

THE DEBATE ABOUT THE SDR AS A GLOBAL RESERVE CURRENCY AND SDR DENOMINATED SECURITIES

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Introduction

The 2008-2009 crisis has underlined the presence of defects at the basis of the international financial architecture as well as the need for global reform. Several factors have been blamed for determining the crisis and various actions have been studied and put forward to solve the difficulties and restore a growing and sustainable economic path. This paper focuses its attention on the monetary factors, in particular on the role played by currencies and their use as reserve currencies.

If the focus is on the monetary side, of course the dollar, its use as reserve currency and the US economy are the starting points.

Recent US economic history has been characterised by a number of worrying intertwined signs: persistent current account deficits and growing foreign debt, a number of bubbles (internet, credit, real estate), private saving rates close to zero, a high volatility of the US dollar with a trend towards progressive devaluation. In the background there has been a monetary policy which has been generally accommodating and supportive of economic growth.

External debt, in particular, has experienced a frightening growth in the past quarter century and it has changed in nature¹. At the time of the collapse of the Bretton Woods System, the deficit in the US balance of payments was determined by movements of capital, that is United States investments in the rest of the world. But, from 1982, the current account balance turned negative and the deficit was financed by attracting savings from the rest of the world not to be reinvested abroad but to finance domestic demand. This means that developing countries were, and still are, transferring reserves to the industrialised countries, mainly the US, that issue the reserve currencies, lending to them at very low interest rates, and, in effect, making it possible for them to live beyond their means.

At the same time the world economic landscape has changed significantly and new world powers have risen while others are on the way, changing the global scene into a multi-polar reality.

These developing and fast growing countries have shown an increasing demand for reserves as a defence in a world of strong financial and terms of trade instability. The Asian and Russian crises of 1997-1998 have shown that developing and emerging countries are subject to strong pro-cyclical capital flows that, if let free to cause exchange rate appreciation and current account deficits, will eventually lead to balance of payments and domestic financial crisis. Therefore these countries reacted to the 2004-2007 capital inflows with a general surge in foreign reserves and the pursuance of strong current account positions (also linked to export-driven economies) in order to be prepared for possible future crises, as a sort of “self-insurance”.

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¹ A. Iozzo, A. Mosconi, *The foundation of a cooperative global financial system. A new Bretton Woods to confront the crisis of the international role of the US dollar*. Federalist Debate, June 2006.

As a result, reserve accumulation rose to 11.7% of world GDP in 2007 versus 5.6% a decade earlier. Reserve accumulations in the period 2003-2007 amounted to an annual average of \$777 billion a year or 1.6% of global GDP.

China represents a good – and the most striking – example of a new world economic power which registered a number of consistent and repeated surpluses with a simultaneous building up of foreign exchange reserves: China's reserves stood at \$2.13 trillion in June 2009. A good portion of these reserves has been invested in US Treasury bonds considered as a “safe haven” (China does not release the currency composition of its reserves, but the dollar is thought to make up around 65% of the portfolio; euro assets make up most of the rest, along with a small amount of pound sterling, yen, and likely even a small amount of Canadian and Australian dollars).

Its currency, the Chinese yuan, until 2005 pegged to the dollar, is now linked to a basket of currencies (among the heavier currencies: dollar, euro, *yen* and Korean *won*; among the less important: sterling, Australian dollar, Canadian dollar, Singapore dollar, rouble, Malaysian *ringgit* and Thai *baht*). Although the weight of each currency in the basket has not been communicated, the Governor of the People's Bank of China has explained that it depends on trading exchanges.

The EU, with the creation of the common currency, has played an important part in the international monetary arena. The euro, which has recently celebrated its first decade of life, has proved its capacity to give monetary stability to the area, sheltering the euro-zone countries from a valuation crisis. The European Central Bank has provided the liquidity needed to face the recent crisis with a common European front. Euro bonds have been playing an increasing role internationally: nonetheless their market is still fragmented (bonds of different government offer different returns, show different liquidity and involve different risks) while the debate about the opportunity to issue real EU bonds is still in progress and is facing German resistance.

Thus, the US dollar, even after the collapse of the Bretton Woods System and the rise of other currencies in the international arena – above all the creation of the euro - has maintained its leading role: after the gold exchange standard and the dollar standard, in a sense there has been a “fiduciary dollar standard”².

Robert Triffin, back in the 1950s, identified a flaw – the “Triffin dilemma” - at the basis of the use of a national currency, namely the US dollar, as the international reserve currency: positive US balance of payments would have brought about a situation of dollar shortage restricting global growth while dollar deficits were necessary to increase global liquidity but brought about dollar inflation and, at the same time, eroded confidence in the dollar as a reserve currency.

At the beginning the dilemma was linked to uncertainty over the ability to maintain the dollar-gold parity. With the shift to a floating exchange rate market the dilemma is now linked to large swings in the current account imbalances of the US and associated volatility of the dollar exchange rate, together with the risk of a loss in value of the reserves held in dollars by other countries.

Monetary authorities and related policies of the country issuing the reserve currency are continuously stretched between the need to respond effectively and contemporaneously both to the domestic needs of the economy to which they belong and, on the other hand, to the needs generated by the international use of the same currency as a reserve.

In effect, Chinese support for the US, through the systematic purchase of US Treasury bonds with the surpluses accumulated, has represented once again the Triffin dilemma which is as present as

² Report of the Commission of experts of the President of the United Nations General Assembly on *Reforms of the international monetary and financial system*, draft version, May 2009.

ever: fears of a possible dollar inflation already became real with the US dollar devaluation and the consequent loss in value of Chinese reserves. The safe haven may not be so safe.

The need for a global supra-national reserve currency

As the Governor of People's Bank of China has noted in his remarks prior to the G-20 London Summit, held in April 2009, "The outbreak of the crisis and its spill-over to the entire world reflect the inherent vulnerabilities and systemic risks in the existing international monetary system. [...] The price is becoming increasingly higher, not only for the users, but also for the issuers of the reserve currencies. [...] The desirable goal of reforming the international monetary system, therefore, is to create an international reserve currency that is disconnected from individual nations and is able to remain stable in the long run, thus removing the inherent deficiencies caused by using credit-based national currencies".

The adoption of a supra-national global reserve currency would eventually solve the Triffin dilemma while, at the same time, making it possible to manage global liquidity. It would bring the international monetary system up to date with an economy in course of globalisation, multi-polar and interdependent. The advantages of a supra-sovereign currency are clear for the users in terms of increased stability.

Nonetheless they apply also to the issuers of international currencies. If the international role played by the US dollar can be seen, in a sense, as a privilege and it certainly made it possible to the US to borrow money at low interest rates – the "exorbitant privilege" indicated by Valéry Giscard d'Estaing - nonetheless it has a cost. The demand for global reserves has been combined with increasing current account deficits in the US with adverse effects on domestic demand. Responding to the need of liquidity of the world can be a burden more than a privilege. The crisis of the international role of the dollar could free up US monetary policies, enabling them to focus on the domestic economy. Furthermore, the US would also take advantage of a more stable and more secure global financial and economic background.

The idea of a global supra-national currency is not new: back in 1942³ Keynes put forward the proposal to internationalise the creation of liquidity (not to leave it completely in the hands of the US) with the construction of an international currency union based on a currency, the *bancor*, with a fixed, but not immutable, content in terms of gold and accepted by all the members for the payment of international debt. But the United Kingdom, which (also to maintain its role in the international monetary arena) supported Keynes proposal at the Bretton Woods Conference, was heavily indebted and could not but recognize the strength of the US as the new hegemonic power and of its currency. Thus, the plan prepared by White, chief international economist at the US Treasury, prevailed and the idea of an international currency was left behind.

The SDR: past and present

If the idea of the *bancor* never made it into existence, nonetheless we do not need to start from scratch: an international reserve asset already exists – the SDR (special drawing rights).

The SDR was created in 1969 by the IMF to support the Bretton Woods fixed exchange rate system. In particular, its aim was to supplement the official reserves of member countries in order to

³ Already present, even if not refined, in the *Treatise on Money*, 1930.

overcome the possibility (and fears) of liquidity shortage that could hamper growth. In fact, the international supply of two key reserve assets – gold and the US dollar – proved inadequate for supporting the expansion of world trade and financial development that was taking place. The solution to the problem of inadequate reserve growth in the system lay in creating an international reserve asset to supplement dollars and gold in official reserve holdings. Some countries favoured the creation of a new reserve unit, while the US, concerned that such a unit would be a competitor for the dollar, preferred to build on the existing automatic drawing rights (the gold tranche) in the IMF. In accordance with its intended function, the SDR would circulate only in the official circuit: it could be held by governments, central banks, the IMF and a narrowly defined group of other “official holders”.

Allocations

The first allocation of SDRs to IMF members (in proportion to their IMF quotas) took place in the 1970-1972 period, for an amount of 9.3 billion.

The broadly held official view underlying the first amendment was that the SDR mechanism could provide a definite solution to the problem of managing the supply of international liquidity, while gold and reserve currencies were regarded to have only a minor incremental role in official reserves. However, soon after the creation of these SDRs, the Bretton Woods System collapsed and rates were left free to float according to market forces, with the underlying idea that the “invisible hand” of the market would adjust possible disequilibria and make things work effectively.

A second allocation of SDRs was distributed in 1979-1981, bringing the cumulative amount to SDR 21.4 billion. A proposal for a new allocation was put forward in 1997 by the IMF’s Board of Governors but for years it lacked the needed approval by three fifths of the IMF membership with 85% of voting power (effectively US approval). As stated in the commitments that followed the G-20 April 2009 Summit, the amendment became effective in August 2009 and was implemented in September 2009. This special⁴ allocation, about US dollar 33 billion, takes account of the fact that those countries which joined the Fund after 1981 (more than one fifth of current membership) never received an SDR allocation.

A general SDR allocation of US\$250 billion, again proposed by the G-20 2009 Summit, became effective on August 28, 2009. The allocation is based on a long-term global need to supplement IMF members’ existing reserve assets and it provides liquidity to the global economic system.

With the two allocations of roughly \$283 billion, the outstanding stock of SDRs has increased nearly ten-fold to about \$316 billion.

SDR valuation

While initially the SDR was defined as equivalent to 0.888671 grams of fine gold (the par value of the US dollar under the Bretton Woods System), in 1974 the SDR was redefined as a basket of currencies of the 16 IMF members with at least 1 percent of world trade. This basket proved to be a poor unit of account because it was difficult to replicate and included some currencies that were not widely traded. In 1981 the valuation criteria was changed to the currencies of the five member countries with the largest exports of goods and services in the previous five years and was thus simplified to a five currency basket: the US dollar, the Japanese yen, the Deutsche mark, the French franc and the pound sterling. The currencies that determine the value of the SDR, the amount of each of these currencies in the basket and the financial instruments used in determining the interest rate are reviewed every five years.

⁴ Allocations under the special amendment to the Articles of Agreement would not be made in proportion to quotas but rather pursuant to a methodology that would bring participants’ net cumulative allocations-to-quota ratio to a specific common benchmark.

The five currency basket was simple enough to be readily replicable by financial markets while still ensuring that the value of the SDR would be fairly stable in the face of wide swings in exchange rates.

With the introduction of the euro in 1999, the Deutsche mark and French franc in the basket were replaced with equivalent amounts of euro, without changing the relative weight of the continental European currencies in the basket.

In the 2000 review (effective from 2001) a second selection criterion was introduced to ensure that the currencies included in the SDR valuation basket are among the most widely used in international transactions. For this purpose the currencies included in the basket need to be “freely usable”⁵.

The most recent review dates back to November 2005 and became effective on January 2006: the weights of the four currencies were revised based on the value of the exports of goods and services and the amount of reserves denominated in the respective currencies which were held by other members of the IMF.

The value of the SDR in terms of the US dollar is calculated daily by the IMF (and available on the IMF website) as the sum of the market values in terms of the US dollar of the amounts of each of the four currencies. The actual share of each currency in the basket depends every day on the exchange rates prevailing on that day (since it is the amount of each currency that is fixed and not the share⁶).

The SDR interest rate

While initially set by the IMF at a fixed rate (1.5% a year, then 5%), the SDR interest rate is now set weekly on the basis of the weighted (using as weights the currency amounts in the valuation basket) average of interest rates on short-term instruments in the markets of the currencies included in the SDR valuation basket. The effective weights of the financial instruments representing each currency reflect not only the level of exchange rates and currency amounts in the basket (as happens for the valuation) but also the level of interest rates in each currency.

The SDR interest rate provides the basis for the calculation of the interest charged to members on regular IMF loans, the interest paid and charged to members on their SDR holdings, and the interest paid to members on a portion of their quota subscriptions.

SDR shortcomings and limitations

Notwithstanding the initial intentions, until now the SDR has had only a limited use as a reserve asset and its main function has been to serve as the unit of account of the IMF and some other international organizations. The initial expectation that SDRs would become a major component of global reserves was not fulfilled. If now the problems linked to the provision of total liquidity are less important, except during extraordinary circumstances, the problem of the dependence of global liquidity on the vagaries of US macroeconomic policies and balance of payments (or, rather, imbalances) remains. Furthermore, most countries still need to increase their reserve holdings to buffer their economies in the face of expanding current and capital account fluctuations, and most of them still have limited or no access to borrowing on the capital markets⁷.

⁵ A currency is freely usable if the IMF Executive Board determines that it is widely used to make payments for international transactions and is widely traded in the principal foreign exchange markets.

⁶ On November 24, 2009 the SDR was equal to 1.601 US dollar, with the US dollar accounting for 40%, euro 38%, Japanese yen 13% and pound sterling 9%.

⁷ See P. Clark, J. Polak, *International Liquidity and the Role of the SDR in the International Monetary System*, IMF Working Paper, December 2002. The paper already supported the idea of modest allocations of SDRs to meet the expected growing demand for international reserves, as it would be costless and would reduce systemic risk.

The main problem is that the SDR is not a currency, as the IMF itself remarks: “The SDR is neither a currency, nor a claim on the IMF. Rather, it is a potential claim on the freely usable currencies of IMF members. Holders of SDRs can obtain these currencies in exchange for their SDRs in two ways: first, through the arrangement of voluntary exchanges between members in a managed market; and second, by the IMF designating members with strong external positions to purchase SDRs from members with weak external positions⁸”.

Another important item is linked to the actual composition of the SDR basket (US dollar, Japanese yen, pound sterling and euro) which does not take into account the increasing role played by new world powers and their growing international weight. A number of countries, whose economies are acquiring an increasingly bigger stake worldwide, are consequently interested in playing a bigger role in the international monetary arena and have attracted attention on this point for the inclusion of their currencies.

Then, the SDR circulates only in the official circuit: it can be held by governments, central banks, the IMF and a narrowly defined group of other “official holders”. But it cannot be used in the other transactions in which central banks and governments engage. It cannot be used to intervene in foreign-exchange markets, or in other transactions with market participants. This means that the SDR is not an attractive unit for official reserves⁹.

While the SDRs still represent only a minimal fraction of world reserves, the efforts to promote its use in private markets have also been largely ineffective. A limited market in private SDRs emerged in the mid 1970s when some banks began to accept time deposits in SDRs and some companies began issuing long-term debt securities in SDRs but these attempts did not prove to be successful. They did not gain the scale needed for a new market to open and be attractive and, above all, could not face and overcome successfully US dollar supremacy.

Furthermore, the SDR is not a market-based asset: it has always been administratively controlled by the IMF in every respect, from its valuation and yield to who may hold it and what it may be used for. This means that the value of the SDR and its yield are not market-determined nor are free to respond to excess supply or demand pressures but reflect changes in the value or yield of its constituent currencies or financial instruments rather than a market clearing price.

Chinese proposal to use SDRs as supra-sovereign reserve currency

In March 2009 the Governor of the People’s Bank of China, Zhou Xiaochuan, put forward a proposal with a number of actions to promote the use of the SDR as a supra-sovereign reserve currency. Even if until now SDR’s role has been restrained by limitations on its allocation and scope of its uses, “it serves as the light in the tunnel for the reform of the international monetary system”. Furthermore, “the SDR has the features and potential to act as a supra-sovereign reserve currency”. In his proposal he also underlined the need for an enlargement of the SDR basket of currencies and suggested that part of the IMF member countries’ reserve be entrusted to the centralised management of the IMF through the establishment of an open-ended SDR denominated Fund which would allow subscription and redemption in the existing reserve currencies by various investors.

⁸ Provision of such foreign exchange is an obligation of participation in the SDR Department. A participant’s obligation to provide currency, however, is limited to twice its cumulative allocation of SDRs, unless agreed otherwise. Since 1987 no transactions by designation have taken place because all exchanges of SDRs for currencies have been accommodated through voluntary transactions plan.

⁹ See B. Eichengreen, *Commercialize the SDR*, Project Syndicate, 2009.

The Chinese point of view is backed by other countries, such as Russia and Brazil. India has also expressed interest in buying IMF SDR-denominated bonds.

In particular, the Russian proposal at the London G-20 Summit held in April 2009 calls for a reform of the international monetary and financial system to enhance its stability and eliminate global economic disproportions. It supports the view that the IMF should study the possibility to introduce a “supra-national reserve currency to be issued by international financial institutions. It seems appropriate to consider the role of the IMF in this process and to review the feasibility of and the need for measures to ensure the recognition of SDRs as a "supra-reserve" currency by the whole world community”.

On the contrary, the US – through the words of Timothy Geithner (Treasury Secretary) and Ben Bernanke (Chairman of the Fed) – have rejected the idea.

For the EU, the European Economic and Monetary Affairs Commissioner, Joachin Almunia, in response to the Chinese proposal has reaffirmed the US dollar’s role as the world reserve currency, which “will continue to be there for a long period of time.”

It is true that a weakening of the US currency, which is an implication of central banks’ shifting away from the US dollar, would be unwelcome to policy makers in the euro-zone, worried about the possibility of stronger pressure on the euro and on their exports. However, taking into consideration these common fears and studying the possible solutions to prevent further pressure on the euro, with the goal of achieving a more stable financial background in mind, Europe should support the Chinese proposal.

The track record of stability introduced with the euro and the experience in the progress to the common currency would constitute important contributions to the international debate and construction of a supra-national reserve currency.

Moreover, if the US dollar has shown its limits as a reserve currency, a switch to another currency – the euro - or to a double system would not solve the problem and should not be supported by the EU. Even though the euro has proved to be a stable currency and its entrance into the international monetary system has brought about the possibility of diversification, replacing the dollar with the euro as the international reserve currency would take us back to the starting point. A multiple reserve system, with the US dollar and the euro serving as reserve currencies, would offer some diversification but would still face the Triffin dilemma and would add an element of instability linked to the exchange rate volatility between the currencies used as reserve assets.

Only a supra-national currency, not linked to an individual national economy, could make it possible to overtake the global imbalances and the financial turbulence experienced, laying the ground for a safer and more stable international financial platform.

Possible actions for the use of the SDR as a reserve currency

If one has to consider using the SDR as an international reserve currency, a number of actions need to be taken to overcome past limitations. The debate around it has put forward some proposal:

- reform of the IMF. After years of neglect, the IMF has recently received international support for a revived activity. In line with this idea various suggestions have been put forward in order to strengthen its activities. Also to support the market of the SDRs, a reform of the IMF is needed. This reform would involve the activities to be carried out by the IMF, the funds at its disposal (currently inadequate), governance both in terms of governing bodies and majorities required for its activities to be carried out and of quotas and representation.

In terms of governance the EU, in particular, should take an important step by grouping its present seats into one (or into two initially as already suggested by Bini Smaghi, one for the euro area and one for other EU countries, which would then be consolidated into one): this would enhance its influence and at the same time free up seats for under-represented emerging markets. The risk in not taking this step is a continuous loss of influence and legitimacy of the IMF itself. If different countries within the EU have different opinions about the IMF's activities, preferences concerning IMF relevant issues are relatively homogeneous. The fact that the IMF is historically concerned with issues regarding – at least in part - exchange rates, together with the fact that roughly half of EU members have the same currency (and therefore the same exchange rate), points strongly in this direction.

- change and increase in SDR allocations. Until now SDR allocations have been rare and the required 85% voting power majority has given some countries an effective veto power. The decisions taken at the April 2009 G20 Summit show that a general consensus about the need to push forward on this issue has been reached but, apart from individual actions, other reforms are needed. In this respect the Commission of experts of the President of the UN General Assembly, studying the possible “Reforms of the international monetary and financial system”, puts forward some proposals, regarding the opportunity to: 1) make SDR issues automatic and regular, 2) adjust total issues in a counter-cyclical way; 3) allocate SDRs with criteria based on need and not merely on quotas. The IMF should also be able to provide additional liquidity in case of shortage¹⁰.

- review of the basket of the component currencies. The SDR basket now comprises only four currencies: the US dollar, the euro, the Japanese yen and the pound sterling. The next review of the basket is due in late 2010: that could be the right opportunity to revise the basket to better reflect the changes in the world economy, together with the increasing role played by some countries. In fact, a number of countries, whose currencies are now excluded from the basket, have auspicated an enlargement of the number of currencies in the basket. The Governor of the People's Bank of China in particular has declared his support for an enlargement of the basket “to include currencies of all major economies, and GDP may also be included as a weight”.

A number of issues need to be addressed and agreed upon in view of the next review:

- how many currencies should be included in the new basket? The trade off is between the need to enrich its current composition providing more diversification on the one hand against the risk of getting back to a too crowded basket, which could be difficult to replicate;
- which criteria are to be followed to select the currencies and their amount in the basket? As previously mentioned the use of the GDP has already been put forward. Perhaps the weight of the different currencies in the basket could be fixed in the Agreements in function of a valuation of each currency based on “economic fundamentals which also include elements which are not today counted as economic, such as human development, ecological sustainability, the concentration/diffusion of assets and incomes, the demographic composition of the population and their tendencies”¹¹.
- do commodities, such as gold, need to be included in the basket as some have suggested?
- is the five year review timing now in place appropriate? Does it match the stability required from the SDR to become a reserve currency?

¹⁰ See B. Eichengreen.

¹¹ The suggestion is made by A. Iozzo and A. Mosconi, in their proposal of a world currency unit (wcu). Since the measurement of these values is today still rough and can lead to discussions, a procedure would have to be designed to revise the Agreement to modify the weights. In future, when reliable and shared measurements are available, the revisions could become automatic. The authors suggest one could think about an evolution from SDRs to the wcu like the one which took place from the European unit of account to the ecu. See A. Iozzo, A. Mosconi, *The foundation of a cooperative global financial system. A new Bretton Woods to confront the crisis of the international role of the US dollar*, Federalist Debate, June 2006.

While the IMF will continue to calculate and publish daily the value of the SDR in terms of the US dollar, with the development of the role of the SDR it should be encouraged its quoting in the different markets, as happened with the ecu. This would provide a real valuation, made in the market, which could differ from the theoretical one provided for by the IMF, taking into consideration the demand and supply present at any given time.

- the establishment of a settlement system between the SDR and other currencies¹². The SDR could thus become a widely accepted means of payment in international trade and financial transactions.

- promotion of the use of the SDR in international trade, commodities pricing, investment and corporate book-keeping¹². This could reduce the fluctuation of prices denominated in national currencies. For example, oil pricing in a global supra-sovereign currency, as already suggested¹³, would help to stabilise the price, which would no longer be influenced by foreign exchange expectations.

- The opportunity to introduce a “substitution account” at the IMF was also recently discussed (for example in 2009 by the Commission of Experts of the President of the United Nations General Assembly, also known as the Stiglitz Commission and before by Bergsten¹⁴). The proposal for a substitution account was first discussed in the late 1970s to facilitate reserve diversification away from the dollar without creating the risk of a major dollar crisis. This proposal envisaged the possibility for central banks to deposit dollar reserves in a special substitution account at the IMF, to be denominated in SDRs. Official holders could deposit their unwanted holdings in the account (instead of converting dollars into other currencies, thus through the market depressing the former) and would be credited with a like amount of SDRs which could be used to finance future balance of payment deficits and other legitimate needs, redeem at the account itself or transfer to other participants.

The exchange rate risk would not disappear but it would be shifted to the IMF and could be covered through the generation of higher returns by the IMF or by guarantees from member states.

- issue of SDR denominated securities¹².

SDR denominated securities

The issue of SDR denominated securities would be a good starting point to increase the appeal of the SDRs and as the forerunner of SDR denominated financial assets. Reference to the experience of ecu bonds for possible similarities and differences is interesting.

The market for SDR denominated securities

- Issuers.

One can make the hypothesis that initially the IMF itself, some Governments and special international financial institutions such as the World Bank could issue SDR denominated securities, which could then be followed by banks and non-financial firms. In fact, in those markets where global imbalances emerged, there is the more impelling and greater need to have debt securities in a supra-sovereign reserve currency. If the positions of the various parties concerned in the issue are

¹² See Zhou Xiaochuan, *Reform the International Monetary System*, March 2009.

¹³ See A. Iozzo and A. Mosconi.

¹⁴ *How to solve the problem of the dollar*, Fred Bergsten, December 2007.

considered, this feature could also allow for the achievement of considerable volumes and a possibly adequate level of liquidity.

Among the Governments, the US could provide a good example for other countries: if it agrees that a shift towards a more stable and globally balanced international monetary system is desirable it could issue part of its bonds not only in US dollars but also denominated in SDRs. If one thinks about the amounts of US Treasury bonds issued in recent years and about the needs ahead - the US will have to borrow some \$3.5 trillion more in the next three years; on top of that, the Treasury has to refinance, or roll over, a huge amount of short-term debt issued during the financial crisis - even accounting for a needed and hoped for reduction in the deficit and considering a small portion of Treasury bonds denominated in SDR, it would show considerable figures. They should encounter a warm welcome from world investors. If recent events have diminished the credibility of the US as a supplier of high-quality financial assets, the possibility to focus its policies on the internal side, and its support for the introduction of a global reserve currency not linked to the US economy would help in re-establishing it and rebalancing the world monetary system. The importance of such a step would constitute a good example to be followed by other countries.

However, considering the current US resistance to these proposals, it is unlikely that the US open the market for SDR-denominated securities. The remarks made by the Governor of the People's Bank of China are supportive of a market for the SDR denominated assets. It has been suggested that therefore they could issue SDR denominated bonds and encourage other G-20 members to follow their example¹⁵. This would be important because it would foster market liquidity for SDR denominated securities, and it would be more important than buying IMF SDR denominated bonds - which they are already doing - since the IMF bonds cannot be traded according to current rules.

The IMF for its part is widely recognized to have inadequate resources to pursue its current and, all the more, possible future tasks. As of early 2009 the Fund had some US dollar 200 billion of quota resources and could tap additional some 50 US dollar billion through borrowing arrangements¹⁶. At the April 2009 G-20 Summit it was agreed to add in the future some 500 US dollar billion through the New Arrangements to Borrow (NAB), and half of this amount has been promised by G-20 leaders¹⁷.

Therefore, there is room for the IMF to raise funds and a step in this direction has already been taken: at the beginning of July 2009, the Executive Board of the IMF approved a framework for issuing notes to the official sector. Issuance of the notes (denominated in SDR) would enable members to invest in IMF paper, while providing an immediate supplement to IMF resources for financial assistance to members. The actual issuance of notes would occur at the time of a loan disbursement to a member.

The first note purchase agreement, following the opportunity introduced by this decision, was signed in September 2009 between China and the IMF for 32 SDR billion (roughly US dollar 50 billion).

¹⁵ Eichengreen *Commercialize the SDR*, Project Syndicate, 2009.

¹⁶ Through two agreements—the General Arrangements to Borrow (GAB) and the New Arrangements to Borrow (NAB)—a number of member countries and institutions stand ready to lend additional funds to the IMF.

The NAB currently comprises credit arrangements with 26 members and institutions for a total amount of SDR 34 billion (equivalent to \$51 billion). The IMF has in the past also temporarily supplemented its resources through bilateral borrowing agreements. A recent example is the IMF's new loan agreement with Japan.

¹⁷ As of July 2009 substantial progress toward the G-20 goal of \$250 billion in immediate resource additions has already been made: three bilateral borrowing agreements are effective for an amount of roughly US dollar 125 billion (Japan \$100 billion, Norway \$4.5 billion, and Canada \$10 billion); European Union members have pledged loans worth €75 billion (\$100 billion), Switzerland has pledged about \$10 billion. EU has announced an additional commitment for €50 billion, bringing the total to €125 billion.

- Investors

When the issue of ecu denominated securities began, the interest for these securities was mainly to be found in the private market. Unlike what happened with the forerunner of the European common currency, the market for SDR denominated securities is institutional.

In particular, a number of countries want to increase and/or diversify their reserve holdings: such countries have been looking for high quality financial assets to invest into and have, until now, acquired large amounts of US dollar denominated bonds. For the reasons mentioned earlier, they share common fears about the value of their investments and it is believed they would be available not only to diversify their investments (which they already can do with euro bonds whose international role has surged but whose market is still fragmented) but to switch to a supra-sovereign global currency.

China is already investing in the SDR denominated securities now available. At the beginning of September, the IMF and the People's Bank of China have signed an agreement under which the People's Bank of China would purchase up to SDR 32 billion (around US\$50 billion) in IMF notes. The note purchase agreement is the first in the history of the Fund, and follows the endorsement by the Executive Board on July 1, 2009 of the framework for issuing notes to the official sector.

Also the other countries have expressed this intention: Russia, Brazil (which in the past sought IMF assistance) and India have indicated their willingness to invest in notes issued by the IMF, US dollar 10 billion respectively.

It has been argued¹⁸ that pension funds and insurance companies are generally on the demand side for government bonds as they match the maturity of their obligations and they would be interested in SDR denominated bonds as well. However, a problem persists in that SDR denominated bonds would not match the currency denomination of their liabilities.

- IMF support to the market

Apart from being one of the issuers of the SDR bonds, it has been suggested that the IMF should also act as market maker to support the market in an initial phase.

As argued by Barry Eichengreen in a recent IMF Paper¹⁹ central banks use their reserves to smooth their countries' international transactions and to intervene in foreign exchange markets. Thus, "making the SDR an attractive unit in which to hold central bank reserves presupposes deep and liquid markets in SDR claims." Moreover, "historically, composite currencies traded commercially have not offered attractive combinations of liquidity and return. For this to happen, someone would have to act as market maker and subsidize the operation of the market until it acquired scale and liquidity. The obvious someone is the IMF."

In short, a deep and liquid market in SDRs requires a critical mass of SDR issuance and a critical mass of trading; aside liquidity it requires also return rates comparable to those of the US dollar debt securities in order to make them attractive. The IMF should stand ready to buy and sell SDR claims to all new comers, private as well as official, at narrow bid/ask spreads competitive with those of the dollar, subsidizing the market in a start-up phase until private market-makers would be able to provide those services at comparable costs. This was done by the Fed in 1920 when it started buying and selling dollar acceptances, backstopping the market. This action by the IMF implies a cost: the members should agree to sustain it in order to move towards a more balanced international monetary architecture.

¹⁸ B. Eichengreen, *The dollar dilemma*, Foreign Affairs, September/October 2009.

¹⁹ B. Eichengreen, *Out of the Box Thoughts about the International Financial Architecture*, IMF Working Paper, May 2009

- Clearing system

The experience with the ecu – the forerunner of the euro – has clearly shown that the setting up of a clearing system is a crucial point. Despite the encouraging signs coming from the market of the private ecu in the early 1980s, only a limited number of market players were involved and the ecu's spread had still a long way to go. From the beginning, banks operating in the ecu market had to find a way to overcome the hindrance to transactions due to the need to continuously bundle and unbundle the basket of currencies.

The establishment of a clearing system for the ecu facilitated its use and the growth of the market, proving to be the best way to build up liquidity. The Bank for International Settlements was called to act as clearing house.

Similarly, but considering the different nature of the market of SDRs (public rather than private), it can be said that the setting up of a clearing system for central banks investing in SDRs would constitute a step of great importance.

SDR basket

Another issue that needs to be addressed is linked to the adoption of a closed or open basket to be used for the SDR denominated securities. In short: should the definition of the SDR change through the maturity of the securities in line with the official definition reviewed by the IMF or remain the one valid at the time of the issue notwithstanding the periodic reviews?

The experience of the ecu may offer interesting hints. When Kredietbank started to accept time deposits in ecu (or in SDRs), it was decided to do so on the basis of a closed basket: the basket of currencies composing the ecu (or the SDRs) remained the same throughout the lifetime of each individual time deposit. The aim was to inspire confidence and reliability maintaining the composition of the currencies stable. When bonds with longer maturities rather than simple time deposits began to be issued in ecu and SDRs and with the development of the market the problem of a closed or open basket presented itself again and it was more real: there were in effect more chances of revision, by the European Commission and the IMF respectively, of the basket of currencies composing the currencies during the lifetime of the securities issued.

To maintain closed baskets, the risk was to have not a single, growing and transparent market but to end up with many sub-markets linked to many different ecu. Therefore, as a general rule all different types of ecu (or SDRs) business turned to the open basket formula (the same basket at any given time, even if different from the one adopted at the time of the issue), providing for an automatic and instantaneous following of any official decision to change the ecu or the SDR.

Would it be reasonable to apply the same criteria nowadays for the SDR denominated bonds?

The interest rate of SDRs

Apart from the theoretical value of the interest rate set weekly by the IMF, if a market for SDRs is to develop and if the SDR is to become a global reserve currency it should also pay interest at a rate attractive enough to encourage its use as an investment for central banks' reserves. To support the growth of a steady demand of SDR denominated securities one should expect initially a positive difference between market rates and theoretical rates. Can we expect a progressive reduction of this positive difference over time?

Of course, the different SDR denominated securities issued by different governments (or, later, firms) would show different spreads linked to the associated ratings of the countries and/or corporate issuers.

Is it therefore reasonable to expect a trend of convergence of these interest rates once the market of SDR denominated securities is well established?

Could it be that the denomination in SDR ends up being considered a favourable item in the issues?

Within the euro-zone the process of convergence was linked to the common currency and to the presence of the Growth and Stability Pact but what can we expect in this case?

Conclusions

The economic and financial world landscape is changing at a fast pace: flows and trends of capitals, goods, services and people are shaping a new reality.

On the monetary ground, even with the emergence of new currencies (namely, the euro) and of new economic powers, the US dollar still plays a predominant role in the international financial markets and in the building up of world reserves. Nonetheless, its international role is in crisis, suffering from the Triffin dilemma which now presents itself in the form of dollar inflation, large US deficits, widespread worries on the risk of losses in the value of the reserve currency. In short, what is usually referred to as global imbalances.

Recently many calls have been made for a reform of the international monetary system. The 2008-2009 crisis have further underlined the urgency and importance of such a reform.

This paper provides some idea of the present debate concerning the use of the SDR as a reserve asset and on the issue of SDR denominated securities.

To overcome the current limitations linked to the use of SDRs, many items lie on the table and should be addressed by the public debate, such as: review of the basket of currencies included in the SDR, actions to foster liquidity of the SDR markets, backing of the global currency, changes required in the IMF (activities, funds needed, governance), clearing system, the use of open or closed baskets for the SDR denominated securities.

As far as the issue of SDR denominated bonds is concerned, a number of factors point in favour of issues by the IMF and Governments, to be placed in the institutional market. In fact: 1) this market has the greater need for a supra-sovereign reserve currency and here global imbalances aroused; 2) these actors could ensure substantial amounts to provide an adequate level of liquidity. It has been argued that to support the market the IMF should also act as market maker, at least initially. For the interest rate of these securities, it should be attractive enough to encourage their use as an investment for central banks' reserves.

A proposal about the use of SDR as a supra-sovereign reserve currency has been put forward by the Governor of the People's Bank of China earlier this year, together with a suggestion to entrust the IMF with the management of part of its members' reserves. Russia and Brazil have supported the use of the SDR as a reserve currency. India as well has expressed interest in buying SDR denominated bonds issued by the IMF. On the contrary, the US have rejected the idea, together with the EU.

While the debate is heating up on this issue there are, on the one hand, optimistic comments on Chinese proposal and, on the other hand, sceptics who do not believe in a future for the SDR. The latter, in particular, argue that the US dollar is still to retain a strong share of global reserves and its leading role in the monetary scene in the years to come.

It is certainly true that it is in nobody's interest a strong shift away from the dollar by central banks and a consequent further devaluation of the dollar: not for the US, nor for the emerging markets with US dollar reserves in their central banks, nor for exporting countries which would see their currencies appreciated vis-a-vis the dollar. This does not mean that we do not have the tools (nor even study the possible) tools to exit from the situation that led to the crisis and that a project for a

global supra-sovereign currency cannot be pursued. There should be studies on the possible options (and necessary actions) to implement in order to have gains on every side – a win-win situation. Furthermore, studies on a global reserve currency do not mean an abandonment of the initiatives of regional integration of currencies: on the contrary these two efforts (regional currencies and global currency) are not alternative and should go along together, with the same stability objective. For example, the presence of regional currencies in the SDR basket would help in the review with the trade-off between not too crowded and not sufficiently representative.

New global economic powers ask for an increasing role in the setting up of a new architecture of the international monetary and financial system, having already acquired an increasing share of its value. The US cannot discard as not important the remarks coming from China, considering Chinese central reserves, accounted to include at least some US dollar 1 trillion. Furthermore, the US has, as well, the interest of overcoming the global imbalances linked to the use of its currency as global reserve currency. The “exorbitant privilege” the US enjoyed is presenting its bill: it may be convenient for them as well to move forward²⁰. From the Obama administration arrive signs that the US will not continue to be the world's consumer and importer of last resort. As recently argued²¹, there is a recognition that US influence can be compromised if it is dependent on foreign investors to bail out its financial sector (as in the early part of this crisis) or to finance its fiscal profligacy (as China and other surplus countries have been doing for a long time). The US also recognises that it might not be able to finance large external deficits in the future at an acceptable price so to some extent it is making a virtue of necessity.

Europe has an important role to play. Europe should back the Chinese proposal. Its experience with the creation of the common currency and the path followed – from the European unit of account to the ecu and then to the euro – and with the establishment of the European Central Bank constitute valuable items. The success of the euro in terms of stability and its affirmation worldwide should constitute a good example and not the reason for being attracted by the temptation of replacing with the euro the US dollar's role as international reserve currency. To play an important role in this task the EU has to speak with one voice. This would also imply the consolidation of its IMF seats into one (or two, one for the euro-zone countries and the other for other EU countries). Such a move would enhance EU influence and at the same time free up seats for emerging countries, giving more legitimacy to the institution.

If this is an exceptional crisis and these are exceptional times, exceptional measures need to be taken and agreements need to be reached. Whatever the body involved and the ways adopted, a new “Bretton Woods Conference” process should take place providing the discussion on the issues involved in the changes and setting out a new order with clear mechanism in place going forward, so that regular decisions and functioning of the relevant institutions (with a revised role for the IMF) would do their job in the future. On several occasions throughout the 20th century, political leaders in major countries sought international agreements on the global economic or financial architecture and many efforts failed, with the major exception of Bretton Woods. Experience shows²² that a successful reform in response to a crisis requires three ingredients: effective and

²⁰ See F. Bergsten, “U.S. policymakers, therefore, must recognize that large external deficits, the dominance of the dollar, and the large capital inflows that necessarily accompany deficits and currency dominance are no longer in the United States' national interest. Washington should welcome initiatives put forward over the past year by China and others to begin a serious discussion of reforming the international monetary system.” *The dollar and the deficits*, Foreign Affairs, November/December 2009.

²¹ See F. Bergsten and A. Subramanian. *America cannot resolve global imbalances on its own*. Financial Times, August 20 2009.

²² See J. Boughton, *A new Bretton Woods?*, Finance and Development, IMF, 1 March 2009.

legitimate leadership combined with inclusive participation; clearly stated and broadly shared goals; and a realistic road map for reaching these goals.

In 1996 a seminar organized by the IMF on the future of the SDR saw the participants divided on many key issues and concluded by expressing doubts about the possibility for the SDR to become the principal reserve asset in the international monetary system and showing only support for the present (minimal) role of the SDR.

But, since then, the consensus on the need to regulate the creation of global liquidity and to correct the present sources of global imbalances has risen. As said by the Governor of the People's Bank of China earlier this year "the creation of an international currency unit, based on the Keynesian proposal, is a bold initiative that requires extraordinary political vision and courage".

Time is ripe for discussion and decision: the debate has now to focus on concrete solutions.

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