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The Reconstitution of SDRs

Procedure and Proposal for Modification

by Rolf M. Jeker, St. Gallen *

Among the various limitations put by the IMF on the free use of Special Drawing Rights (SDRs) is the reconstitution requirement which binds participants in the Special Drawing Account to maintain a stipulated average level of allocated SDRs. Using the example of Zambia which is representative for many developing countries, this article displays the adverse effects which arise from the present reconstitution rules and proposes a possible modification.

The debate on the International Monetary System in the 1960's led to the conviction that sooner or later it would be necessary to have the means to augment the liquidity that would be unconditionally and automatically available to members of the International Monetary Fund. The outcome of these discussions was the creation of the Special Drawing Rights (SDR) as a new reserve asset to supplement gold and foreign exchange. Yet, when the scheme became operational on July 28, 1969 the International Monetary Fund (IMF) put various limitations on the free use of the new reserve asset. One such restriction relates to the reconstitution requirement which binds participants in the Special Drawing Account, to maintain a stipulated average level of allocated SDRs.

The reconstitution provisions incorporated in the Special Drawing Account were intended to discourage:

- the prolongation of balance of payments deficits which allocation of SDRs might otherwise permit,
- the use of SDRs for longer-term financing, and
- the disproportionate use by participants of SDRs because of a preference for the retention of other reserve assets ¹.

Although it is generally conceded that it is of "the essence of monetary reserves that they are used to meet temporary difficulties and then restored" ², the existence of a very rigid formula

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which is binding, imposes adverse effects on countries in balance of payments need. This fact was acknowledged by the Executive Directors in their review of the rules for reconstitution in 1972 but the old formula still continued to apply. Moreover, the Second Amendment of the Articles of Agreement, presently awaiting ratification, does not resolve the problem either, but simply stipulates that modification or abrogation of the rules for reconstitution can be brought about with a qualified majority ³.

Rules for Reconstitution

Under the rule for reconstitution, a participant is allowed to use all of its SDRs without maintaining a permanent minimum balance but will not be allowed to make use of the full amount permanently ⁴. A participant's net use of its SDRs must be such "that the average of its daily holdings over a five year period will not be less than 30% of the average of its daily net cumulative allocation of SDRs over the same period" ⁵. As a result, if a country has reduced its holdings of SDRs below 30% of net cumulative allocation, it is not sufficient to restore its holdings to 30% of its allocation to meet the requirement. "To achieve the required *average* position it is necessary to bring holdings from below 30% to above 30%

¹ International Monetary Fund, Selected Decisions of the International Monetary Fund; Special Drawing Account: A report by the Executive Directors to the Board of Governors on the Rules of Reconstitution; also: Resolution No. 28-2 of December 18, 1972, Washington D. C., May 10, 1976.

² *ibid.*

³ International Monetary Fund, Second Amendment to Articles of Agreement, Washington D. C. 1976.

⁴ J. G o l d , Special Drawing Rights, Character and Use, Pamphlet Series No. 13, Washington D. C. 1970.

⁵ International Monetary Fund, Selected Decisions . . . , *op. cit.*

of the cumulative allocation and to keep them above that level long enough to make the product of time and amount in excess of 30 % at least equal to the product of time and amount below that level"⁶.

Thus, in principle, a country during the first basic period could have used all its SDRs for the period under consideration and replenished its account at the end of the fifth year to reflect the required average. However, if there is little time, i. e. if the reconstitution begins only late or even at the end of the five year period, the amount necessary to achieve the required position may be far above 30 % of the cumulative allocation, it may well assume an almost astronomical figure.

Therefore, to ascertain that reconstitution requirements remain manageable and give participants adequate warning about problems they may encounter with regard to reconstitution, the Fund has been making calculations for each participant since December 31, 1971. When the point is reached where it must be considered as unlikely that a country will be able to meet its obligations under the reconstitution provision if it does not start reconstituting some of its holdings and refrain from further use of SDRs in its transactions, the IMF, based on provisions under Schedule G of its Articles of Agreement, will inform the member accordingly and apply graduated pressures in case of non-conformance. Assessment of the critical point is based on the magnitude of the quarterly reconstitutions necessary over a certain period to replenish holdings in order to meet the required average holdings of SDRs at the end of the five year period. In accordance with these provisions, the Fund:

□ simply indicates the need to reconstitute a specific amount which could be acquired voluntarily from another participant in transaction by agreement under Article XXV, Section 2 (b) (ii) or from the General Account *if the quarterly amount calculated has not yet reached the level equivalent to 10 % of net cumulative allocation of SDRs;*

□ actually *designates* a participant to reconstitute some of its SDR holdings "if the calculation shows that a participant would need to obtain SDRs for any reconstitution period... *in an amount per quarter that equals or exceeds 10 % of the participant's net cumulative allocation at the end of the period*"⁷;

□ serves a country with a *special notice* that it is unlikely to be able to comply with the reconstitution requirements, if it still continues to use SDRs to the extent that the *quarterly amount re-*

quired to meet the obligation is equal or in excess of 50 % of net cumulative allocation.

If the member fails to satisfy the reconstitution provision the Fund can impose sanctions provided for by Article XXIX, Section 2 (b).

Zambia's Use of SDRs and Reconstitution Obligations

Zambia's total allocation under the newly created Special Drawing Right scheme amounted to SDR 24.6 mn, received in amounts of SDR 8.4 mn in 1970, SDR 8.1 mn in 1971 and SDR 8.1 mn in 1972. During the first basic five year period, the 30 % holding requirement had to be satisfied at the end of the fifth year after the first allocation. The first allocation was made January 1, 1971; therefore the first relevant five year period ended December 31, 1974.

To conform with the rules for reconstitution, Zambia could have satisfied the 30 % requirement by any combination of holdings that would have equalled a total of SDR 29.6 mn x 365 days.

Table 1
Zambia: Holding Requirements under First Basic Period January 1, 1971 to December 31, 1974¹
(in SDR mn)

Year 1	8.4 × 30 percent × 5 years × 365 days
Year 2	+ 8.1 × 30 percent × 4 years × 365 days
Year 3	+ 8.1 × 30 percent × 3 years × 365 days
Year 4	+ — × 30 percent × 2 years × 365 days
Year 5	+ — × 30 percent × 1 year × 365 days
	= 29.6 × 365 days ²

¹ For formula see: J. Gold, Special Drawing Rights, Character and Use.

² No account was taken of leap years; figures rounded to one decimal point.

If the country would have made immediate and full use of the allocation, to which it was entitled, and had delayed adjustment to the last day of the basic five year period, the amount necessary for reconstitution would have been an absurd figure of SDR 10.8 bn. Even if reconstitution had started during the last year, the amount required would still have amounted to SDR 29.6 mn or 120 % of the total allocation to the country.

In actual fact, Zambia held SDRs in excess of allocation for the first two years of the basic five year period⁸ (Table 2) but depleted its holdings completely at the beginning of 1972 to finance adverse balance of payments developments. It did not replenish its holdings until it was designated to do so in 1974. This reconstitution was fairly massive as Zambia had to accumulate holdings equivalent to almost 50 % of its total allocation. Yet, this reconstitution coincided with a period of

⁶ J. J. Polak, Some reflections on the nature of Special Drawing Rights, Pamphlet Series, No. 16, Washington D. C. 1971.

⁷ *ibid.*

⁸ Zambia was designated to receive SDR 2.5 mn during this period.

balance of payments surplus and could thus easily be sustained⁹.

The hypothetical example above does not only demonstrate the unusual magnitude reconstitution requirements could reach but it also shows that such requirements may increase very quickly, causing problems to a country. Under the first basic period, the problem of reconstitution was minimized by the fact that the 30% requirement only had to be met at the end of the five year period. This allowed a country a relatively long period of adjustment and the quarterly reconstitution obligations were known to increase steadily the closer the end of the five year period. The country was therefore in a position to recognize that further use of SDR or failure to engage in voluntary reconstitution would gradually result in larger amounts once reconstitution became compulsory.

The uncertainty about future reconstitution obligations, as to the date and magnitude and possible

effects of omitting or delaying voluntary reconstitution, has risen after the end of the basic five year period, when countries were required to meet the stipulated reconstitution ratio at the end of every calendar quarter covering the previous five year period. The moving five year average could become highly unpredictable, showing a reconstitution need at a particular time which could be reversed shortly afterwards without action having been taken. Similarly, Monetary Authorities following the recommendations of voluntary or compulsory reconstitution might be surprised to see that further reconstitution, in a different magnitude than the previous instalment requirement indicated, falls due again in the following quarter¹⁰.

Determination of the Reconstitution Ratio

The elements to determine the reconstitution ratio, namely average net cumulative allocation as well as average net cumulative holdings are calculated by summing the entries in a country's SDR Account for holdings and net cumulative allocation, respectively, at the end of each calendar day over a five year period and dividing these sums by the number of days in the five year period.

The calculation based on Zambia's SDR allocation and holdings over the five year period ended June 30, 1976 is simplified and deviates from actual developments insofar as due to unavailability of daily data, end of month figures of holdings and allocations are considered to be representative for the entire month¹¹. This simplification should not unduly influence the results of the calculations since holdings and calculations were in actual fact unchanged over considerable periods of time (Table 2).

Total units of SDRs held during the period under consideration amounted to SDR 14,211,485 (Table 3; all figures henceforth expressed in SDR 1,000) and total net cumulative allocation over the same period SDR 43,440,156 (Table 4).

⁹ Reconstitution of SDR does not entail a loss of reserves but merely a change in the composition of reserves. However, in exceptional circumstances shown below, SDR reconstitution can affect the amount of "usable" reserves.

¹⁰ Due to the moving period and possible further use of SDRs, the quarterly instalment figure quoted by the IMF to the Monetary Authorities applies only to the particular quarter under consideration, regardless whether the recommendation is to reconstitute a certain amount in (say) 4 equal quarterly instalments. The following quarter, the reconstitution obligation might disappear completely or appear in different amounts. See also: Annual Report of the IMF, 1976, p. 49: "For many participants, the need for reconstitution of their holdings arose each time they used SDRs for payment of charges."

¹¹ The data were extracted from the monthly Bank of Zambia balance sheet presentation in the Government Gazette, covering the period July 1971 to June 1976. A discrepancy to "real" figures might also have arisen from the fact that balance sheet figures are expressed in Kwacha and needed reconversion into SDR. Starting June 1974 the SDR/Kwacha rate varied daily but this fact does not seem to be fully reflected in the Bank of Zambia balance sheet. Thus, some adjustment was introduced to offset those deviations but figures might still not fully coincide with data of the SDR Account as administered in the International Monetary Fund.

Table 2
Zambia: Allocation and Use of Special Drawing Rights 1970-1976¹
(in SDR 1,000)

Month	1970	1971	1972	1973	1974	1975	1976
January							
Allocation	8,400	16,533	24,588	24,588	24,588	24,588	24,588
Holdings	8,400	17,020	490	168	315	9,817	15,363
February							
Allocation	8,400	16,533	24,588	24,588	24,588	24,588	24,588
Holdings	8,400	17,020	490	—	6,552	9,817	15,718
March							
Allocation	8,400	16,533	24,588	24,588	24,588	24,588	24,588
Holdings	8,900	19,020	490	—	6,552	9,411	15,027
April							
Allocation	8,400	16,533	24,588	24,588	24,588	24,588	24,588
Holdings	8,900	19,020	490	—	6,552	9,411	15,027
May							
Allocation	8,400	16,533	24,588	24,588	24,588	24,588	24,588
Holdings	8,900	19,029	490	—	12,767	8,821	14,972
June							
Allocation	8,400	16,533	24,588	24,588	24,588	24,588	24,588
Holdings	8,900	19,029	490	18	12,419	8,485	11,720
July							
Allocation	8,400	16,533	24,588	24,588	24,588	24,588	24,588
Holdings	8,887	19,029	490	18	12,419	8,485	11,720
August							
Allocation	8,400	16,533	24,588	24,588	24,588	24,588	24,588
Holdings	8,887	19,029	262	18	12,061	8,485	
September							
Allocation	8,400	16,533	24,588	24,588	24,588	24,588	24,588
Holdings	8,887	19,029	262	18	12,061	11,301	
October							
Allocation	8,400	16,533	24,588	24,588	24,588	24,588	24,588
Holdings	8,887	19,029	262	18	12,061	11,301	
November							
Allocation	8,400	16,533	24,588	24,588	24,588	24,588	24,588
Holdings	8,887	19,029	168	18	12,045	17,700	
December							
Allocation	8,400	16,533	24,588	24,588	24,588	24,588	24,588
Holdings	8,887	19,029	168	18	11,653	15,363	

¹ End of month.

Source: Government Gazette, Lusaka, and International Financial Statistics, International Monetary Fund, Vol. XXIX, Number 12, December 1976.

Table 3
Zambia: Holdings of SDRs July 1971 – June 1976
(in SDR 1,000)

Year	Month	Amount held	number of days	monthly total
1971	July	19,029	31	589,899
	August	19,029	31	589,899
	September	19,029	30	570,870
	October	19,029	31	589,899
	November	19,029	30	570,870
	December	19,029	31	589,899
1972	January	490	31	15,190
	February	490	29	14,210
	March	490	31	15,190
	April	490	30	14,700
	May	490	31	15,190
	June	490	30	14,700
	July	490	31	15,190
	August	262	31	8,122
	September	262	30	7,860
	October	262	31	8,122
	November	168	30	5,040
	December	168	31	5,208
1973	January	168	31	5,208
	February	—	28	—
	March	—	31	—
	April	—	30	—
	May	—	31	—
	June	18	30	540
	July	18	31	558
	August	18	31	558
	September	18	30	540
	October	18	31	558
	November	18	30	540
	December	18	31	558
1974	January	315	31	9,765
	February	6,552	28	183,456
	March	6,552	31	203,112
	April	6,552	30	196,560
	May	12,767	31	395,777
	June	12,419	30	372,570
	July	12,419	31	384,989
	August	12,061	31	373,891
	September	12,061	30	361,830
	October	12,061	31	373,891
	November	12,045	30	361,350
	December	11,653	31	361,243
1975	January	9,817	31	304,327
	February	9,817	28	274,876
	March	9,411	31	291,741
	April	9,411	30	282,330
	May	8,821	31	273,451
	June	8,485	30	254,550
	July	8,485	31	263,035
	August	8,485	31	263,035
	September	11,301	30	254,550
	October	11,301	31	350,331
	November	17,700	30	531,000
	December	15,363	31	476,253
1976	January	15,363	31	476,253
	February	15,718	29	455,822
	March	15,027	31	465,837
	April	15,027	30	450,810
	May	14,972	31	464,132
	June	11,720	30	351,600
			Total	14,211,485

If divided by the number of days in the relevant five year period, daily average holdings are calcu-

Table 4
Zambia: Total Allocation of SDRs, July 1971 – June 1976
(in SDR 1,000)

Year	Month	Net cumulative allocation	number of days	monthly total allocation
1971	July	16,533	31	512,523
	August	16,533	31	512,523
	September	16,533	30	495,990
	October	16,533	31	512,523
	November	16,533	30	495,990
	December	16,533	31	512,523
1972	January	24,588	31	762,228
	February	24,588	29	713,052
	March	24,588	31	762,228
	April	24,588	30	737,640
	May	24,588	31	762,228
	June	24,588	30	737,640
		Subtotal	366	7,517,088
1972-1975	July-June	24,588	1,095	26,923,860
1975-1976	July-June	24,588	366	8,999,208
		Total	1,827	43,440,156

lated at SDR 7,778.6 and average net allocation at SDR 23,776.8 (Table 5).

Table 5
Zambia: Average Daily Holdings and Net Cumulative Allocation
(in SDR 1,000)

	Total units (1)	Total days (2)	Daily average (3)	Reconstitution ratio ¹ (4)
SDR allocations	43,440,156	1827	23,776.8	
SDR holdings	14,211,485	1827	7,778.6	32.7

¹ Reconstitution ratio expresses SDR daily average holdings as a percentage of daily average net cumulative allocation.

The reconstitution ratio of 32.7 (Table 5) indicates that average daily holdings are in excess of need and thus no reconstitution requirement arises as of June 30, 1976. However, to be suitable for policy purposes, a look in the future is required to detect possible reconstitution obligations at a later date.

The analysis reveals further that based on the assumption of unchanged SDR holdings and allocations between the date of calculation and the relevant calendar quarter, the country would meet the requirement up to September 1976 but would fall short of it as of December 31, 1976 when average daily holdings would represent only 28.6% of daily average net cumulative allocation¹². Furthermore, it is apparent that by June 30, 1977 the 30% requirement is again more than adequately met even if no reconstitution takes place in the in-between period¹³ (Table 6).

¹² The calculation procedures remain the same but the time period covered changes.

¹³ If the authorities are aware of the actual movement of the ratio they have a sound basis for determining whether recommended "voluntary" reconstitution should be made use of. In the above case assuming reconstitution does not become compulsory for December, the authorities could simply refrain from further use of SDRs without acquiring SDRs under the reconstitution procedure.

Table 6
Zambia: Forward Calculation of Reconstitution Requirement Ratios at Particular Dates
 (in SDR 1,000)

Five year period ended	Average daily holdings	Average daily allocation	Reconstitution ratio
(1)	(2)	(3)	(4) = $\frac{(2)}{(3)} \times 100$
June 30, 1976 ¹	7,778.6	23,776.8	32.7
Sept. 30, 1976 ²	7,410.5	24,182.4	30.6
Dec. 31, 1976	7,042.5	24,588.0	28.6
June 30, 1977 ³	7,885.4	24,588.0	32.1

¹ Actual as of June 30, 1976 as per calculation in Tables 2; 3; 4.

² For all calculations for future dates it is assumed that holdings and allocations remain unchanged for the forward period under consideration. The calculation procedure is the same as outlined for June 30, 1976 actual position.

³ The calculation of average daily holdings is based on 1826 days due to the exclusion of the leap year figure of 1972.

Single Sum Acquisition and Reconstitution Requirements

The level of SDR holdings, if allowed to remain at the level of June 30, 1976 (SDR 11,720), will not be sufficient to meet the 30% ratio by the end of the year. The average daily holdings over the whole period which was calculated at SDR 7,042.5 has to be raised to an average daily level of SDR 7,376.4:

$$ADH_R = \frac{ADA}{100} \times 30 \quad (1)$$

with: ADH_R = Average daily holdings required over 5 years,

ADA = Average daily net cumulative allocation over 5 years;

thus,

$$ADH_R = \frac{SDR 24,588}{100} \times 30 \\ = SDR 7,376.4$$

The difference in actual daily holdings and required daily holdings has to be adjusted over the period remaining from the date of calculation to the end of the calendar quarter under consideration (i. e. June 30, 1976 to December 31, 1976).

The single sum (S_s) to be acquired immediately following the date of calculation which will meet the 30% requirement is calculated as follows:

$$S_s = \frac{T_{HR} - T_H}{t_x} \quad (2)$$

in which:

T_{HR} : Total units to be held over period to meet requirement (i. e. $1827 \times SDR 7,376.4$);

T_H : Total units held over five year period assuming no change in holdings or allocation until end of period (i. e. $1827 \times SDR 7,042.5$);

t_x : number of days between date of calculation and end of five year period for which holdings are to be raised;

$$S_s = \frac{SDR 13,476,682 - SDR 12,866,647}{184} \\ = SDR 3,315.4$$

The requirement is fully met as of December 31, 1976 if on the first day of July 1976, SDR holdings are raised from the existing level of SDR 11,720 to SDR 15,035.4.

The amount to be reconstituted in a single sum is a function of the number of days between the proposed reconstitution date and the end of the relevant calendar quarter. If reconstitution does not immediately take place following the date of calculation, the single sum to be acquired will rise rapidly towards the end of the period since the number of days for which the additional amount will be held is shrinking. If reconstitution takes place one month after June 30, 1976 which in practice seems to be the earliest possible date considering the information and transaction lag, the single sum acquisition rises to SDR 3,987.2 and to SDR 19,678.5 if reconstitution is delayed to December 1, 1976. Thus, for all practical purposes t_x in equation (2) would need to be redefined as "the number of days covering the period between actual reconstitution date and end of calendar period."

Acquisition in Quarterly Instalments

To meet the pending obligation the country is given the option to reconstitute in one single sum or avail itself of a number of equal quarterly instalments. Under the second option the individual reconstitution amount is smaller but the total

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amount needed for reconstitution purposes will be larger.

The quarterly instalment amount (Q) is determined along the lines of equation (2) but adjusts for the fact that the quarterly amount reconstituted is not held for the same number of days.

$$Q = \frac{T_{HR} - T_H}{(t_x + t_{x-1} + t_{x-2} + \dots)} \quad (3)$$

in which:

t_x : number of days between first date of acquisition and end of period;

t_{x-1} : number of days between second date of acquisition and end of period; etc.

To meet the requirement on December 31, 1976, it is assumed that quarterly reconstitution takes place on August 1, 1976 and three months hence on October 1, 1976.

$$\begin{aligned} Q &= \frac{\text{SDR } 610,035}{(153 + 61)} \\ &= \text{SDR } 2,850.6 \end{aligned}$$

The amount to be reconstituted is SDR 2,850.6 which raises SDR holdings from SDR 11,720 to SDR 14,570.6 on August 1, 1976 and SDR 17,421.2 on October 31, 1976.

Reconstitution Obligation and Reserve Management

The forward projections of the reconstitution requirement ratio (Table 6) should serve as a basis for decision making regarding the use of SDRs. In the particular circumstances where the requirement ratio falls below the required level but recovers without additional reconstitution, the country may refrain from acquisition and abstain from further use of its holdings until the situation has improved. However, this option only applies if the reconstitution obligation is voluntary. In our example, the quarterly acquisition of SDR 2,850.6 exceeds 10% of net cumulative allocation which renders reconstitution compulsory.

Developments in the SDR-account¹⁴ show that Zambia's holdings due to reconstitution obligations rose by SDR 6.3 mn from SDR 9.5 mn in September 1975 to SDR 15.8 mn in December 1975 and again by SDR 8.8 mn from SDR 11.6 mn in June 1976 to SDR 20.4 mn in October 1976. Thus, between September 1975 and October 1976 the country had to raise its SDR holdings by more than 100% to meet the rigid reconstitution requirement.

The reconstitution requirement as presently formulated clearly defeats the purpose for which

¹⁴ These developments refer to the end of month SDR holding figures published in the International Financial Statistics of the International Monetary Fund, Vol. XXIX, Number 12, December 1976.

reserve assets are held by a country and it displays at the same time that the present formula is far from being an appropriate instrument to purpose the objectives it was intended to fulfill.

Zambia's practical experience shows that it had to set aside, read immobilize, substantial parts of its foreign reserves at a time when it had to face the most serious exchange crisis ever. It is most important to note that this diversion of reserves was required, although the level of SDR held in September 1975 and June 1976 amounted to 38.4% and 47.2% of cumulative allocation, which in itself would have guaranteed the fulfillment of the 30% holding requirement in relatively short time. The inflexibility in the rule forced the country to immobilize 25.5% of its reserves by October 1976 by acquiring SDRs to a level equivalent to 83% of cumulative allocation¹⁵. During this period, Zambia was compelled to defer payments for obligations incurred and to borrow extensively in international financial markets¹⁶.

Modification of Rules

To maintain the objective of temporary use of SDRs while allowing countries enough flexibility with regard to reserve use, the reconstitution requirement needs modification.

As in the past, countries could be informed about reconstitution requirements when the ratio falls below 30%. However, reconstitution should become compulsory only, if:

- the quarterly amount calculated is equal to or in excess of 10% of net cumulative allocation,
- the country's holdings as of the date of calculation are less than 40% of net cumulative allocation, and
- the existing holdings are not sufficient to bring about an automatic satisfaction of the 30% formula within a period of 12–18 months.

During a period of balance of payments need, a possible reconstitution should not be pursued to the extent that SDR holdings might exceed 40–50% of net cumulative allocation. On the other hand, during periods of balance of payments surplus, the International Monetary Fund should be authorised to bring pressures upon countries with relatively low holdings, to replenish some of the holdings through the designation process or purchases from the General Account.

¹⁵ The gross reserve level at the end of October 1976 according to IFS statistics stood at SDR 80.2 mn of which SDR 20.4 mn was actually in form of Special Drawing Rights. The fact that Zambia will later again be allowed to use its SDR reserves is of small comfort. Reserves should be available when payments need requires them most.

¹⁶ In actual fact, Zambia's drawing under another Fund facility was almost completely eroded as the pending reconstitution obligation was offset against it.