6. A Roadmap for SDR Evolution

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Introduction

The financial crisis of 2008–09 has shaken the confidence of both public and private actors in the dollar-based monetary system that had supported world growth so effectively for the previous 35 years. It may prove to be the early tremor of a larger earthquake to come. There were many warnings about the build-up of global imbalances before the crisis as high saving nations – exporters of manufactured goods and commodity producers – generated huge surpluses which were balanced by a limited number of high consuming nations, most prominently the United States.[1] This fault-line between savers and consumers put increasing strain on the US economy, eventually causing it to buckle under the burden of household debt it had created. Much of that debt has been transferred to the public sector, but global imbalances have not been resolved and the next crash will find the public-sector balance sheets of the high consuming countries unable to take further strain.

The world economy, with the dollar as its anchor currency, may still be some years away from its tipping point. But the trends are clear enough, and the historical parallels are dire enough, that it is time to give serious thought to alternatives. No other currency is waiting in the wings to take the place of the dollar. More fundamentally, no other country is likely to achieve the dominance that the US economy acquired in the aftermath of the Second World War. Instead, a multipolar world economy is rapidly taking shape and it is time to design a multicurrency regime to support and sustain it.

This chapter develops one such design, based on an evolution of the Special Drawing Right (SDR) and an enhanced role for the IMF. This would build on existing foundations, while facilitating a gradual shift away from the dollar as an international store of value (for surplus countries) and unit of account (for OPEC and other commodity exporters). It would not turn the SDR into a global currency, nor the IMF into a world central bank. Rather, it would provide a bridge over the dangerous chasm that has opened up between global savers and borrowers and between fixed and floating currencies. It would be an important contribution to the G20 objective of balanced and sustainable world growth.

The difficult birth and current status of the SDR

The strangely named Special Drawing Right is a synthetic currency created in 1969 by the member countries of the International Monetary Fund in an attempt to avoid a breakdown of the Bretton Woods system of fixed exchange rates.[2] It failed in that task and during three turbulent years of international discussions, as the system of fixed exchange rates gradually collapsed, the original purpose for creating the SDR as a global reserve asset was largely overtaken by events.

Nonetheless, considerable progress was made in the early 1970s and the structure put in place then – to support fixed but adjustable exchange rates against the dollar – is actually quite well-suited to today's multipolar world economy with a mix of floating and fixed exchange rates. The SDR is currently defined as a basket of four currencies: the dollar (44%), the euro (34%), the Japanese yen (11%) and the British pound (11%). Each of these is a fully convertible currency with a market-determined (i.e.,

1 There were many contributing factors to the crisis, including US monetary policy, regulatory gaps and Chinese exchange rate policy. However, most commentators agree that the savings/investment imbalances were implicated as both cause and effect of policy choices.

2 For a brief description see Chapter 1, Box 1, above, and Williamson (2009a) for an excellent summary of the history and current functioning of the SDR.

floating) exchange rate. They are the four most widely used currencies in international trade and financial flows. The weights were chosen to 'reflect the relative importance of currencies in the world's trading and financial systems', although such a determination is not an exact science. Because most of the currency volatility that affects actual trade and cross-border financial flows takes place between these currency pairs, a basket that includes all of them will be more stable over time than any one of them. And, of course, stability of purchasing power over time is the *sine qua non* of a desirable reserve currency and unit of account.

This point is critical to understanding the attractions of the SDR. Under the current IMF rules, the SDR basket is rebalanced every five years using the market exchange rates of the three months preceding the end of the five-year period. One SDR is currently equal to approximately 63 US cents plus 41 euro cents plus 18 yen plus 9 British pence. These equate to the weights mentioned above at the last date of rebalancing (31 December 2005). Five years from then, suppose that the dollar had fallen against the euro by 20% while the yen and sterling had remained the same in relation to the SDR basket. Then, at the time of rebalancing and for the next five years, one SDR would require 76 US cents and just 34 euro cents to maintain the same currency weights in the SDR basket. A country holding its foreign exchange reserves solely in dollars would have lost value during that period, while a country holding its reserves in SDRs would have seen its value preserved.[3]

In terms of stability, a similar benefit would arise from denominating the price of internationally traded goods in SDRs rather than in dollars. This could be particularly important for commodity producers whose imports do not come predominantly from the United States. For example, if OPEC countries decided to price crude oil in terms of SDRs, and at the same time hold their foreign exchange reserves in SDR accounts, then they would effectively shield their economies from much of the volatility that a dollar-based oil price has created. Oil-importing countries – other than the United States – would also face a more stable oil price on which to base their domestic energy policies. The value of internationally traded oil and gas in 2008 has been estimated at $2.3 trillion, or roughly 16% of world merchandise trade.[4] Thus a change in the unit of account for this single sector could have a major effect on the international usage of the dollar, if coupled with further reforms to allow greater private use of the SDR.

At present SDRs are official reserve assets of governments, held in their accounts at the IMF. The allocation of SDRs to member governments has been sporadic, with the first new allocation since 1981 agreed at the G20 meeting in London in April 2009. As part of the package of emergency measures to restore confidence in financial markets and support global recovery, an SDR allocation of $250 billion was agreed. Although the amount of SDRs outstanding still makes up less than 5% of foreign exchange reserves, the willingness of key countries to act and the ease with which the IMF was able to implement the agreement show how the SDR could be used to take the pressure off the dollar as a global reserve currency and ease the transition to a multi-currency international monetary regime.

The next steps in SDR evolution

Although the Chinese central bank governor has called for reform to be 'guided by a grand vision' (Zhou Xiaochuan 2009), historical experience indicates that a more modest, step-by-step approach, with learning and adaptation along the way, is more likely to succeed. Another lesson from history is that the governance and voting structures of the IMF are exceedingly difficult to change even though they are poorly suited to the current pattern of global production or other measures of economic power. It is generally easier to graft new arrangements onto the old.

With these lessons in mind and within the constraints they impose, steps should be taken on two fronts: to expand the supply of SDRs in a predictable and politically independent way and to increase the demand for SDRs by allowing and facilitating their use in trade and finance.

3 Of course, a country could achieve the same result by holding its reserves in the four currencies directly, either according to their weights in the SDR or using weights related to its own trade patterns. The global stability advantages of the SDR stem from its further development and usage, as discussed later.

4 John Gault, independent energy consultant, in a private communication.

Expanding SDR supply

There are two routes to expanding the supply of SDRs and both should be pursued. The first is new allocations by the IMF to its member countries. Currently each new allocation of SDRs requires the agreement of 85% of the votes of IMF members. Both the United States and the combined Eurozone countries have sufficient votes for a blocking minority. Thus their agreement to new allocations would be critical. It is also justified in a practical sense because their two currencies together constitute 78% of the current SDR basket.

However, such a structure lacks both global legitimacy and political independence. Therefore it should be augmented by a new committee, perhaps called the International Monetary Policy Committee (IMPC), which would produce a regular recommendation to the IMF board for an allocation of new SDRs to member governments' accounts based on its independent analysis of the state of global economic growth, inflation prospects and financial stability indicators.

The IMPC should be chaired by the Managing Director of the IMF and composed of the heads of the four central banks whose currencies make up the SDR, along with four other term-limited individuals chosen on the basis of their economic expertise and, if possible, hailing from other G20 countries whose weight in the world economy is large or growing.[5] China and Brazil are obvious examples. Their membership on the IMPC could be a precursor to the eventual inclusion of their currencies in the SDR basket, at which point they would become permanent members.

The SDR basket would be reviewed every five years in advance of SDR rebalancing, with the economic criteria for inclusion remaining as they are today and the political decision left to the IMF board. Inclusion in the SDR basket requires that the currency be freely floating and have a substantial presence in cross-border trade or financial transactions. It is therefore possible that the Brazilian real could qualify in 2015 and the Chinese renminbi in 2020.

The IMPC would meet every six months in advance of the regular IMF board meetings. It would take decisions by majority vote and publish both its votes and its recommendation to the IMF board for a specific SDR allocation (which could be zero) based on its analysis. The IMF board could then approve or reject, but not alter, the IMPC's recommendation. In this way, the ultimate authority for SDR allocations would remain with the IMF board, while the pressures of transparency and expert advice from the IMPC would provide a counterweight to the threat of veto by the United States or the Eurozone countries.

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The remit of the IMPC would be to achieve a growth in international reserves over time which is consistent with the sustainable non-inflationary growth rate of the world economy (generally thought to be 3–4% per annum). Until SDRs make up a much larger share of international reserves, these small but regular allocations would have little effect on global liquidity. Initially, it is likely that they would be viewed as additional precautionary reserves, thereby reducing the demand for ever larger dollar holdings. As a private market in SDR use built up (as set out below), the global liquidity implications of SDR allocations would need to be considered by the IMPC in making its recommendation.

5 This structure of nine members including four 'independents' with published minutes and votes is loosely based on the Bank of England's Monetary Policy Committee, which has had over a decade of generally successful experience. A similar proposal was made by Sir Nicholas Stern for an independent international body to provide an early warning system for financial breakdowns, although his view was that it should be completely independent of the IMF (Stern 2009).

Even initially, however, the IMPC could use its published recommendation as a signalling device. It could vary the growth of SDR reserves in a counter-cyclical way by recommending lower or zero allocations when it judged that global liquidity was growing excessively and, conversely, larger than average allocations when a global output gap was developing.[6]

The second way to expand the supply of SDRs is to create a 'substitution account' whereby member countries could deposit dollars, euros, yen or sterling with the IMF and receive the equivalent amount of SDRs in their account based on the exchange rate then prevailing. Such a proposal was actively considered, but eventually rejected in 1978. At the time the United States would not agree to allow two-way substitution whereby it would ultimately bear the risk of converting SDRs back into dollars, if the owners so wished, at an exchange rate that might have moved against the dollar in the meantime. It is likely that today the European Central Bank would be equally reluctant to take on such risk with respect to the euro.

There are two options: either a one-way substitution account could be established, or the member countries of the IMF could collectively assume the risk of conversion out of SDRs. Such risk could be controlled both by limiting the size of the substitution account and/or by running it like a ring-fenced currency board, with redemptions limited in size and timing to maintain a buffer and avoid sudden runs during periods of currency market turbulence. For example, a six-month notification period between a redemption request and its execution could be specified.

The size of the substitution account could be limited initially and increased gradually as experience develops with its usage by member countries and the pattern of their deposits and redemptions. For example, its size could be limited at first to the total of outstanding SDRs. There could be an initial six-month window of time for countries to use the facility up to their individual SDR holdings. Not all countries would choose to exchange their reserves for SDRs up to their quotas, so beyond that time limit the remaining facility could be made available to those countries wishing to over-subscribe their quota for reserve substitution.

By tying the total size of the substitution account to SDR allocations, a potential doubling of the quantity of SDR reserve assets would be achieved. With the recent $250 billion equivalent of SDR allocation agreed by the G20, this would mean that SDRs could immediately grow to nearly 10% of global reserves. If all proceeded smoothly, the ceiling on the substitution account could then be raised, subject to approval by the IMF board.

If it proved impossible to negotiate even such a controlled two-way substitution account, then it could be established with one-way convertibility. Countries could exchange their foreign currency reserves for SDRs but not vice versa. That would limit the SDR's attractiveness to surplus countries, but it need not prove a major obstacle if at the same time private-sector uses of SDRs were facilitated, as set out below.

Expanding SDR demand

The dollar's role as a global currency stems both from its usefulness for international trade and from the deep liquidity of its capital markets for international financial transactions. These, in turn, rest on institutional and legal underpinnings that have evolved over decades. A similar long-term horizon is appropriate for considering how SDR use could be facilitated, not only as a reserve currency, but also for international trade and investments.

On the trade side, two relatively straightforward changes would be required to enable the SDR to play a bigger role. First, the IMF would need to agree that SDR accounts could be opened by private-sector actors. Second, a settlement system would need to be created either by the IMF or by an authorized provider to enable transactions that were denominated in SDRs to take place directly between buyers and sellers on a secure and transparent platform.

Initially the IMF could declare itself to be the monopoly holder of SDR accounts. As experience accumulates it would be entirely possible to allow private financial institutions to provide SDR accounts with regulatory supervision

6 Barry Eichengreen (2009a) has suggested such a counter-cyclical approach to regular increases in IMF quotas, which could be another route to the same end if SDR allocations were tied automatically to quota increases.

(just as many banks today provide multiple currency accounts to depositors who have need for such). In the initial stage the currency backing for SDR accounts should be 100% so that no risk exposure would be created. In effect, these accounts would be one-way substitution accounts for private as well as public depositors. A new account would be created by the depositor 'selling' convertible currencies to the IMF and 'buying' the equivalent in SDRs.

Along with allowing the private sector to open and hold SDR accounts, the IMF would need to establish (or outsource the creation of) a secure settlement system. This is where transactions denominated in SDRs would take place between buyers and sellers. For example, if OPEC denominated its oil exports in SDRs and its state oil companies established SDR accounts at the IMF, then the major purchasers of OPEC oil (chiefly the trading arms of the large private-sector oil companies) would find it useful to establish SDR accounts and clear their purchases directly through the IMF settlement system. The technology and know-how for settlement systems is widely available in central banks today.

There have been recent news reports that discussions are taking place between China and oil-exporting countries such as Iran and Russia to agree on a currency basket that could be used for some of their bilateral trade. That is likely to be an inefficient and cumbersome approach if the basket includes managed currencies such as the renminbi and rouble. Their objectives of dollar diversification could be achieved more securely and efficiently if a neutral settlement platform for the SDR were available.

In addition to facilitating trade denominated in SDRs, it would be important to develop SDR-denominated financial instruments and markets in which to trade them. There is nothing to prevent governments or indeed corporations from issuing SDR bonds and a few international organizations have done so. What is lacking is a market-maker willing to buy and sell such bonds at bid/offer spreads which are competitive with those in more liquid bond markets. John Williamson suggests that this may be due to an 'infant market' problem where benefits to the first mover would only materialize if and when the market became widely used (Williamson 2009). Barry Eichengreen has pointed out that the IMF is the obvious candidate to be the market-maker in SDRs (Eichengreen 2009a). However, this would require a change in its remit to allow it to transact with private investors and, potentially, to subsidize bid/offer spreads during the market's infancy.

The G20 summit in April 2009 agreed to increase the resources of the IMF by $500 billion, to be raised by issuing bonds. China and Russia have indicated their willingness to buy $50 million and $10 million, respectively. Both countries have also supported a greater use of SDRs and it is likely that a substantial portion of the $500 billion will be offered as SDR bonds. This would be an important step in expanding the supply of SDR-denominated assets. The next step should be for the G20 to request the IMF to prepare a working paper on becoming a market-maker in SDR-denominated bonds.

A global cost-benefit assessment

Who would be the winners and losers from SDR expansion? A fundamental feature of the evolutionary roadmap described above is its voluntary nature. No country is required to participate in any new feature, whether it be the substitution account, the settlement system or SDR bond purchase. In addition, the IMF board retains its current structure and voting distribution. The institutional changes proposed, such as the International Monetary Policy Committee, are additional to, not replacements for the current arrangements.[7] Since all participation would be voluntary, no country would lose directly or immediately from the introduction of new mechanisms. And indeed, all countries would benefit from regular new allocations of SDRs in line with their IMF quotas.

However, a more fundamental question is where the costs and benefits might settle over time. It is widely assumed that the United States would be the big loser from the replacement of the dollar as the world's reserve

7 This is not because the current arrangements are ideal, but simply that they have proved to be very difficult to change.

currency. However, a recent study by the McKinsey Global Institute has estimated that the so-called 'exorbitant privilege' enjoyed by the United States from seigniorage is now very small – equivalent to less than half of one per cent of its GDP (McKinsey Global Institute 2009). Fred Bergsten has argued recently that the international role of the dollar was a significant contributing factor to the US financial crisis because it undercut the ability of the Federal Reserve board to tighten monetary policy during the credit build-up – the 'conundrum' discussed by Chairman Alan Greenspan at the time (Bergsten 2009).

Surplus countries – such as Japan and China – would clearly benefit from the greater stability afforded by a composite currency as a store of value for their reserves. Deficit countries – such as the United States and the United Kingdom – would benefit to some degree from the additional option of issuing debt in more stable SDRs as that market developed. Large commodity exporters and importers would also benefit from the greater price stability of SDR-denominated commodity markets.

Smaller IMF member states would be beneficiaries both through their regular SDR allocations and through the greater diversification they could achieve in their own foreign exchange reserves if SDRs were more widely held and used. They would also benefit if SDR allocations were skewed towards the poorer countries to incorporate a poverty reduction objective.

Conclusion

Over the last 25 years the shape of the world economy has been transformed. The Asian countries have achieved rapid and self-sustaining growth. China has now become the world's largest exporter. The European Union has expanded to be larger than the United States in its total output and most of its members have adopted a common currency. The USSR has collapsed and Russia has become a large oil and gas exporter. The OPEC countries have grown on the back of higher oil revenues, much of which they have invested domestically. These developments have led to a multipolar world economy where the weight of the United States is in decline.

At the same time, the dollar has remained the dominant currency of international transactions and foreign exchange reserves, accounting for around 85% and 65%, respectively. There are efficiency gains to be had from a single world currency, but it also creates vulnerabilities.[8] The risks grow if the economic policies of the currency provider are inconsistent with maintaining a stable currency value, a steady growth of supply and a balanced pattern of world trade. This becomes ever more difficult if the currency provider runs a chronic balance-of-payments deficit. Such a situation eventually brought down sterling as the dominant world currency, albeit under a system of fixed exchange rates. Today's 'non-system' of both floating and fixed rates is subject to similar pressures when global imbalances mount.[9]

Fortunately, during previous periods of global currency crises, the groundwork was laid for bringing into use a basket currency, the SDR. This chapter has sketched out a roadmap for expanding its supply and putting in place the institutional infrastructure to facilitate its use by the private sector. The political obstacles to this route seem manageable, particularly if it does not require contentious changes in IMF voting shares and when the benefits of currency stability are shared by both surplus and deficit countries. An important step was taken at the London summit of the G20 when a major expansion of SDR allocations was agreed. The proposals in this chapter provide a roadmap to help sustain that momentum and prevent future crises.

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8 See Mateos y Lago et al. (2009) for a mapping of the trade-offs among nine criteria for international monetary systems.

9 For a description of today's 'non-system', see Chapter 5 by John Driffill.

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