be guaranteed in terms of gold and would carry a modest rate of interest. The issuer would maintain the gold value of balances of its currency held by the GCA and would pay a modest rate of interest on them.

Balances deposited initially would be retained in the GCA and amortized by the issuer gradually because a purpose of this plan was to safe-

guard the issuer's stock of gold against demands for the conversion of outstanding balances. Currency subsequently transferred to the GCA would be automatically and immediately redeemable by the issuer with gold or with the currencies of other participants accumulated by the issuer.

A depositor would be entitled to use its deposit to obtain the currency that it needed to replenish working balances. It would be able to obtain gold from the GCA for its deposit to the extent that the ratio of its gold holdings to its total reserves was below the average ratio of other participants. The gold would be provided by the participants with the highest ratios in return for credits to their deposit accounts. Various measures were specified for meeting a shortage of gold, including an acceleration of the amortization of the balances deposited originally. This arrangement would permit a controlled and equitable conversion of accumulated balances into gold.

The accession of other countries to the GCA would be possible on terms to be agreed. These terms would include provision to prevent the dilution of the average ratio of gold holdings to reserves of the original participants. The assets in the GCA could be invested if a global shortage of reserves should develop.17

Some aspects of Professor Triffin's proposal should be emphasized because they are related to issues that have arisen in connection with other plans for substitution. Although participants would have privileges that they could exercise at their own discretion, including the privilege of voluntarily increasing their deposits beyond the obligatory amounts, the plan, in its various tranformations, rested on a foundation of compulsory substitution. Deposited gold and currencies were not wholly immobilized because members could reach them in certain circumstances. The plan called for a controlled amortization by the issuer of deposited balances of its currency. It should be noted further that substitution, which would not change the total of global reserves, was only one major purpose of the plan. The increase in global reserves by the exercise of powers conferred on the Fund was another major objective.

Finally, it has been seen that Professor Triffin's plan called for the restructuring of the Fund. In 1979, Mr. J.J. Polak, the Economic Counselor of the Fund, published a plan of his own to restructure the Fund that would base it wholly on the SDR.18 The purposes of the plan were to simplify the Fund's activities and to promote the role of the SDR. As a transition to the new structure, the Fund would issue SDRs in an amount that would be sufficient, together with its existing holdings of SDRs, to

17 U.S. Congress, Joint Economic Committee, supra note 16, at 138-139.
18 J.J. Polak, Thoughts on an International Monetary Fund Based Fully on the SDR, (IMF Pamphlet Series, No. 28 Washington, 1979).
acquire, from the issuers, the currencies of members held by the Fund in amounts less than their quotas. The Fund would return to each member an amount of its currency equal to quota. The effect of this feature of the plan would be to substitute SDRs for reserve tranche positions. The Fund would also return to the issuer any remaining balances of its currency that the Fund held, and the member would have an equivalent obligation denominated in SDRs. Indebtedness is already based on the SDR as the Fund’s unit of account, but under the plan the SDR-denominated claims would not be attached to holdings of currency. The Fund would hold no currency and would conduct its activities in SDRs.

IV. Mutual Currency Accounts

On May 16, 1962, Mr. Robert V. Roosa, at that time Under Secretary for Monetary Affairs of the U.S. Treasury, suggested that the industrial countries should be prepared to hold each other’s currencies in their monetary reserves in order to increase international liquidity and reduce the use of gold.19 The essence of the idea was that the number of reserve currencies should be extended beyond the two main reserve currencies, the U.S. dollar and the pound sterling. At that time the United States held gold but not substantial amounts of currencies in its reserves, while the United Kingdom held gold and U.S. dollars. There were almost no holdings of currencies other than the dollar and sterling in the reserves of countries at that time. Mr. Roosa proposed that a country in surplus in its balance of payments that received the currency of an industrial country in deficit in its balance of payments would retain the currency and not seek conversion of it into gold, U.S. dollars, or sterling. This innovation would make the two main reserve currencies less susceptible to speculative pressures. The United States was the only country that had undertaken to maintain the value of its currency by freely buying and selling gold for its currency in transactions with the monetary authorities of other members of the Fund, but other currencies could be converted into dollars. A consequence of Mr. Roosa’s suggestion was that global reserves would be increased, because the deficits of all participating countries, and not only the deficits of the United States and the United Kingdom, could be financed by increasing the reserves of surplus countries by accruals of the currencies of deficit countries.

The idea was advanced at a time when the United States was in deficit and its stock of gold declining because of conversions of dollars into gold. The main emphasis in Mr. Roosa’s speech was on the conservation

of the gold holdings of the United States for the good of the international monetary system. If the deficit of the United States were to be replaced by a surplus, a crisis of liquidity would not have to occur because the United States, though no longer supplying the world with reserves in the form of dollars, would be increasing global reserves by holding the currencies of deficit countries. The proposal involved no element of substitution in the sense that existing assets were to be exchanged for another asset and to become unavailable for normal use.

Building on the idea put forward by Mr. Roosa, Mr. Reginald Maudling, then the Chancellor of the Exchequer of the United Kingdom, referred, in his speech to the Board of Governors of the Fund at its annual meeting in 1962, to a Mutual Currency Account (MCA) that would involve an element resembling substitution. The objectives of the Maudling Plan were similar to those of Mr. Roosa, but the MCA was intended to eliminate two disadvantages that were seen to exist in the earlier initiative. One disadvantage was the risk that a currency held in the reserves of other countries might be devalued. The other was that the holder of the currency might need to use it when it was weak in the market. Use in these circumstances would put further pressure on the currency.

The basic idea of an MCA type of plan was that a member in surplus could acquire the currency of a country in deficit and transfer it to an MCA in the Fund in return for a reserve asset defined in terms of gold. Each member could have a maximum debit position, which would mean that the MCA would hold no more than an established amount of a currency, but these amounts could be increased from time to time in accordance with decisions on the desirable volume of global reserves. No limits would be placed on the holding of assets received by a participant through the MCA, but the structure of the plan implied a maximum for each member equal to the total of all maximum debtor positions minus its own. The participants in an MCA could be restricted to the main industrial countries, on the model of participation in the Fund's General Arrangements to Borrow. Only in the later stages of the debate that led to the SDR was the thesis accepted that all members of the Fund should share in the benefits of the deliberate creation of reserve assets.

The initiative for an operation through an MCA would rest with a participant (D) in a weak balance of payments or reserve position. If it did not wish to use its existing reserves or purchase the currencies of

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21 Selected Decisions of the International Monetary Fund and Selected Documents, Eighth Issue, 98-113 (Washington, May 10, 1976). The participants in the General Arrangements to Borrow are the Group of Ten, see note 3, supra.
other members from the Fund to meet part or all of its deficit, it could propose to a participant in a strong balance of payments and reserve position (S) that it accept, for transfer to the MCA, an agreed amount of D's currency. S would be expected, but would not be obliged, to enter into an agreement of this kind, but S would have an obligation to the extent that the MCA held its currency. D could provide its currency in return for the currency of S, which D would use in support of its own currency, or, after the agreement, S would intervene in the market and accumulate D's currency in support of it. Under either arrangement, S would deposit D's currency in the MCA and obtain a credit.

If at a later date S had a need to obtain foreign exchange, it would be entitled to use its credit, and a partner for S would have to be forthcoming. To the extent of its credit, therefore, S could not be compelled to provide gold or other reserve assets in settlements with a participant in a strong position (P). Instead, P could be required to be the partner in a transaction initiated by S. P would obtain S's currency and deposit it in the MCA. The credit position of S would be reduced by this amount, and P would receive a corresponding credit. If D was the partner and transferred S's currency to the MCA, D's currency in the MCA would be redeemed in an equivalent amount and its debit position reduced.

A participant could obtain a debit or use a credit in the MCA if it had either a balance of payments or a reserve need. Both kinds of need would be recognized because a participant might be in equilibrium or even in surplus in its balance of payments and still be faced with the prospect of losing reserves. For example, a country in surplus, S, might obtain U.S. dollars from countries other than the United States even though the United States was not in deficit. If the United States preferred not to provide gold for these dollars, its reserve need would justify an agreement with S that the dollars would be transferred to the MCA.

Currency transferred to the MCA would be invested in non-negotiable, interest-bearing securities of the issuer of the currency. The MCA would pay interest on credit positions and receive interest on debit positions. The issuer of a currency held by the MCA would maintain the value of the MCA's holdings in terms of gold. Both debit and credit positions would be expressed in the asset issued by the MCA, which would have a constant value in terms of gold.

A participant with a debtor position could eliminate it either by entering into a transaction in which it accepted the currency of another participant for transfer to the MCA or by paying gold to the MCA. In the latter event, the MCA would distribute the gold among participants with creditor positions in proportion to those positions.

On liquidation of the MCA, the issuer of each currency would re-
deem the MCA’s holdings of its currency with gold. A participant withdrawing from the MCA would redeem with gold any of its currency held by the MCA. On the occurrence of either event, the gold would be distributed to participants in proportion to their creditor positions.

An MCA along the lines set forth above would involve an element resembling substitution in the deposit of currency in return for the asset issued through the MCA. This arrangement differed, however, from some other plans in that the currency deposited was obtained for the purpose of deposit and did not come from the reserves of the depositor. Moreover, the currency deposited might not be a currency that normally would be held in reserves. The arrangement would be for the purpose of improving the international monetary system but not by withdrawing reserve assets from normal use. A new type of asset would be issued, but the effect would be to increase global reserves and not to change the composition of the same quantity of reserves.

The MCA plan was resisted by the United States because it suggested that the dollar needed to be reinforced with a guarantee of its gold value and in other ways. Furthermore, the United States considered it undesirable to have two categories of dollar balances, one that was guaranteed in value and another that was not. The United States preferred the various techniques to buttress the dollar that Mr. Roosa had developed. Some European countries were not attracted to an MCA because they considered it unlikely that they would be in deficit in the future, with the result that such a plan would operate exclusively for the benefit of the United States and the United Kingdom and might inspire them to press for increases in debit limits as their deficits persisted.22

Although Mr. Maulding’s proposal did not succeed, it was an early official acceptance of the view advanced by Professor Triffin and others that action was needed to construct a more rational and internationally controlled mechanism for managing the volume of global reserves. The conviction in favor of this view that emerged in the next few years was expressed ultimately in agreement on the SDR and on the First Amendment of the Fund’s Articles.23

A more important step in the evolution of the SDR was the Report, dated May 31, 1965, of the Study Group on the Creation of Reserve Assets (the Ossola Report). The Deputies of the Ministers and Governors of Central Banks of the Group of Ten had appointed the Study Group to examine various proposals for the creation of reserve assets as part of the long-term evolution of the international monetary system. One of the pro-


posals examined in the Report was a variant of the MCA.

This variant did involve substitution. A new asset would be provided in replacement of balances of a normal reserve currency without drawing on the reserves of the issuer. The holder of the balances would be entitled to deposit them in an MCA in the Fund in exchange for an asset denominated in an MCA unit defined in terms of gold. Under this version, the holder of the balances would have the right to deposit them, while under the earlier plan the deposit would be made on the initiative of the issuer and by agreement between the issuer and the holder. Furthermore, under the earlier plan, the balances would be obtained for the purpose of immediate deposit. The issuer might even supply its currency for this specific purpose. Under the version in the Ossola Report, however, the deposited balances would have accrued to the holder in the normal way as the result of intervention in the market. This version was not designed as a means of financing balance of payments deficits by specially negotiated support operations. Nor was it designed to increase global reserves. Its main objective was to prevent the contraction of global reserves that would result from conversions of balances of a reserve currency by the issuer.

A member in deficit that held MCA units would be able to transfer them to a member in surplus in order to obtain its currency. No limit would be placed on the time during which balances might remain in the MCA, but if the MCA held balances of a currency, the issuer would have to redeem them with MCA units as it acquired them. The issuer would be entitled to redeem its currency with gold, which would then be distributed pro rata to holders of MCA units, with a consequent extinction of equivalent amounts of units.24

The Report noted two weaknesses of the MCA that it described. First, notwithstanding multilateral surveillance, the plan might encourage deficits by providing the resources to finance them. The international adjustment process would be weakened by the creation of reserve assets that outstripped the optimal need for global reserves. A similar fear had created opposition to Mr. Roosa's proposal. Second, if it became known that a holder was exercising its right to deposit a currency in the MCA, other holders might be impelled to seek conversion by the issuer of the balances they held, which would result in a contraction of global reserves.

V. MR. BERNSTEIN'S RESERVE SETTLEMENT ACCOUNT

The creation of the SDR as a further reserve asset and the adoption of the two-tier system for gold25 inspired Mr. Edward M. Bernstein, who

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had a leading role in the negotiation of the original Articles of the Fund, to propose in 1968 a Reserve Settlement Account (RSA), which would be administered by the Fund. 26 "The principal reason for establishing a Reserve Settlement Account is that it would avoid a competitive scramble for gold that would disrupt the international monetary system." 27 In a world of multiple reserve assets in the form of SDRs, gold, and reserve currencies, it seemed to him essential that all of them should be used without discrimination in international settlements. The growing preference for gold could be disruptive because the amount of gold in the system was virtually static, so that one country's holdings could be increased only by decreasing the holdings of others. It was undesirable that so large a proportion of total reserves as was represented by gold should become dormant, but it was also undesirable that conversions of currency into gold should reduce both total reserves and the component in them that members were more willing to use. There was no reason to rejoice at the greater readiness to dispose of reserve currency, and even SDRs, whenever possible. This tendency might suggest that the assets were unattractive, with further unsettling effects.

To resolve these dilemmas, Mr. Bernstein proposed that countries should "earmark" their reserves of gold, foreign exchange (except working balances in amounts agreed with the Fund), and SDRs in the RSA, but not reserve positions in the Fund, in return for an equivalent amount of a composite reserve unit, which would be defined in terms of gold. Reserve positions in the Fund were not included in the plan, as they had been in Professor Triffin's, because Mr. Bernstein did not propose to restructure the Fund and was content to accept the functions it performed through

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27 U.S. Cong., Hearings, Proposed IMF Quota Increase and its Implications for the Two-Tier Gold Market, supra note 26, at 44. For a less elaborated scheme, involving the centralization of reserve assets, participants' own currencies, and such other commodity or financial assets as would be authorized from time to time by the administrators of the scheme, and the issue of a new asset in substitution for them, see Robert A. Mundell, A Plan for a World Currency, in U.S. Cong., Hearing, Next Steps in International Monetary Reform, supra note 26 at 24-28; Fritz Machlup, Remaking the International Monetary System ch. 6, reproduced in id. 57-83, at 77-79.
its two departments in providing conditional liquidity and creating reserves. The new asset to be issued in substitution for other assets was again named the CRU, although it was fundamentally different from the asset described earlier in this paper.

Surpluses and deficits would be settled only by crediting and debiting the CRU accounts of members. These transfers would involve implicit transfers of gold, foreign exchange, and SDRs in equitable proportions, namely the ratios in which the deficit country held various reserve assets under earmark in the RSA. Each surplus country in receiving CRUs in settlement of its surplus would acquire by implication these reserve assets in the average ratios in which they were earmarked for the deficit countries, so that all surplus countries would acquire the various reserve assets in the same ratios. The surpluses and deficits for the purpose of settlements would be cumulative. The effect of these formulae would be that whenever a country's CRU account was equal to its earmarked assets, which would mean that its cumulative surpluses and deficits were equal, the implicit composition of its reserves would be unchanged. Actual transfers of the assets would occur only in a settlement of accounts with a member if it withdrew from the RSA.

Mr. Bernstein pointed out that his plan would give effect to "harmonization" in the use of reserve assets, as this process had been called during the negotiation of the First Amendment. Harmonization was recommended by some negotiators in order to avoid an excessive use of SDRs as compared with the use of other reserve assets, because this practice might undermine the desirability of the new reserve asset. It was proposed, for example, that transfers of SDRs should be accompanied by transfers of gold, or of all other assets, in fixed ratios. The concept of harmonization did not receive sufficient support, so that it was not given the form of a strict obligation, partly because it was agreed that the right to use SDRs should not be encumbered. Harmonization is expressed, therefore, as a velleity:

Participants shall also pay due regard to the desirability of pursuing over time a balanced relationship between their holdings of special drawing rights and their other reserves.29

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29 Schedule G, para. 1(b). The provision appeared originally as Schedule G, para. 1(b) in the First Amendment, in which it read as follows:
Participants shall also pay due regard to the desirability of pursuing over time a balanced relationship between their holdings of special drawing rights and their holdings of gold and foreign exchange and their reserve positions in the Fund.

The more complicated original language was designed to avoid referring to the SDR as a reserve asset because of political considerations. See Joseph Gold, Special Drawing Rights: The Role of Language, 16-18 (IMF Pamphlet Series, No. 15 Washington, 1971).
This provision does not refer to a balanced use of all kinds of reserve assets but only a balanced use of SDRs as compared with the use of all other reserve assets as a group.

A country would retain ownership of the gold and other reserve assets earmarked for it in the RSA. The legal arrangement under which assets would be transferred to the RSA under earmark, with members retaining ownership, was not elaborated, but the intended psychological effect of this element of the plan is obvious. The effect was enhanced by permitting a member to hold its gold for the account of the RSA in its own central bank, which meant that the gold would remain within the territory and control of the member. The retention of ownership by a member was subject to the implicit transfers involved in a cumulative debit position in its CRU account. A country would continue to show its holdings of gold, foreign exchange, and SDRs in its earmarked account as part of its reserves. A credit position in its CRU account would be shown as reserves due from the RSA and a deficit position as reserves due to the RSA. Countries would no longer engage in gold transactions. It will be seen that the European Monetary System, which is discussed in a later section, has dealt with some problems similar to those considered by Mr. Bernstein, for example in connection with the ownership of participants' assets, and that some of the solutions resemble, while others differ from, those that he proposed.

The Fund would earmark its own gold in return for CRUs, and transactions with the Fund that would otherwise be conducted in gold would be carried out in CRUs. The plan therefore contemplated a reduced role for gold in the international monetary system, and a central role for the CRU. Similar objectives have been embodied in the Second Amendment in the treatment of gold and the SDR, but the objectives have been pursued by different methods.

Participants would receive interest on their earmarked holdings of SDRs and foreign exchange but not gold. Interest on holdings of SDRs would be received from the Fund, because participants would continue to own them. The RSA would transfer earmarked balances of currency to the issuer and receive in return non-negotiable notes guaranteed in gold value, convertible on demand into the currency earmarked, and bearing interest at an agreed rate. The RSA would pay interest on earmarked balances from this income. Ultimately, the RSA might pay a uniform rate of interest on all holdings of CRUs.

The intention was to avoid competition among participants in the RSA in buying gold from non-participants and the depletion of aggregate reserves by sales by participants to non-participants. Instead, the RSA would buy or sell gold from non-participants on behalf of participants through a separate account and in return for CRUs. See U.S. Cong., Hearings, Proposed IMF Quota Increase and its Implications for the Two-Tier Gold Market, supra note 26, at 44-45.
The foreign exchange reserves earmarked for countries would remain fixed in amount and guaranteed in gold value. If the balance of payments of the United States was in persistent surplus and its holdings of CRUs exceptionally large, the RSA might request it to retire some of the dollars in the RSA, using CRUs for this purpose. This reduction in global reserves would be offset by the Fund’s allocation of an equivalent amount of SDRs to all participants in the Special Drawing Rights Department. The amount of gold earmarked for participants in the RSA would be fixed because they would no longer engage in gold transactions.

The only reserve asset that would increase substantially in volume would be the SDR. Allocations would be made regularly to meet the need for global reserves. Allocations would be the only way in which the volume of CRUs would be increased. Transfers of SDRs between participants in the Special Drawing Rights Department would not take place except implicitly in the transfer of CRUs. All SDRs when allocated would be deposited in the RSA. In this way, the SDR would be the instrument for controlling the growth of global reserves.

A central bank requiring U.S. dollars as working balances with which to intervene in the exchange market would sell CRUs to the Federal Reserve Bank of New York acting on behalf of the United States. A country accumulating U.S. dollars in excess of working balances would have to get the excess converted into CRUs by drawing down its dollar balance at the Federal Reserve Bank of New York. The United States and other reserve currency countries would have to convert excess balances with CRUs, so that their deficits would not increase total reserves.

Clearly, the plan was not designed solely to prevent competition for gold. Other major aims were to prevent the expansion of reserves in the form of currency and to make the SDR the principal instrument for the control of global reserves.

The plan did not attract official support. One reason was the traditional resistance of members to limitations on their freedom to determine the composition of their reserves. Another reason was the changing fortunes of gold. The plan was intended to avoid competition for gold among countries at a time when the two-tier arrangement, inaugurated in March 1968, was still in effect. Under that arrangement gold held in reserves was to be used only in transfers between monetary authorities and was not to be sold in the market. It was agreed also, as part of the arrange-

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32 Joseph Gold, Legal and Institutional Aspects of the International Monetary System: Selected Essays 218-23 (Washington, 1979) [hereinafter referred to as Gold, Selected Essays].
ment, that as the existing official stock was sufficient, there was no longer any need to buy gold in the market. The arrangement was intended to isolate the official and the private markets from each other and to show that the price in the private market did not reflect on the soundness of the par values of currencies, which were defined in terms of gold. The two-tier arrangement was terminated in November 1973 at a time when both the par value system and the simulacrum of it created by the Smithsonian agreement had broken down.

At the Annual Meeting of the Board of Governors of the Fund in 1979, a Minister proposed that a new reserve asset should be substituted for all the reserve assets of all members. The reaction of Mr. Jacques de Larosière, the Managing Director of the Fund, at a press conference was that the proposal:

is a very bold concept of a totally integrated world in which all countries would pool all of their reserves and live under the authority of one central bank issuing one currency. It is an interesting view of the future, but I do not think that, in the world in which we are living, it is a very practical idea. If I can add one point, I think that in these matters of monetary reform we should advance step by step and in a pragmatic way...

VI. COMMITTEE OF TWENTY’S OUTLINE OF REFORM

One of the most intensive international debates on substitution took place in the Committee of Twenty, its subsidiary body (the Deputies), and the Technical Groups established by the Deputies. The Committee was created as a result of the breakdown of the par value system after the renunciation of official convertibility by the President of the United States on August 15, 1971, that is to say, the refusal of the United States thereafter to convert with gold or other reserve assets the dollar balances held by the monetary authorities of other members. The willingness of the United States to convert the balances of dollars with gold, while the monetary authorities of other members intervened in exchange markets by buying and selling dollars, had been fundamental practices of the par value system as it had developed. The Committee’s task was to prepare a plan for reform of the international monetary system. Substitution had been discussed in the Executive Board’s Report of August 18, 1972 to the Board of Governors on Reform of the International Monetary System. That report became, in effect, the agenda for the Committee.

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33 Solomon, supra note 23, at 119-27.
34 For an account of this effort at reform, see id. at 235-66.
The work of the Committee was wound up with a Report of June 14, 1974 to the Board of Governors, to which was appended an Outline of Reform. The Committee concluded that, in the conditions that had developed, a complete reform of the system was not feasible, with the result that the Outline of Reform did not purport to be a complete blueprint. It was intended to indicate the general direction in which the Committee believed that the system could evolve in the future. The Committee had not reached full agreement on all aspects of a possible reform, and on these aspects the Bureau, consisting of the Chairman and Vice-Chairmen of the Deputies, prepared ten annexes to the Outline to record the state of the discussion and to provide illustrative schemes and operational detail.

The Outline gives little impression of the range of objectives that the negotiators had in mind in dealing with substitution. The different objectives, or main objectives, of negotiators inspired a cento of proposals and much embroidery of them with variants.

Two of the assumptions of the Outline were that a par value system would be restored, although with greater flexibility and with room for floating in particular situations, and that a form of official convertibility would be reintroduced. It was agreed that the obligation of convertibility should be symmetrical for all members, so that a reserve currency country like the United States would be unable to finance its deficits by means of increased holdings of its currency by other members, because all members would be required to settle their deficits with reserve assets. At the same time, symmetry required that the United States, when in surplus in its balance of payments, should receive assets that would augment its reserves instead of having its currency liabilities reduced by means of settlements with U.S. dollars, which had been the practice under the original par value system. The United States could not be expected to restore the official convertibility of the dollar unless it was assured of sufficient assets to perform that obligation. Moreover, a new obligation of official convertibility should ensure that the United States did not lose reserve assets when it was not in deficit in its balance of payments. Under the former system of convertibility the United States had redeemed dollars with reserve assets even when it was not in deficit because the dollar was used in settlements between other countries. A member in surplus that received dollars was able to present them to the United States for conversion. To distinguish the new form of official convertibility from the old, the report of the Executive Board had coined the expression “asset settlement.”

56 Outline of Reform, paras. 2(a), 11-13, in Documents of the Comm. of Twenty, supra note 2, at 8, 11-12.
57 Id. paras. 18-20, at 13-14.
The Committee reached little agreement on asset settlement. The two principles that were sufficiently acceptable for inclusion in the Outline were that “[a]ll countries maintaining par values will settle in reserve assets those official balances of their currencies which are presented to them for conversion,” and that “[t]he Fund will establish appropriate arrangements to ensure sufficient control over the aggregate volume of official currency holdings.”\textsuperscript{38} The word “those” in the first of these principles was obviously a calculated ambiguity, as was the word “appropriate” in the second principle.

Three possible “appropriate arrangements” were foreseen in Annex 5 to the Outline.\textsuperscript{39} They differed in the extent of asset settlement and the degree to which it would be obligatory. These characteristics of asset settlement by members maintaining par values would determine the control the Fund could exercise over the volume of currency in reserves. If this control were effective, the Fund could manage the volume of global reserves by means of allocations or cancellations of SDRs.

All three approaches assumed that, in one way or another, asset settlement should be under the control or influence of the Fund as the central authority in contrast to the bilateral mechanism of official convertibility in the past. That mechanism had not worked well. Moreover, both requests for conversion and abstention from them had created political tension and other problems. Another assumption was that settlements would be made with “primary reserve assets,” i.e., assets that were not controlled in their creation by a single member.

The first of the three approaches in Annex 5 was a full and mandatory system of asset settlement. Periodically, the Fund would establish a maximum for the total volume of each reserve currency that might be held in reserves and in the Substitution Account. Initially, this

\textsuperscript{38} Id. para. 20, at 14. See also paras. 18-19:
18. It is agreed that the basic objectives to be accommodated in the reformed convertibility system should be symmetry of obligations on all countries including those whose currencies are held in official reserves; the better management of global liquidity and the avoidance of uncontrolled growth of reserve currency balances; adequate elasticity; and as much freedom for countries to choose the composition of their reserves as is consistent with the overall objectives of the reform.
19. As part of the better international management of global liquidity, the aggregate volume of official currency holdings will be kept under international surveillance and management in the Fund. In this connection the Fund will take account of any necessary increase over time in official currency holdings in relation to the growth of international transactions and also of the special position of a limited number of countries with large reserves deriving from depletable resources and with a low capacity to absorb imports.

\textsuperscript{39} Documents of the Comm. of Twenty, supra note 2, at 37-40.
maximum could be the volume held by members at the time of the introduction of asset settlement. If, as the result of monthly calculations, the Fund found that the maximum had been exceeded, the issuer of the reserve currency would redeem the excess by transferring primary reserve assets in return for balances of its currency. The balances to be presented for redemption would be those in the Substitution Account in the first instance, if substitution arrangements had been made for the currency, and, for the rest, balances could be presented to the issuer by members that volunteered or in the last instance by members that were designated by the Fund. A member that accumulated balances of a reserve currency as the result of a surplus in its balance of payments would deposit them in the Account and receive SDRs in substitution, which had been transferred to the Account by the reserve center as the result of its deficit. The arrangements for settlement through a Substitution Account would eliminate the need for a member to approach the issuer of a reserve currency directly in order to have balances converted, and would avoid the resentment or nervousness sometimes provoked by bilateral requests for conversion.

The issuer of a reserve currency could earn reserve assets when in surplus by providing its currency to countries in deficit in return for SDRs or, if existing balances of its currency held by other members had been run down, which would mean that the reserve currency had been used to meet deficits, by obtaining SDRs for its currency from the Substitution Account.

The second approach to asset settlement depended on requests for settlement by the holder of balances at its discretion. The issuer of a reserve currency, however, could request other members to limit, or to present for conversion, increases in their holdings of its currency, and holders would act in accordance with these requests. The Fund would be prepared to recommend procedures, if necessary, for orderly reductions in the volume of currency in reserves. The United States was among the countries that preferred this looser approach, but coupled it with the proposal that a country should not be entitled to demand conversion if its primary reserve assets rose above a predetermined level. The purpose of this proposal was to put pressure on a member in excessive surplus to adjust its balance of payments.

The third approach resembled the first, except that the Fund would have a discretion to require the conversion of balances in excess of levels that it had established. If, however, the excess was greater than a predetermined amount, the issuer would be bound to redeem the excess beyond that amount unless the Fund decided otherwise. Redemption would be carried out in the same way as under the first approach.40

40 See also id. at 125-38.
A variant of the first and second approaches, proposed by Italian officials, was that the issuer of a reserve currency would be required to make full asset settlement by transferring primary assets to a Substitution Account, but the holders of the currency would make their own decisions on whether they would transfer their holdings of reserve currency to the Account for primary assets. If the Account did not have enough currency to return to the issuer when it made a settlement, the Fund would designate members to provide the needed currency in return for primary assets. This proposal was intended to prevent the growth of global reserves as a result of increases in the holdings of reserve currencies, because primary assets would have to be deposited in the Account by the issuers of those currencies, but at the same time members would be free to determine the composition of their reserves because they would be allowed to decide how much currency they would hold. Finally, under this proposal, a country would be able to obtain currency from the Account for SDRs if it had a balance of payments need or wished to restore its working balances.

A function of a Substitution Account, as described above, would be to facilitate asset settlement. If the Italian proposal were accepted, the Account would have the further function of supplying reserve currency to the members that needed it. The Substitution Account that was considered for the purpose of all approaches to asset settlement differed in an important respect from the definition of substitution that has been offered earlier in this paper. Substitution would not be confined to one or a few occasions, but would be a feature of the continuous operation of the international monetary system. There was much agreement, however, that a Substitution Account should have another function that could be fully compatible with the definition. The Account would be the instrument for dealing with the “overhang” of U.S. dollars that would be in existence when asset settlement was introduced.

Asset settlement would have to be protected against the presentation for conversion of balances in the “overhang.” Paragraph 22 of the Outline dealt with this objective as follows, but the words “as necessary” reflected differences of opinion not only on the kind of provision that might be made but also on the necessity for special provision for “consolidation”:

The Fund will, as necessary, make provision for the consolidation of reserve currency balances to protect the future convertibility system against net conversion of any overhang of such balances which may exist at the restoration of general convertibility, and to ensure that the issuers of the currencies concerned will be able to acquire reserve assets when in surplus and will not lose reserve assets beyond the amount of any future official settlements deficits. For this purpose, and also to permit coun-

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41 The deficits would be in the balance of payments presented on the basis of official settlements. In simplified terms, this presentation aims at showing financing through the
tries that wish to do so to exchange official currency holdings for SDRs, the Fund will have authority to establish a Substitution Account. Possible operational provisions of a Substitution Account with an illustrative scheme are discussed in Annex 7. In addition, the Fund may also assist those countries that desire to negotiate bilateral funding of currency balances.\textsuperscript{42}

Annex 7 explained the purposes of the Substitution Account in the following sentence:

In order to promote the resumption and maintenance of general convertibility, the reduction of the role of reserve currencies, the development of the SDR as the principal reserve asset, and the achievement of a more stable pattern of reserve composition, it is agreed that the Fund would have authority to establish a Substitution Account through which SDRs may be issued in exchange for reserve currencies.\textsuperscript{43}

The Substitution Account sketched in Annex 7 provided for a “continuing facility”\textsuperscript{44} for the substitution, apparently at any time, of the amount of balances outstanding in reserves when the Account was established, but it was noted that an alternative suggestion had been made that the Account should be open on a single occasion only. The question of timing was related to the question whether substitution should be mandatory or voluntary, but if it was to be voluntary a member that did not take advantage of the opportunity of substitution would not be deprived of the right to request conversion by the issuer at a later date. As noted in the next paragraph, the issuer might receive SDRs in compensation if conversion took place later.

A member holding balances of a currency for which substitution arrangements had been made would be entitled to deposit them in the Account and receive SDRs in accordance with such rules as were established. Members would not be able to obtain currency from the Account for SDRs, except that an issuer would receive its own currency when amortizing balances of it held in the Account. If total deposits of a currency in the Account exceeded the established maximum, the issuer would redeem the excess with SDRs. If the total amount of the currency held in reserves declined below the established maximum, the issuer would be entitled to obtain SDRs from the Account in return for its currency. A decline would mean that the issuer had converted “old” balances.

The issuer would amortize its currency held in the Account, and the


\textsuperscript{42} Documents of the Committee of Twenty, supra note 2, at 14-15.

\textsuperscript{43} Id. at 41.

\textsuperscript{44} Id.
maximum amount for the purposes described above would be reduced correspondingly. The Fund would be authorized to issue SDRs through the Account for the purpose of the operations of the Account. Interest would be paid in SDRs on the SDRs issued through the Account, and the Fund would be able, in consultation with the issuer, to invest balances of the issuer's currency deposited in the Account.

It has been seen that Annex 7 mentioned two possibilities on the timing of substitution of the overhang. Some proposals recommended an initial mandatory substitution of the full amount or of some agreed proportion, while other proposals favored mandatory installments that would be fixed at the outset. Numerous variations were played on these themes, often in order to arrange a compromise between mandatory and voluntary substitution.45

One argument for a full or substantial substitution at the outset was that it would put the United States in a better position to undertake the obligation of asset settlement with little or no delay. Another consideration was that substitution in this way would reduce the risk of a disturbing diversification of reserves into a number of currencies. Diversification will be discussed later in this paper.

Some officials, particularly those from developing countries, were opposed to substantial mandatory substitution because the resulting increase in the volume of SDRs might be a deterrent to the adoption of decisions to increase the volume further by allocations of SDRs. In addition, these experts tended to regard all of their country's holdings of reserve currency as working balances, and they preferred to earn a higher rate of interest on the balances than they would get by holding SDRs. They pointed out, further, that there were uses of currency that could not be made with SDRs, such as setting currency aside to secure the repayment of loans by commercial banks. Other objections to mandatory substitution, such as the customary insistence of monetary authorities on the right to determine the composition of their monetary reserves, were advanced by officials who came from both developed and developing countries.

Annex 7 noted that as part of the arrangements for substitution of holdings of a currency, agreement would have to be reached with the issuer on the interest payable on balances in the Account, maintenance of the value of claims against the issuer, the disposition of profits and losses arising in the operation of the Account, and amortization. In addition, agreement would be necessary on provisions relating to liquidation of the Account and the withdrawal of a member from it.

The complexities of some of these aspects of substitution, which are

45 See id. at 166-76.
likely to confront the negotiators of any plan, were noted in the following passage in a report of one of the Technical Groups:

The Group discussed in general terms the relationship between the exchange value obligations to be undertaken by reserve centers and the interest rate to be paid by reserve centers to the Substitution Account on the one hand and the corresponding obligations of the account to holders of SDRs on the other. There was also some discussion of the way to deal with any profits or losses of the Substitution Account that might arise from differences in these two sets of obligations. The representative of the United States had reservations about a Substitution Account that would require the issuers of currency balances substituted to accept liabilities in terms of SDRs, since this could be highly onerous with some forms of SDR valuation; if a Substitution Account would provide important advantages for the international community, its benefits and risks should be shared, possibly among the membership in proportion to Fund quotas, or in relation to the amounts of currency that individual members substituted for SDRs, or in relation to countries' shares in total currency holdings. The view that the Fund membership should share the profits or losses was supported by a few representatives on the condition that substitution was carried out in an acceptable form, while others felt that sharing in relation to amounts substituted would discourage substitution. It was also pointed out that sharing in relation to quotas or to currency holdings would mean that less developed areas would bear part of the responsibility even though these countries might not make much use of a Substitution Account. Most participants felt that the Substitution Account should operate in such a way as to avoid profits or losses. In support of this, the Canadian representative suggested that reserve centers would at least need the incentive of paying a rate of interest lower than that paid on their currency liabilities to compensate them for any exchange value guarantees they were asked to undertake.\(^\text{46}\)

The reaction of the United States was prompted in part by the consideration that the benefit it would derive from a decline in the exchange rate of the dollar would be reduced by an obligation to maintain the value of balances in the Substitution Account.

The report of the Technical Group mentions proposals that currency deposited in the Substitution Account should be used to make loans to less developed countries. These loans, it was argued, could help to resolve some of the technical problems of maintenance of value and loss because the borrowers would assume obligations of repayment denominated in SDRs and would be willing to pay higher rates of interest than the issuers of reserve currencies. These proposals were opposed because the loans would defeat the purpose of substitution by returning currency to

\(^{46}\) Id. at 175.
reserves and because loans would be inflationary. In response, it was sug-

ged that the loans could be confined to the financing of imports from
the issuer of the currency lent and that repayments could be made to
correspond with the schedule of amortization that the issuer would have
to follow. 47

VII. NEGOTIATION OF SECOND AMENDMENT

Part II of the Outline proposed that a number of steps should be
taken immediately to begin an evolutionary process of reform of the in-
ternational monetary system and to help in meeting the current problems
facing both developed and developing countries. 48 In a paragraph dealing
with liquidity, the Outline declares that, in the period before a full re-
form of the system is in place, members will cooperate with the Fund to
promote the principle of the better management of global liquidity, and
that periodically the Fund will review the aggregate volume of official cur-
rency holdings. If these holdings were judged to have increased exces-
sively, the Fund will consider with the countries concerned “what steps
might be taken to secure an orderly reduction.” 49 In a separate sub-para-
graph, which was designed no doubt to imply that it was dealing with
only one way of bringing about this reduction, it is said that:

The Fund will also give consideration to substitution arrangements and
examine whether an amendment of the Articles of Agreement would be
desirable in this connection. 50

In another paragraph, the Executive Board was requested to prepare
a draft amendment that could be adopted as an immediate step and that
would “authorize the Fund to establish, as and when agreed, a Substitu-
tion Account.” 51 This language was drafted so as to refer to a power
under which the Second Amendment would not necessarily bring a Sub-
stitution Account into being as soon as the amendment took effect but
would authorize the Fund to take this step whenever agreement was
reached. Flexibility was sought not only as to timing (“when”), but also in
connection with the structure of the Account (“as”). The interest in a
Substitution Account expressed in these paragraphs was not based on the
expectation that it would be the mechanism for making asset settlement
work. It was clear that the amendment of the Articles to be undertaken
immediately would not provide for asset settlement. Substitution was
contemplated, therefore, as a means of satisfying different and more lim-
ited objectives.

47 Id. at 175-76.
48 OUTLINE OF REFORM, supra note 36, para. 32, at 18-19.
49 Id. para. 37(a), at 20.
50 Id. para. 37(b), at 20.
51 Id. para. 41(d), at 22.
In the course of drafting by the Executive Board of the provisions of the Second Amendment dealing with gold, it was agreed that there should be a gradual reduction in the role of gold in the system.5 There was a widespread, although probably not a unanimous, view that the supply of gold was too unreliable to be a satisfactory source of reserves, and that the fluctuations in its market price were a further objection to its role as a reserve asset. It was agreed, therefore, that, as part of the Second Amendment, the official price of gold would be abrogated and that members would be free to buy and sell gold at any price that they were able to negotiate. Some Executive Directors were skeptical that provisions of this kind would promote a gradual reduction of the role of gold in the system. They were equally skeptical about the agreement of the Group of Ten that for a period of two years they would not peg the price of gold and would not increase the total stock of gold held by them, the Fund, and Switzerland. They thought also that the immense expansion in the value of global reserves that would result from abandoning an official price for gold would deter the Fund from allocating SDRs and would impede progress toward making it the principal reserve asset of the system and the instrument of a rational control of global reserves.

In the Fall of 1975, during the preparation of the Second Amendment, some Executive Directors, hoping to find a remedy for these ills, requested a draft of provisions dealing with a Gold Substitution Account (GSA) that could be included in the Articles. An approach was developed that sought to give effect to a number of interrelated aims:

(i) When the Fund found that participants in the Special Drawing Rights Department holding a sufficiently large share of the total stock of monetary gold were prepared to deposit in the GSA a substantial proportion of their holdings, the Fund would give them the opportunity on a single occasion to obtain SDRs in return for part or all of their gold. SDRs would be offered as reserve assets that in practice would be more readily usable than gold, would be more stable in value, and would bear interest. The Fund would establish the terms and conditions on which substitution would be carried out. The Fund itself would be able to deposit gold held by it in the General Resources Account of the General Department. The decision on substitution could apply to both participants and the Fund, or solely to either of them. In relation to the SDRs it would receive, the Fund would be treated for many purposes as if it were a participant in the Special Drawing Rights Department. No more than a single opportunity for substitution would be offered in order to ensure that the Fund would not provide a continuing market for gold, appear to

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5 See Proposed Second Amendment to the Articles of Agreement of the International Monetary Fund: A Report by the Executive Directors to the Board of Governors Part II, ch. I, § 1 (March, 1976).
establish an official price for gold, or give indirect support to a price. The Fund would determine the price it would pay for gold as one of the terms and conditions for substitution. The price could have some relationship to the market price at the time of the decision to permit substitution.

(ii) The substitution of SDRs for gold would bring reserves under more effective international control and enhance the status of the SDR. In addition, substitution could avoid an excessively rapid increase in reserves by spreading over time the effect of the increase in the value of gold. The Fund would issue an immediate first installment of SDRs on the basis of the former official price of gold, SDR 35 per fine ounce. The balance would be issued in annual installments, with the possibility of an acceleration for the benefit of members in balance of payments difficulties.

(iii) Some members were concerned about the activation of dormant liquidity that would result from the removal of legal prohibitions on the sale of gold at market prices. They were disturbed not only because there would be a large unregulated increase in liquidity but also because it would accrue to no more than a few members. Moreover, all of these members would be developed countries. When substitution had been considered earlier in 1975, it had been suggested that, because of this concern, the issue of SDRs in substitution for gold could be combined with allocations of SDRs in an effort to correct the unbalanced distribution of reserve assets. The Fund could decide to allocate SDRs to all participants in the Special Drawing Rights Department whenever it issued an installment of SDRs in substitution after the first installment. The reason for the distinction was that the first installment would not represent the creation of new reserves if gold was valued for this installment at the official price before the Second Amendment. Allocations of SDRs to all participants would be made at the same proportion of the quotas of all participants, as is required by the Articles. The criteria in the Articles for allocations would be observed in arriving at this proportion. The annual installment payable to a depositor of gold as a result of substitution would be reduced by the amount of the allocation it received in the same year as a participant in the Special Drawing Rights Department. Later, this proposal to empower the Fund to combine allocations to participants with issues of SDRs to depositors was abandoned in favor of a proposal simply to empower the Fund to issue SDRs in substitution for gold. The incentive to transfer gold to the GSA would be reduced if allocations were offset against the installments stemming from substitution.

(iv) In principle, the rights and obligations connected with SDRs issued in substitution for gold would be confined to those SDRs and would affect only those participants that transferred gold to the GSA. The rights and obligations connected with SDRs allocated to all participants would not be affected. (In accordance with this principle, the Fund
would invest the proceeds of the sale of gold in order to earn income with which to pay interest on the SDRs issued in substitution for gold.) Again in principle, the characteristics and uses of the SDRs created by both allocation and issue should be the same. Nevertheless, some differences in the treatment of the two in the administration of the Articles seemed inevitable. Some critics objected to these potential differences, and so a compromise was offered that would define the differences in advance and at least avoid surprise.

(v) The Fund would dispose of gold in the GSA in the market at a pace that would not disturb the market. In this way, the reduction of the role of gold in the system would be promoted.

Some members proposed that the proceeds of the sale of gold in the GSA in excess of the official price should be used, either directly or through other international organizations, to give financial assistance to the poorest members of the Fund. Alternatively, the assets to be used in this way might be confined to the excess proceeds resulting from sale of the Fund’s own gold. The difficulty of deciding in advance on the use of the proceeds of sale led to the suggestion that the Fund should be able to take decisions of this kind from time to time after the plan became effective. This suggestion was opposed as discouraging substitution because the holders of gold would want to know what would happen to the proceeds before they subscribed to the plan.

At one time during the discussion of substitution it was proposed that the GSA should be established outside what became the two Departments of the Fund. The main purpose of this proposal was to provide that decisions affecting gold in the GSA should be taken by members that had transferred gold to it, by voting power proportioned to their transfers, and not by all members or by all participants in the Special Drawing Rights Department on the basis of their normal weighted voting power. It was argued in opposition to this proposal that the GSA would be important for the whole system, and that although the assets of the GSA should be kept separate from all other assets of the Fund, the GSA should be set up within the General Department, so that all members of the Fund would be entitled to take part in decisions affecting the GSA on the basis of their weighted voting power. The argument of the importance of the GSA for the system led also to the proposal that a high majority of the total voting power should be necessary for decisions to issue SDRs in substitution for gold and to prescribe the terms and conditions on which an issue would be made. This controversy illustrates the problems of control and voting power that arise in connection with many plans for substitution if it is expected that not all members will participate under them or if participation will be according to some key other than quotas in the Fund.

When it became evident that agreement on detailed provisions of the
Articles on substitution was unlikely, an alternative legal technique was suggested. The alternative was a broad power of the Fund to establish a Substitution Account and make any necessary changes in the Articles without going through the procedure of amendment. It was also suggested that the opportunity should be taken to provide for the substitution of SDRs for holdings of reserve currencies. The reason given for this suggestion was that reserve currencies were responsible for a larger increase in global reserves than gold. The suggestion may have been a tactical one by members who were not enthusiastic about reducing the role of gold and who wished to keep alive the hope of asset settlement in a more symmetrical system.

The following draft was prepared to give effect to the various suggestions that had been advanced:

**SUBSTITUTION OF SPECIAL DRAWING RIGHTS FOR**

[GOLD] [OTHER RESERVE ASSETS]

In order to promote the gradual reduction of the role of [gold] [gold and reserve currencies] in the international monetary system and to make the special drawing right the principal reserve asset in the system, the Board of Governors may decide, by an eighty-five percent majority of the total voting power,

(i) to establish a Substitution Account in the General Account and to issue special drawing rights in exchange for [gold] [other reserve assets] transferred to the Substitution Account,

(ii) to prescribe the terms and conditions for the substitution, and

(iii) to make any modifications in this Agreement that may be necessary or appropriate for this purpose, notwithstanding the provisions of Article XVII, provided that

(a) special drawing rights issued under this Article shall not differ from those allocated under Article XXII, and

(b) the assets of the Substitution Account shall be held separately from the other resources held in the General Account.

The draft was prepared before the final terminology, in which the General Account became the General Department, was settled.

None of the suggestions for a Substitution Account was adopted. There was resistance by some, including the United States, to the inclusion of reserve currencies and by others to the exclusion of them. It seemed that comprehensive substitution for reserve currencies would require agreement, which was not in prospect, on asset settlement and several other important proposals in the Outline of Reform. One criticism of the GSA was that the SDR could not be used as freely, or was not competitive with, gold or the assets that could be obtained with gold. Some officials thought that a special quality of gold as compared with other
assets was that it could be called into service in emergencies. Another reason for reluctance was that if the criterion of global need for allocations of SDRs would determine when SDRs would be issued for gold, members would be parting with present assets for assets to be received at dates that could not be foreseen. Furthermore, this uncertainty would be aggravated by the absence of international control over the addition of currencies to reserves. They might be added in a volume that would make it difficult or even impossible to find that there was a global need for the allocation of SDRs.

Some objections to substitution were based on the effect of a GSA on the policy of a gradual reduction in the role of gold in the system. The announcement of a price at which gold would be accepted for SDRs could establish something in the nature of an official price, particularly if the Account held a substantial amount of gold and there was a tendency not to sell gold from it below the price that had been paid for the gold. Even if the Account held only a modest amount of gold, members might be unwilling to see it marketed if the effect would be to reduce the value of the gold they had retained. Arguments of this kind accepted the desirability of allowing gold to remain dormant in reserves and of not substituting a more active asset for it that would increase effective global reserves.

Problems of policy of a monetary character were not the only basis for opposition to a Substitution Account during the drafting of the Second Amendment. Among the legal difficulties, "self-amendment" by the Fund was prominent. A widespread conviction existed that legislatures would object to authority conferred on the Fund to take decisions and to amend the Articles on matters of importance that legislators would regard as properly within their constitutional competence and political concern.53

The Executive Board’s consideration of a Substitution Account was in response to both the Outline and to a request of the Interim Committee. There was enough support to justify a request by the Committee in its communiqué of June 12, 1975 for the study by the Executive Board of a GSA through which members would be able to exchange “a part or all of their gold holdings for SDRs issued by the Fund for this purpose.”54 The Executive Board reported to the Committee at its meeting in Jamaica that agreement had not been reached on either the desirability or the content of provisions on a GSA. The Committee, in the communiqué of January 8, 1976 that it issued after the meeting, announced that “The Executive Directors should continue their consideration of the subject of a substitution account without delaying completion of the comprehensive

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53 GOLD, SELECTED ESSAYS, supra note 32, at 333-35, 348-49.

draft amendment.”

This sentence recorded the Committee’s recognition of the impracticality of expecting that agreement could be reached without an unacceptable delay in the submission of a proposed Second Amendment to the Board of Governors and to members of the Fund.

The Second Amendment made no explicit provision for a GSA. Some experts were troubled that the agreement reached on gold and recorded in the Interim Committee’s Jamaica communiqué would not succeed in reducing the role of gold in the system because members would be free under the prospective Second Amendment to buy gold from each other or from the market. Mr. Henry H. Fowler, formerly Secretary of the United States Treasury, suggested that a GSA (or Gold Consolidation Account as he called it) should be established in which a member would be entitled to deposit gold in return for SDR 35 per ounce. The member would retain ownership of the gold and would be able to resume possession of all or part of it if the member repaid the SDRs it had received for the gold and was taking possession in order to sell the gold in the market or because it was withdrawing from the Fund. If a member repossessed itself of gold, it would not be able to redeposit the gold. Redeposit was proscribed in order to prevent unsettling switches among reserve assets.

Mr. Jacques de Groote, an Executive Director of the Fund, advanced a plan of his own, both within the Fund and in the same U.S. Congressional hearings as those in which Mr. Fowler made his proposal. The transfer of the Fund’s own gold, or some part of it, to a GSA was an essential element in Mr. de Groote’s plan. The objectives were to use the increase in the value of the Fund’s gold to grant assistance to its poorest members, associate those members that did not hold substantial amounts of gold with the expansion in global reserves resulting from the increase in the value of gold, reduce the role of gold and enhance the role of the SDR, and give the Fund and members an opportunity to substitute a more usable and more stable asset for gold.

SDRs would be issued to the General Resources Account on the basis of SDR 35 per ounce in substitution for gold. Additional amounts of SDRs, calculated on the basis of a formula related to the market price, would be issued by the Fund to a trust fund for the benefit of developing members or would be distributed to these members directly. The Fund would be under no obligation to sell its deposited gold in the market. Members could deposit their own gold in the GSA, receiving SDR 35 per

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57 Id. at 22-29.
ounce at once and the rest in installments in accordance with determinations on the global need for reserves. The price would be established by the same formula that applied to the Fund's gold. Members would retain ownership of the gold they deposited, and could recover it if they withdrew from the Fund or if the Fund was liquidated. They would decide collectively whether the gold they had deposited should be sold and how the proceeds of sale should be used. The effect of this plan was that it need not influence the market price of gold. The opportunity to distribute reserve assets in substitution for gold without reducing the market price of gold was emphasized as one of the advantages of the plan.

Some of the plans for a GSA, all of which have been unsuccessful, were affected by the sentiment that it was inequitable that the increase in the value of reserves resulting from the greater value of gold should be confined to the members that had held gold in substantial amounts and that the members that had refrained from this practice should receive no benefit. Among the latter members were developing countries. This sentiment might have been a motive for the proposal, on which the Fund acted, to establish a Trust Fund, financed with some of the profits from the sale of one-sixth of the Fund's gold. Balance of payments loans have been made on concessional terms through the Trust Fund to the neediest of developing members. The resources provided to the Trust Fund in this way, however, are only a small proportion of the increase in the value of official holdings of gold.

VIII. SUBSTITUTION AND ALLOCATIONS OF SDRs

The Fund allocated approximately 9.3 billion SDRs in the first basic period of 1970 through 1972. No allocations were made in the second basic period of 1973 through 1977. Mr. H. Johannes Witteveen, the former Managing Director of the Fund, was convinced that the objective of the Second Amendment of making the SDR the principal reserve asset in the system would be difficult enough to achieve in any circumstances but that the task would be enormously more difficult if the status of the SDR was not improved in the short run. The Second Amendment, in declaring that the SDR is to be the principal reserve asset, recognizes that the SDR

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Ministers also affirmed that no arrangements with regard to gold would be acceptable to the developing countries unless . . .
(b) they did not accentuate the already inequitable distribution of international liquidity.
In this context, Ministers agreed that there was a need to expedite the study of a gold substitution account.

59 U.S. Congress, Hearing, IMF Gold Agreement, supra note 56, at 35.

60 Art. VIII, § 7; Art. XXII.
can and should be an instrument to strengthen the system. There was growing agreement that this instrument should not be allowed to rust away after the arduous international effort that had been exerted to construct it, and that its future effectiveness would be influenced by the volume of SDRs in existence, the ratio of them to total reserves, and the pace and direction of changes in that ratio. The abundance of currency in reserves had brought about a reduction in the proportion of SDRs to total reserves exclusive of gold from ten percent at the end of the first basic period to approximately four percent in 1978, and it seemed likely that the proportion would decline even further.

These circumstances stimulated interest in the revival of allocations of SDRs in the third basic period. The criterion for allocation is formulated in the Articles in these words:

In all its decisions with respect to the allocation and cancellation of special drawing rights the Fund shall seek to meet the long-term global need, as and when it arises, to supplement existing reserve assets in such manner as will promote the attainment of its purposes and will avoid economic stagnation and deflation as well as excess demand and inflation in the world.61

According to this provision, decisions on allocation must be based on judgments whether global reserves at present and in the foreseeable future are likely to be adequate for the purposes stated in the provision. The judgments involve intricate economic analysis about which there is usually much disputation among the experts.

In the debates of the late Seventies on the question whether a "long-term global need" existed within the meaning of the provision, the volume and rapid expansion of reserves in the form of holdings of currency were cited as evidence that there was no such need. Moreover, reserves might expand even further because of the ready availability of resources in the international capital markets and the growing propensity of governments to borrow in them in order to add to their reserves. In these conditions, it was protested by some experts, allocations of SDRs might increase the already high rates of inflation in the world. The experts who were less impressed with these phenomena agreed that a substantial proportion of reserves had resulted from borrowing, but, in their view, with less than ideal results. They pointed out that governments with less ability to borrow considered the capital markets unsatisfactory for them, there was a maldistribution of reserves among countries, and those members that had been able to borrow might face difficulties in connection with refinancing. These experts argued that allocations of SDRs might induce governments to forbear from a certain amount of borrowing as a

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61 Art. XVIII, § 1(a).
means of bringing about the secular increases in reserves that they want because of the growing volume of their international transactions.

In a situation in which it was desirable to protect the SDR against a threatening decay, in which allocations of SDRs might deter resort to a certain amount of borrowing, and in which this forbearance might support the case for a global need for reserves, the Managing Director concluded that it was logical to convert the hypothesis of a global need into something closer to an assurance. He suggested that allocations of SDRs should be made if participants in the Special Drawing Rights Department undertook to transfer an amount of reserve currency to a Substitution Account. The currency was likely to be the U.S. dollar. The concurrence of the United States would be necessary, therefore, to give life to the project. The Committee of Twenty had not discussed a Substitution Account for the purpose of making room for allocations of SDRs, but the recent examination of substitution in the Committee had familiarized everyone with the idea, so that employing it for a different purpose did not seem revolutionary.

The transfers to a Substitution Account might be equivalent to the whole, or to some identical proportion, of the allocations to each country. On the one hand, allocations greater than transfers might encourage some countries that would be hesitant about parting with U.S. dollars to support the project. On the other hand, transfers equivalent to allocations would be more persuasive to those countries that were hesitant because allocations seemed to them incompatible with the criterion of a global need for reserves.

It was thought that the currency in the Substitution Account would remain there except in such unlikely events as the liquidation of the Fund or of the Special Drawing Rights Department or the termination of a member's participation in that Department. A power to liquidate the Substitution Account in other circumstances was open to the objection that liquidation would undo the purpose of the plan, because return of the currency would increase global reserves. It was also thought that there need be no obligation on the part of anyone to maintain the value of currency in the Account if substitution was irreversible. The difficulties that had arisen in the Committee of Twenty on maintenance of value would be avoided. Members would not treat the assets in the Account as part of their reserves whatever rights they might have in them. U.S. dollars in the Account would be invested in long-term securities of the United States, and the interest earned on them would be distributed among members in proportion to their transfers to the Account. The rate of interest earned on these securities was likely to be higher than the rate of interest that members would receive by investing their balances in shorter-term securities.

The United States would have no obligation of amortization. An obli-
gation seemed to be unjustifiable by contrast to the plan discussed by the Committee of Twenty because under that plan a surplus in the balance of payments of the United States would result in an increase in its reserves in the form of SDRs, and the United States would have been able to use these SDRs for the purpose of amortization. Substitution for the purpose of allocations of SDRs would leave members with substantial holdings of U.S. dollars, with the probable result that a surplus in the balance of payments of the United States would result in the cancellation of some of its currency liabilities but not an increase in its reserve assets that it could use for amortization.

The plan was modest compared with the Substitution Account considered by the Committee of Twenty. The protagonists of the plan sought an improvement in the international monetary system by means of an improvement in the composition of existing reserves, but they did not aspire to control the amount of currency that would be held in reserves in the future. Nor was the plan put forward as an instrument for dealing with any overhang of dollars. Nevertheless, the scheme was not without its difficulties of principle and technique, some of which will be noted at once.

For decisions of the Board of Governors on allocations of SDRs a majority of eighty-five percent of the total voting power of participants in the Special Drawing Rights Department is necessary, and a participant cannot refuse to accept SDRs in accordance with the decision unless it refrained from voting in favor of it. It would not be possible, therefore, to carry out the plan for substitution if participants with more than fifteen percent of the total voting power refrained from voting in favor of a decision to allocate SDRs because they did not wish to engage in substitution. If participants with this voting power would be unwilling to vote in favor of a decision to allocate, the practical problem would be how to go about negotiating sufficient support. The difficulty would be to find a criterion for selecting the reluctant countries with no more than fifteen percent of the total voting power that should be accepted as irreconcilable. This difficulty was responsible for the postulate that adoption of the plan should depend on the participation of all countries. It was never necessary to abandon this postulate because the plan itself was abandoned.

Another problem that troubled some officials was a lack of symmetry that they saw in the plan. Members other than the United States would be depositing reserves in return for offsetting allocations of SDRs, and therefore they would receive no increase in their total reserves. For the United States, the allocations would constitute an increase in reserves because it would transfer its own currency to the Substitution Account and

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62 Art. XVIII, § 4(d).
63 Art. XVIII, § 2(e).
not reserves. A response made to this criticism of asymmetry was that if the United States deposited its own currency, the monetary authorities would have to borrow it in their capital market and pay interest. In addition, the United States, it was argued, would enjoy no net benefit from its share of the income earned by investment of the assets of the Substitution Account because, as the issuer of the securities in which the investment was made, it would pay the interest on those securities.

It would not have been a solution to arrange with the United States that it would not receive allocations of SDRs under the plan, if only because then the majority of the total voting power necessary for decisions to allocate SDRs could not be assembled. The United States has more than fifteen percent of the total voting power of participants in the Special Drawing Rights Department. Nor would it have been a solution for the United States to agree to accept transfers of SDRs resulting from substitution from other participants in return for U.S. dollars. If these transfers were made, the United States, it is true, would assume an additional cost, because the interest it would receive on the SDRs would probably be less than the interest the transferors would receive by investing the balances of dollars they obtained from the United States in exchange for the SDRs. But the effect of this operation would be to undo part of the substitution, because the transferors of the SDRs would increase the holdings of dollars in their reserves.

The Interim Committee, in its communiqué of April 30, 1978, noted the suggestion of the Managing Director that "an allocation of SDRs could be combined with a reduction in the amount of reserve currency outstanding through a Substitution Account administered by the Fund," and that "some members believe that agreement on a Substitution Account would facilitate an allocation of SDRs." The Committee agreed that the suggestion should be studied further and that the Executive Board should submit a report to the Committee "for consideration" at its next meeting. The language was tentative, implying that not all members of the Committee were attracted by the suggestion and that the report would be considered but not necessarily endorsed for action.

By the time of the next meeting of the Committee on September 24, 1978 opinion had developed to the point at which it was agreed that there was justification, both economic and legal, for a resumption of the allocation of SDRs without the need for a Substitution Account for the purpose of ensuring an equivalent contraction in the amount of currency held in reserves. The Committee announced in its communiqué that it supported allocations of SDR 4 billion in each of the remaining three years, 1979 to

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1981, of a third basic period of four years. Mr. J. de Larosière, the Managing Director, made a proposal for these allocations, and the Board of Governors adopted a resolution that gave effect to it.

The communiqué in which the Interim Committee expressed its support for allocations of SDRs in 1979 to 1981 contained the following sentence: “The Committee noted that the Executive Board intends to keep under review the question of a substitution account.” The sentence registered the continuing conviction of some members of the Interim Committee that a Substitution Account for certain purposes, including those discussed by the Committee of Twenty, would strengthen the international monetary system. Other members of the Interim Committee, who did not share this conviction, were content not to record their skepticism provided that no more than study was proposed and that the Substitution Account was referred to as a question and not as a proposal. Nevertheless, the idea of substitution was kept alive.

IX. DIVERSIFICATION OF RESERVES

Periods of weakness of the U.S. dollar and fluctuations in its exchange rate have stimulated the interest of some countries in a diversification of reserves out of dollars into currencies that have been stronger in the market. Diversification through the market could have disturbing effects on exchange markets and on exchange rates for the dollar even if there were to be a major improvement in the balance of payments of the United States. A substantial diversification into the deutsche mark, yen, and Swiss franc has occurred not only because of uneasiness about the U.S. dollar but also because monetary authorities are said to be aware of advantages in applying the principle of portfolio management to foreign exchange reserves in a world of floating currencies. The issuers of currencies other than the U.S. dollar have been reluctant to see their currencies become reserve currencies on a major scale. They might have to choose between the application of troublesome measures to discourage this development and lessened control over the money supply or an unwanted appreciation of the exchange rate for the currency.

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national plane, diversification subjects the international monetary system to the destabilizing effects of shifts by monetary authorities back and forth among currencies in response to changing circumstances and national policies. These dangers could be averted by a coordination of policies among the issuers of present and potential reserve currencies, but there is no confidence that sufficient coordination could be achieved.

In the face of growing diversification, it was to be expected, after agreement was reached on allocations of SDRs and after the Interim Committee noted in its communiqué of September 24, 1978 that the Executive Board intended to keep the question of a Substitution Account under review, that the idea of substitution would be transformed once again. The new objective would be to help fend off the risks inherent in further diversification and at the same time reduce the preponderant reliance of the system on a single currency.

Substitution for this purpose would have some relationship to the plans that have been advanced for dealing with the overhang. Furthermore, if the asset substituted for U.S. dollars was sufficiently attractive and the obligations assumed by the United States in connection with it sufficiently weighty, substitution might resemble a partial restoration of official convertibility. The terms for substitution could ensure an orderly and internationally controlled plan of diversification in place of the random process of unilateral diversification by members through the markets.

Circumstances were more propitious for the consideration of such a plan because of the improvement in the underlying trends in the balance of payments of the United States following the measures it took on November 1, 1978 to strengthen the dollar and to mobilize international resources amounting to $30 billion with which to intervene in exchange markets in support of the dollar. It was possible to emphasize the fact that the plan was not intended to weaken the adjustment process by encouraging the persistence of deficit in the balance of payments of the United States. Among the suggested techniques for giving effect to the plan were allocations of SDRs along the lines of the plan that had been advanced with the objective of meeting the criterion of a global need for reserves, and the issue through the Substitution Account of claims denominated in, and having a certain resemblance to, SDRs although not constituting SDRs proper. Under either plan the SDRs allocated or claims issued would be equivalent in value to the total amount of reserve currency transferred to the Substitution Account. Under either plan, participating countries could conclude that, in effect, they had diversified part of their reserves into the sixteen currencies in the basket that determine the value of the SDR and in the proportions in which the currencies make up the basket. Countries might conclude that they were no longer
under any further pressure to adapt their holdings of currency in accordance with a concept of portfolio management.

The version involving claims denominated in SDRs would not require, as a legal necessity, so widespread a participation as the plan involving allocations of SDRs. Nor would it require a finding of a global need for reserves. The rationale of substitution has gone through subtle transformations since late 1978, but the idea of providing a satisfactory means of diversification has not disappeared. In addition, the issuance of claims denominated in SDRs rather than the issuance of SDRs proper continues to be the favored technique for the purpose of substitution. Before the latest episode is discussed, it will be useful to consider a European development involving substitution.

X. European Monetary System

On March 13, 1979 the European Monetary System (EMS) became effective in accordance with the Bremen communiqué of July 7, 1979 and the Resolution of December 5, 1978 adopted by the European Council, which is composed of the Heads of State and Government of the members of the European Community (EC). These actions were taken in order to initiate a plan for the creation of closer monetary cooperation leading to a zone of monetary stability in Europe. The initial dispositions concentrate largely, although not exclusively, on a preliminary and experimental period of two years, after which it is intended that a final system is to be established.

A principal feature of the EMS, sometimes described as the central feature, is the creation of the European Currency Unit (ECU). It will serve as the common denominator for the exchange rate mechanism, the basis for an early warning system to indicate that the exchange rates for a currency are diverging from other EC currencies and to create a presumption that the issuer of the divergent currency should take corrective action, the denominator for operations in both the intervention arrangements and the credit operations, and a means of settlement among members of the EC.

The ECU is equal to the European Unit of Account (EUA), which consists of a basket of fixed amounts of the nine EC currencies. The amounts of the currencies in the basket are to be reviewed, and if neces-

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71 The Resolution, the agreement of March 13, 1979 among central banks, and other instruments relating to the EMS are gathered in Comm. of Governors of the Central Banks of the Member States of the European Economic Community, Texts Concerning the European Monetary System (1979) [hereinafter referred to as Texts Concerning EMS].
sary revised, within six months after entry into force of the EMS and at intervals of five years thereafter. The first review was carried out in September 1979 but no changes were made. In addition, the amounts may be changed, as the result of a request for a review, if the percentage share of any currency has changed by twenty-five percent or more on the basis of exchange rates. Revisions will be made in accordance with "underlying economic criteria" and "have to be mutually accepted." 72

The discussion of the EMS that follows is confined to those aspects of it that are relevant to substitution. The discussion must begin with a brief description of the arrangements with respect to exchange rates and intervention. A central rate is established in terms of the ECU for the currencies of all participants in these arrangements. The original participants include all members of the EC except the United Kingdom, which has decided not to participate for the time being. As a result of the establishment of central rates, a grid is created consisting of bilateral relationships, sometimes called "bilateral parities", between each two currencies. Margins of 2.25 percent above or below parity must be observed for exchange transactions, but a participant that was not in the European common margins arrangement (the "snake") when the EMS began to operate may avail itself of margins not in excess of six percent, but these wider margins are to be gradually reduced as soon as economic conditions permit. Italy has exercised the option of wider margins. Central rates can be adjusted by "mutual agreement by a common procedure." 73

Intervention at the boundary of the margins is obligatory without limitation, but intervention within the margins is not precluded and may be appropriate when the divergence indicator sounds a warning. In principle, intervention is conducted in the currencies of participants, but room is left for intervention in the currencies of nonparticipating members of the EC or of other countries (including the United States).

Among the financial arrangements of the EMS is a "very short-term facility" for financing intervention. The participants in the exchange rate and intervention arrangements must establish reciprocal lines of credit of unlimited amount. The claims and obligations resulting from intervention are recorded daily in ECUs, at the rate of the day for the ECU, in the books of the European Monetary Cooperation Fund (EMCF). Settlements must be made at prescribed dates and in prescribed means of payment.

Settlements are carried out between the central banks of participants by the debtor's use in the first instance of the creditor's currency held by

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72 Resolution of the European Council of 5th December 1978 on the Establishment of the European Monetary System (EMS) and Related Matters, para. 2.3, TEXTS CONCERNING EMS, supra note 71, at 44.
73 Id. para. 3.2.
the debtor, but the central banks may hold only working balances of the currencies of other participants within limits that are laid down and may be exceeded only with the consent of the central bank of the issuer of the currency held. The rest of a settlement may be made in ECUs, but a creditor is not obliged to accept them in excess of fifty percent of the claim that is being settled. Any remaining balance must be settled in reserve assets in accordance with certain provisions, but a debtor and creditor may agree on some other form of settlement. If a debtor does not hold sufficient ECUs, it can obtain them, under certain provisions, from central banks that hold them in excess of the amounts that have been issued to them or from the EMCF.

It is now necessary to consider how a central bank obtains ECUs in the first instance, and it is in this operation that a form of substitution is involved. Each central bank of a participant must "contribute" to the EMCF twenty percent of its holdings of gold and U.S. dollars as at February 28, 1979. The EMCF credits each central bank with an amount of ECUs corresponding to its contribution. An EC member that does not participate in the exchange rate and intervention arrangements may obtain ECUs in accordance with the same provisions. European countries that do not belong to the EC but have particularly close economic and financial ties with the EC may participate in the exchange rate and intervention arrangements under agreements entered into by the central banks.

The contributions of gold and dollars take the form of revolving swaps of three months in duration. At the beginning of each of these periods, the central banks and the EMCF make the necessary adjustments to ensure that each central bank maintains its contributions at the level of at least twenty percent of its gold and U.S. dollar reserves as recorded on the last working day of the preceding quarter and also to take account of any changes in the price of gold or in exchange rates for the dollar since the initial contributions or last adjustment.

The value of the gold portion of the contribution is determined by the average of the prices, translated into ECUs, recorded daily at the two London fixings during the previous six calendar months, but not exceeding the average price of the two fixings on the penultimate working day of the period. The value of the dollar portion is determined by the exchange rate of the dollar prevailing two working days prior to the value date.

ECUs may be used in intra-EC settlements in accordance with applicable provisions. Central banks may transfer ECUs to one another against dollars, EC currencies, SDRs, or gold, or, between periodic adjustments of contributions, to the EMCF by unwinding a swap in order to replenish dollar holdings. None of these uses of ECUs may be made for the sole purpose of changing the composition of a participant's reserves.

Interest is paid in ECUs by central banks on the amount by which
their holdings of ECU's are below the amounts issued to them in return for their contributions, and is received by central banks in ECU's on the amount by which their holdings exceed the ECU's issued to them. The rate of interest is equal to the average of the official discount rate of all EC central banks weighted in accordance with their shares in the ECU basket.

Unless there is unanimous agreement to the contrary, the swaps of gold and dollars against ECU's are to be unwound at the end of the transitional period of two years. In the liquidation at that time, a net user of ECU's must bring its holdings up to the level of the amount issued to it, by obtaining ECU's, either directly or through the EMCF, from net accumulators of ECU's.

But the central banks show the ECU's and not the contributed assets as part of their reserves. Nevertheless, the effects of fluctuations in the price of gold or in the exchange rate of the U.S. dollar on contributed assets are for the account of the contributing central bank, and it receives the interest earned by the investment of the U.S. dollars. Each central bank manages its contributed assets on behalf of the EMCF to the extent that management is entrusted to the central bank under a contract with the EMCF. This aspect of the arrangement and the concept of the renewable swap suggest that ownership passes for periods of three months to the EMCF, although it appears that the EMCF cannot dispose freely of the assets. The right of the central banks to the return of the assets at the end of each period and their rights in the liquidation of the arrangement may give the central banks a sufficient basis for considering that they remain the owners of the contributed assets in a sense compatible with their domestic laws. The rights and obligations that are incidental to this arrangement as a result of the basic texts or the contracts between the EMCF and each central bank may be unusual but they do not necessarily negate this analysis.

Whatever the correct legal analysis may be, the arrangement can be considered the substitution of ECU's for the contributed assets. The primary purpose of the substitution, however, is not to improve the international monetary system by making the assets unavailable to participants for normal use but to improve the system by creating ECU's without increasing the reserves of participants. Another aspect of the arrangement to be noted is that provisions for dealing with the ownership of assets transferred in return for substitute assets have to take account of psychological considerations as well as considerations of compatibility with domestic law.
XI. Substitution Now

The rationale of discouraging diversification into other reserve currencies lacked sufficient appeal to give substitution much impetus. Some members thought that substitution for this reason might make it easier for the United States to finance a persistent deficit in its balance of payments. At the time of earlier discussions of substitution, the official opinion of the United States was that the Second Amendment gave the promise of a more flexible but also a more stable international monetary system, that there was no overhang of U.S. dollars, and therefore that no need existed for a Substitution Account. The instability of exchange markets, fluctuations in the exchange rate of the dollar, and the consequences of these conditions have produced a different outlook. The United States has expressed the view that it does not insist on any particular international role for the dollar and that it does not object to some gradual reduction in its role as part of the further evolution of the international monetary system. Nevertheless, to rest the main weight of the case for substitution on the discouragement of diversification into other currencies seemed to diminish the reputation of the dollar by suggesting that it needed the prop of substitution to strengthen it in the market. By the time the Interim Committee met on March 7, 1979 it was clear that the United States was not averse from considering substitution, but only if the rationale were the evolution of the system by promoting the role of the SDR. The Committee's communiqué contained this paragraph:

The Committee considered a report by the Executive Board on an Account, to be administered by the Fund, that would accept deposits of foreign exchange from members of the Fund on a voluntary basis in exchange for an equivalent amount of SDR-denominated claims. The purpose of such an Account would be to take a further step toward making the SDR the principal reserve asset in the international monetary system. There was broad support in the Committee for active consideration in the Executive Board of such an Account, and the Executive Board has been asked to present its conclusions to the next meeting of the Committee.  

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A number of important preferences were compressed into this paragraph. To begin with, the word substitution does not appear because the United States considered that it had a derogatory connotation for the dollar. For the same reason, foreign exchange is mentioned and not the U.S. dollar. But the word substitution is too entrenched to be driven away, and it continues in full use. Second, the paragraph reflects greater support for substitution than was apparent in any of the earlier communiqués of the Interim Committee. Third, the Committee implicitly preferred that substitution be made with claims denominated in SDRs and not with SDRs. Fourth, the Committee implicitly preferred the legal technique of an account administered by the Fund to other legal techniques such as the creation of another international entity, which might be an affiliate of the Fund.\footnote{Cf. Gold, Selected Essays, supra note 32, at 128-47.} The Fund would administer an account under Article V, Section 2(b), a provision not given great weight by some of the negotiators of the Second Amendment but likely to have a prominent role in the future legal development of the system. Article V, Section 2(b) provides that:

> If requested, the Fund may decide to perform financial and technical services, including the administration of resources contributed by members, that are consistent with the purposes of the Fund. Operations involved in the performance of such financial services shall not be on the account of the Fund. Services under this subsection shall not impose any obligation on a member without its consent.

Another question of legal technique would be how to safeguard the interests of participants in the Substitution Account, particularly if they do not include all members of the Fund. Under the Articles, decisions of the Fund are taken by a majority of the votes cast unless a special majority is prescribed by the Articles. A special majority is not required for decisions under Article V, Section 2(b). Moreover, the votes that can be cast are the number of votes allotted to all members under the formula in the Articles, which involves an equal number of basic votes for all members and further votes that are proportioned to quotas. The Fund might have to consider whether it would be necessary or desirable to arrange special safeguards for participants in the Substitution Account.

Notwithstanding the emphasis on Article V, Section 2(b), amendment of the Articles and a new treaty are options that remain open as legal techniques for substitution. Either of these options might provide simpler solutions for some problems. If amendment of the Articles were the chosen technique, the question would arise why SDRs proper should not be issued, instead of claims denominated in SDRs, in return for deposited balances of currency.
Two further comments on the communiqué of March 1, 1979 are appropriate. First, the preferences of the Committee, as expressed in the communiqué, or in any other communiqués, are legally not binding on the organs of the Fund, but they carry great political weight. In addition, nothing prevents the Committee from changing its views. Second, although the problem of diversification was not the rationale of substitution, it has not disappeared as an influence in support of substitution, but it is now subsumed under the broader rationale of evolution of the system by promoting the role of the SDR. The existence of an overhang is not being cited as part of the case for substitution. An overhang in the present context would have a different meaning from the overhang discussed by the Committee of Twenty. Then, the overhang was the accumulation of dollars against which safeguards had to be interposed so as to protect asset settlement. Now, an alleged overhang would imply an excess of global reserves, but it is unlikely that there would be widespread agreement on such an analysis. Alternatively, the overhang might refer to that part of global reserves that members would prefer to hold in a form other than dollars, but that brings the case back to diversification and evolution of the system.

The Executive Board reported to the Interim Committee, which reacted as follows in its communiqué of October 1, 1979:

The Committee considered the report submitted by the Executive Board on the question of a substitution account . . . Such an account, administered by the Fund, would accept deposits of U.S. dollars from members of the Fund and certain other official holders in exchange for an equivalent amount of SDR-denominated claims. In the light of the report submitted by the Executive Board, the Committee concluded that such an account, if properly designed, could contribute to an improvement of the international monetary system and could constitute a step toward making the SDR the principal reserve asset in the system.

In order for the account to achieve widespread participation on a voluntary basis and on a large scale, among other things it should satisfy the needs of depositing members, both developed and developing; its costs and benefits should be fairly shared among all parties concerned; and it should contain satisfactory provisions with respect to the liquidity of the claims, their rate of interest, and the preservation of their capital value.

The Committee, noting the progress that has been made and recognizing that a number of issues remain to be resolved, asked the Executive Board to continue to direct priority attention to designing a substitution account plan in accordance with the preceding paragraphs and in light of the views expressed by the members of the Committee, and to report progress to the next meeting of the Interim Committee.77

It will be observed that the Interim Committee referred to U.S. dollars and not foreign exchange as the reserve asset that was to be the subject of substitution. This clarification and various other aspects of the paragraph reflect a certain progress toward agreement on a possible form of substitution. Some of this progress resulted from a more detailed exposition of the views of the United States in a speech of the Under Secretary of the Treasury for Monetary Affairs on August 27, 1979. Some of these views have made their mark on the communiqué, as will be noted later in this paper. Although progress has been made, consensus had not yet been reached by October 1979, as is evident, for example, in the caveat "if properly designed."

The contribution to evolution of the system that is foreseen for substitution has not been made precise, but the speech of the Under Secretary contains an ambitious suggestion. Substitution now cannot be a dramatic step or revolutionary change,

But what a substitution account can do is important and worth doing. It would set out clearly the direction we intend to move in the future. It would represent a firm step toward increased reliance on an international reserve asset, holding potential for more active official management of liquidity.

The last clause is in contrast to the position taken during the negotiation of the Second Amendment that obligations with respect to the composition of reserves should not be imposed on members. Only with much difficulty was it possible to include a provision on the obligation of members with respect to reserve assets, but that provision was written in terms of collaboration to promote surveillance over global reserves and to promote the future of the SDR. The obligation with respect to the SDR implies more authority for the Fund over reserves than is implied in the obligation with respect to surveillance, but both aspects of the provision were drafted with calculated imprecision. Article VIII, Section 7 of the Second Amendment is entitled "Obligation to collaborate regarding policies on reserve assets" and provides that:

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79 Id. at 7. Cf. the statement by Mr. Hans Matthoefer, Federal Minister of Finance of the Federal Republic of Germany, at the Annual Meeting of the Board of Governors, 1979: It would be desirable if we could reach an international consensus—that the composition of reserves is a matter of mutual interest;—that to the extent that there is a desire to change the composition of reserves, substitution is an internationally accepted avenue;—and that policies should be pursued to avoid the replacement of "substituted" foreign exchange holdings by newly created currency.
Each member undertakes to collaborate with the Fund and with other members in order to ensure that the policies of the member with respect to reserve assets shall be consistent with the objectives of promoting better international surveillance of international liquidity and making the special drawing right the principal reserve asset in the international monetary system.

The paragraph in the Interim Committee's communiqué of October 1, 1979 reflects also the fact that developing countries have their own concerns about substitution, as they made clear in the communiqué of September 28, 1979 of their Group of 24:

With regard to the substitution account, the Ministers noted that, at the forthcoming meeting of the Interim Committee, the Ministers will be called upon to decide whether or not to endorse the further study of a proposed substitution account. Since these would tend to be considered as steps toward a decision of substance, the Ministers analyzed the impact of such an account upon the economies of the less developed countries. In this regard, they recommended that the support of the Group of 24 countries be conditioned upon further clarification of the features of this account on matters of interest to the developing countries, such as: the voluntary character of the account at all stages of the mechanism, the liquidity, yield and usability of the new SDR-denominated asset, the impact on IMF charges and on the international capital markets and on the stability of the exchange markets. Its effect on the preservation of the capital value of the reserves also requires further examination. In addition, it was generally agreed that a substitution account would have to be seen within a framework of a balanced program of immediate action for the reform of the international monetary system. In this connection, they stressed that regular annual allocations of SDRs should figure prominently in the package.49

The special interest that inspired the last sentence is that the infusion of a large volume of claims expressed in SDRs into reserves should not induce industrial countries, which could be expected to hold substantial proportions of them, to forbear from supporting allocations of SDRs because they would not want to hold more than a certain amount of assets in the form of, or denominated in, SDRs. Other considerations mentioned in the communiqué of the Group of 24 are that substitution should not reduce the resources available in the capital markets to the point at which it would become difficult for developing countries to borrow and should not have the effect of increasing the charges levied by the Fund for the use of its resources.

A Substitution Account to be administered under Article V, Section 2(b) could be established by a decision of the Executive Board taken by a

majority of the votes cast. Developing countries could not prevent the adoption of such a decision, but a logical implication of evolution of the system as the rationale for substitution implies that a broad spectrum of members should support and participate in the plan. In his speech of August 27, 1979, the Under Secretary of the United States Treasury stated that for substitution to assist in the evolution of the system, "it needs to have broad and genuine support and widespread participation by the international community."81

If less emphasis were placed on the evolution of the system and more on removing U.S. dollars from reserves, the number of participants would be less important than the volume of currency to be transferred to the Substitution Account. To induce participation by a large number of members that did not consider their holdings of dollars to be excessive would be one reason, but by no means the only reason, why the assets offered in substitution would have to be attractive. It is not difficult to see why the Interim Committee mentions both widespread and voluntary participation. No legal basis exists for imposing an obligation to participate, as is obvious from Article V, Section 2(b), but there might be some concern about political pressure.

Although there has been no official indication of the amount that should be the subject of substitution, the Chairman of the Interim Committee has said that "it is certain that it is impossible to manage a substitution account with only a few billion dollars."82 Members will probably want to know in advance of participation what the total amount of transfers to the Account is likely to be. Each member could be asked to declare its intentions, but it may be difficult for some to be precise, particularly if substitution will be possible from time to time. In view of the emphasis on the voluntary character of participation, members may be unwilling to give firm undertakings to make transfers of specified amounts.

Widespread participation will not be possible without the support of developing members. The current rationale for substitution provides developing members with a basis for the statement of the Group of 24 that substitution must be considered within the framework of a program for reform of the system. The Group has prepared a comprehensive Outline for a Program on International Monetary Reform, which has been endorsed by the Group of 77 at a meeting on September 29, 1979.83 The point has been made that:

Another tendency in the affairs of an international organization with widespread membership is the establishment of a policy for the particu-

81 See Address by Anthony M. Solomon, supra note 78.
83 See id. at 319-23.
lar benefit of developing members at a time when developed members are pressing for or establishing a policy in which they have a special interest.84

An issue that has been mentioned already is whether a Substitution Account should be open on a single occasion or on a number of occasions, and if on more than one occasion, how they should be selected. This issue, it has been seen, arose in the Committee of Twenty. If the Account were to be open on more than one occasion, safeguards would be needed to avoid operations for the purpose of affecting exchange rates. The risk of speculation would be even greater if the Account were open at all times rather than on discrete occasions.

In order to enhance the status of the SDR as a reserve asset, it would seem logical that the claim denominated in SDRs that would be issued through a Substitution Account should be comparable to the SDR in characteristics and uses, although there need not be a complete identity. If the claim were substantially more attractive than the SDR, the effect might be to create a multiple SDR system instead of a multiple reserve currency system. The effect might even be to diminish the status of the SDR. Similarity between the SDR and the claim could be achieved not only by following the model of the present characteristics and uses of the SDR in fashioning the claim but also by improving those characteristics and uses, for which there is much latitude in the Articles. The improvements might be made in accordance with a model that was considered desirable for the claim.

It must be understood that in fashioning the characteristics and uses of the claim there is no legal compulsion to observe the provisions of the Articles that govern the SDR. Claims denominated in SDRs would derive their characteristics and uses from the legal instrument under which they would be created. However closely the claims might resemble the SDR, they would not be SDRs. Therefore, the claims would not be subject to such provisions of the Articles as those that deal with the designation by the Fund of transferees of SDRs85 or with the limit on the amount of SDRs that a member can be required to hold.86 The Fund would not be able to accept claims in discharge of obligations that members must discharge with SDRs. Claims would not count towards performance by a member of the obligation to reconstitute its holdings of SDRs so as to maintain over time an average minimum proportion of total allocations of SDRs to it.87 An entity that is not a member of the Fund could hold

84 Gold, Selected Essays supra note 32, at 60.
85 Art. XIX, § 5.
86 Art. XIX, § 4.
claims even though it had not been, and could not be, prescribed by the Fund as a holder of SDRs.86

The Interim Committee's communiqué of October 1, 1979 discusses the need for an attractive asset. Attractiveness means that the asset compares favorably with other assets, and that it has sufficient quality to be regarded by monetary authorities as a reserve asset. It is essential that the asset should have this quality, because members will not want to show a decline in their reserves as the result of substitution. The character of claims as reserve assets is implicit in the reference in the communiqué of October 1, 1979 to the acceptance of U.S. dollars "from members of the Fund and certain other official holders." In some countries, reserves are held by entities that are not within the structure of the government but can be regarded as "official holders."

If substitution is confined to "official holders," for which however there is no legal compulsion, it could be made available to nonmembers of the Fund, such as Switzerland, and to multilateral financial organizations. They too can be considered "other official holders." Article V, Section 2(b), it is true, refers to the performance of financial and technical services that include "the administration of resources contributed by members." This language should not be considered as so restrictive that the Fund could not administer resources, such as the assets of a Substitution Account, that include assets contributed by a nonmember or other entities. It is not an objection to the activities of the Fund entered into for the benefit of members that they will enure to the benefit of nonmembers or other entities also.89 The test is whether benefit to them is a necessary or reasonable concomitant of the activities entered into for the benefit of members.

Although a primary purpose of substitution is to make available to members a claim that they will consider worthy of inclusion in their reserves, it does not follow that the claim should not be assignable to nonofficial entities. The communiqué of October 1, 1979 refers to satisfactory provisions with respect to the liquidity of claims. A reserve asset must be readily available in support of the holder's currency. Members would be transferring to a Substitution Account reserve assets that had this quality, and would want substituted assets to have a similar quality. This consideration would be important for all members, but particularly for those that regarded their holdings of U.S. dollars as working balances. Claims could be made assignable among the transferors to the Account without impediment and on such terms as the parties might agree upon.

86 Art. XVII, § 3.
but the liquidity of the claims might be improved if, either originally or at some later date, they could be assigned to nonofficial holders and if they were then assignable among both the transferors of currency to the Account and nonofficial holders. It is unlikely, however, that assignments to nonofficial holders would occur to any great extent unless the claims were competitive with other assets available in the market.

If claims could be assigned to nonofficial holders as soon as they were created, members (and official holders) might undertake to transfer more U.S. dollars to a Substitution Account than they would transfer in the absence of a right of immediate assignment. Such a right might mean that a Substitution Account would absorb private holdings of U.S. dollars. The implication then would be that the objective of substitution was broader than the provision of an alternative reserve asset.

Freedom to assign claims could not give the full assurance that members would be able to mobilize their claims at will, because there might be no willing assignee however wide the authorized market for claims might be or no assignee willing to accept claims at a price acceptable to the intending assignor. The broader the authorized market, the less likely these risks would be, particularly if the interest rate were attractive, but it might still be necessary to give members the assurance of their ability to assign claims at a floor price, which probably would be face value.

One arrangement for this purpose might be an obligation by members to accept an assignment of claims and provide currency at the prevailing rate of exchange for the SDR if designated for the purpose by the Fund according to principles and procedures resembling those that apply to the designation by the Fund of transferees of SDRs. Too onerous an obligation, however, might lessen the attractiveness of claims. A participant can be designated by the Fund as a transferee of SDRs until its holdings of SDRs are equivalent to three times the allocations of SDRs that it has received. A similar obligation to receive assignments of claims might be regarded as too burdensome, particularly in view of the fact that while a participant gives no value for allocations of SDRs, it would give value for the claims issued to it.

Another arrangement that might increase the liquidity of claims would be a right to encash claims with the Substitution Account itself, at the rate of exchange for the SDR at the time of encashment, but such a transaction would counteract some of the effects sought by substitution until the transaction was reversed. Encashment with the Account might be available only if an assignee could not be designated in accordance with the principles and procedures for designation. One of the principles might be that encashment should not be called for unless a member had a

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90 Art. XIX, § 5.
need to use reserves and was not simply changing the composition of its reserves.

Similarly, members might be protected against requests for the designation of an assignee inspired by a desire to change the composition of reserves by requiring an intending assignor to make a representation in good faith, possibly without subjecting the representation to challenge, that the intending assignor had a need to use reserves. Another safeguard might be the imposition of charges on a member requesting encashment of its claims or on a member holding claims that were less in value than the currency it had transferred to the Substitution Account. These safeguards might be considered brakes on the use of reserves and, once again, might reduce the appeal of the claims as assets.

Assignability is not the only question that would arise in connection with the uses that holders might make of claims. Uses as broad as those that can be made of other reserve assets, such as pledging them to secure the performance of obligations, would probably be a desideratum.

The rate of interest on the claims would be an important aspect of their attractiveness. The question of interest is related to the question of maintenance of the value of claims, because both elements enter into a holder’s perception of the effective yield of an asset. The rate of interest would be especially important for the marketability of an asset that had no maturity and might never be redeemed by amortization or by liquidation of the Account. The Fund determines the rate of interest on holdings of SDRs by a seventy percent majority of the total voting power.\footnote{\textit{Art. XX, § 3.}} The formula for the rate of interest on the SDR at the present time is eighty percent of a combined market rate determined by a weighted average of short-term interest rates in the United States, the Federal Republic of Germany, the United Kingdom, France, and Japan, rounded to the nearest one-quarter of one percent.\footnote{\textit{ANNUAL REPORT, 1979, at 66.}} It would be necessary to establish the relationship between the rate of interest payable on holdings of SDRs and the rate on holdings of claims.

\textit{Prima facie}, it might seem that the rates should be the same, but a number of considerations would enter into the determination of the rate of interest on claims. For example, the rate of remuneration that the Fund pays to members that provide the general resources in outstanding use through the General Resources Account must be in the range of eighty to 100 percent of the rate of interest on holdings of SDRs. The main source of the Fund’s income for paying remuneration is the periodic charges levied by the Fund on the use of its general resources made available through the General Resources Account.\footnote{\textit{Art. V, § 8(a); Rules and Regulations, Rule I, BY-LAWS, RULES AND REGULATIONS, 32-40 (36th Issue, Aug. 1, 1979).}}
claims were high and the rate of interest on holdings of SDRs were raised to, or toward, the rate on claims, the impact could be severe on the members, including the indigent among them, that were using the Fund's general resources. This consideration explains why the Group of 24 has referred in its communiqué to the effect of substitution on charges.

There is no legal requirement that the rate of interest on SDRs must be the same as the rate of interest on claims. The source of income for paying interest on claims would be the interest received on the long-term investment in U.S. Government securities of the dollars transferred to the Substitution Account. If a high rate of interest were received as a result of this investment, a higher rate of interest could be paid on claims than on SDRs. The holders of claims would then have a liquid asset and something more like the rate of interest they would have obtained by investing their dollars in a less liquid asset. A substantially higher rate of interest on claims than on SDRs, however, might be unhelpful to the status of the SDR and the objective of making it the principal reserve asset in the system.

Other problems related to interest would have to be resolved. It would be necessary, for example, to ensure that the Substitution Account would be able to pay interest at all times without an irremediable loss of capital. The medium in which income would be earned and interest paid would have to be determined. Income might be received, for example, in SDRs or dollars, and interest might be paid in these media or in claims denominated in SDRs.

Amortization and liquidation would have to be considered. There would be no need for compulsory amortization by the United States, but voluntary amortization might be permitted. The Substitution Account could be a permanent arrangement, but liquidation provisions might be necessary nevertheless because of the influence they would have on the attitude of potential holders to the claims as assets. Nobody seriously considers that the Fund or its Special Drawing Rights Department will be liquidated, but there are liquidation provisions for each. In the determination of acceptable liquidation provisions, problems of the treatment of profits and losses resulting from the operation of a Substitution Account that arose under earlier plans would arise again. Claims issued through a Substitution Account would be denominated in SDRs. The value of these claims would have to be maintained in some way. There could be no assurance that the income of the Account would be greater than the interest paid on the claims or that the excess of income over interest would be sufficient in liquidation to ensure that all claims would be redeemed in full on the basis of the SDR as the unit of account. The question of maintenance of value need not be confined to liquidation. Participants in a Substitution Account might prefer that the value of its assets be maintained at all times so that no question would arise about the soundness of
the claims.

The absence of satisfactory provisions for maintenance of value might weaken the reputation of the claims. The Under Secretary of the U.S. Treasury in his speech of August 27, 1979 referred to this problem as "particularly thorny", but he was clear that there would have to be "an equitable division of any costs" arising from the operation of the Substitution Account. That is to say, the obligation to maintain value would not be borne in full or even in part by the United States. The justification that has been offered for this position is that substitution would be for the benefit of the system and not for the relief of the United States. The communiqué of the Interim Committee mentions that "the costs and benefits" of substitution "should be fairly shared among all parties concerned."

A question that might be considered is whether allocations of SDRs to all participants in the Special Drawing Rights Department would be possible because of the reduction of global reserves that a loss in the liquidation of a Substitution Account would represent. It would be difficult, however, to give an assurance of allocations at an uncertain date in the future because of the necessity to find, by a high majority of the total voting power, that a global need for reserves existed at that date. Major discrepancies between participation in the Special Drawing Rights Department and in the Substitution Account and between quotas in the Fund and the amounts of U.S. dollars transferred by members to the Substitution Account would pose other problems. These difficulties would result from the fact that allocations are made to members of the Fund that participate in the Special Drawing Rights Department at the same percentage of quota.

XII. SOME CONCLUDING OBSERVATIONS

The idea of substitution has shown remarkable powers of survival. It has been the main feature of, or an element in, numerous plans. They have had a great range of individual or combined objectives, some of which have been asset settlement, elimination of the overhang of U.S. dollars in reserves, demonetization of gold, prevention of the conversion of reserve currency into gold, equitable treatment of the increased value of gold held by monetary authorities, elimination of the multiplicity of

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Footnote:

reserve assets, backing for a new reserve asset, reduction in the role of currency in reserves, promotion of the role of the SDR, discouragement of the diversification of reserves through the market, resumption of the allocation of SDRs, and the use of deposited assets to redirect investment from reserve centers to countries in need of capital imports. In a broader sense, the objective of many plans has been the better control of global reserves in order to promote the purposes of the Fund. Each proposal since the conclusion of the work of the Committee of Twenty, other than the one that led to the EMS, has provoked the objection by some critics that the proposal did not amount to asset settlement or did not ensure a lasting better balance in the composition of reserves. Technical skill has been more evident than political will in the history of plans for substitution so far.

A political dilemma that the advocates of substitution have had to face is that their plans have been considered too radical or not radical enough. If a plan would bring about a substantial change in the system, monetary authorities react to it with caution or with antagonism because it would entail the surrender of sovereignty or the compromise of interest. If the plan is a modest one, it encounters the objection that it is not ambitious enough and therefore not worth the effort of negotiation. The latest plan for substitution is described as modest, but it is presented as a worthy idea because it may be a step in the evolution of the system. The direction in which the step would be taken is made reasonably clear—it would be toward a more effective international control of the system—but the destination is too far off to justify prediction.

The objective or objectives of a plan give rise to complexities of principle in the balancing of rights and obligations among countries in different circumstances and with different interests. Some of the categories between which the need for symmetry is emphasized are familiar: the issuers of reserve currency and other countries, developed and developing members, and countries in surplus and countries in deficit in their balances of payments. The stage of detailed drafting in order to give legal form to agreed principles was not reached in the past, except for the EMS, but even the preliminary thought that was given to the preparation of a legal instrument to give effect to some plans was sufficient to suggest that the technical task would not be simple. Broad enabling powers in order to put off problems, whether of principle or technique, have had little support. It is clear, however, that if agreement on principles were reached, the Fund could administer a substitution plan under Article V, Section 2(b) of the Articles if that legal technique were chosen.

A problem that has to be faced whatever the plan for substitution

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85 The reference to the purposes of the Fund is not only to Art. I, but also to Art. IV, § 1 and Art. XVIII, § 1(a).
may be is that the holders are asked to give up a reserve asset with which they are familiar for a new asset or one with which they are less familiar. To help overcome this difficulty it is necessary to offer an alternative asset that is sufficiently attractive. The creation of such an asset is not a simple task because it may require the acceptance of obligations as the counterpart of attractive characteristics, or because attractiveness may have the undesired effect of lessening the appeal of the SDR as an existing asset.

The unfamiliarity of an alternative asset may be one reason why under some plans it has been proposed that the transferors' of assets to a Substitution Account should retain the ownership of them, although unfamiliarity is not always the reason or the only reason. This proposal is made even though the transferors get ownership of the alternative asset. Even the Executive Board of the Fund, in an earlier discussion of substitution for the purpose of making room for allocations of SDRs, declared that:

Ownership would remain vested in the depositing participants and they would receive earnings from the account's investments. In this way, SDRs would in effect have replaced currencies in members' liquid reserve holdings. However, a number of difficult questions have been raised concerning this proposal and these will have to be considered further.***

The last sentence would be a fitting motto for this article.