The SDR and Its Potential as an International Reserve Asset

Jeff Chelsky

Since the onset of the global financial crisis, there has been an upswing of interest among some prominent policy makers and academics in the International Monetary Fund's (IMF) Special Drawing Right (SDR) as a "safe" international reserve asset. But preexisting constraints on the SDR and the magnitude of support required to push through the reforms necessary to enhance the SDR's role make it unlikely that ambitious aspirations for this "quasi-currency" will be realized. Moreover, the case for enhancing the SDR's role has been somewhat overstated, as has the view that the current international monetary system requires the dominance of a single currency, namely the U.S. dollar. To a significant extent, U.S. dollar dominance is the result of specific policy choices by individual countries (for example, export-led growth strategies, close links to the U.S. dollar) rather than an inherent rigidity in the international monetary system. Many of the problems that some policy makers are seeking to address through a greater role for the SDR can more easily be achieved in the context of the continuing trend to a multicurrency reserve system.

In the wake of the global financial crisis, there has been increased interest in the IMF's SDR, which was created in 1969 "to meet the need, as and when it arises, for a supplement to existing reserve assets." However, despite support over time from a number of senior political leaders and leading academics, the SDR has never come close to achieving a status anywhere near that of "the principal reserve asset in the international monetary system" envisaged in the IMF's Articles of Agreement (IMF 1944, Article VIII, Section 7). This note describes the renewed interest in the SDR and assesses the SDR's prospects to contribute to greater stability in the international monetary system.

What Is the SDR?

A good place to start is with what the SDR is not. It is not a currency, nor is it a claim on the IMF. Instead, it is a potential claim on the "freely usable currencies" of IMF members. The "creation" of an SDR involves the creation of both an asset and a liability (to the IMF's SDR department), which results in no increase to the recipient's net reserves. The liability is the SDR "allocation" itself, which is, in effect, a fixed line of (unconditional) credit. Members receive an SDR allocation in proportion to their quota, on which they are charged the SDR interest rate. At the same time, members are given "holdings" of SDRs, equivalent to their allocation, which increase their gross reserves. These holdings, if left on deposit with the IMF, are remunerated at the SDR rate. If members leave their entire SDR holdings on deposit, total remuneration equals the allocation charge, and there is no net financial cost or benefit. Modest allocations of SDRs were made in 1970–72 (SDR 9.3 billion) and 1979–81 (SDR 12.1 billion), with no further creation for almost 30 years. Following the adoption of the Fourth Amendment to the IMF's Articles of Agreement, which granted a "spe-
The SDR was created by the IMF in 1969 to augment gold and the U.S. dollar, which were the key reserves underpinning the Bretton Woods system of fixed exchange rates, but which were considered to be in inadequate supply to support the expansion of world trade and financial development (IMF 2011). However, the Bretton Woods system collapsed in 1971, following U.S. President Nixon’s decision to suspend the convertibility of the U.S. dollar into gold. While the subsequent floating of most major currencies diminished the need for a supplementary reserve asset, heavy selling pressure on the U.S. dollar led a number of (largely) European countries (France, in particular) to promote the SDR as a substitute for U.S. dollars. A range of proposals were considered by the Committee of Twenty and its successor, the Interim Committee (both precursors to today’s International Monetary and Financial Committee) and the IMF’s Executive Board, including a compulsory replacement of a portion of existing foreign exchange reserves with SDRs. However, none of the proposals was able to garner the critical mass of support needed to proceed.

In 1996, following the failure of the Interim Committee to reach agreement at the 1994 Annual Meetings on a new allocation of SDRs, the IMF held a major seminar on the future of the SDR. At that time, with no apparent shortage of global liquidity, and with an international monetary system dominated by flexible exchange rates, the danger of instability was seen as remote. The general consensus was that the establishment of the SDR as a principal reserve asset was “unlikely” (IMF 1996, 35, box 2). However, there was little support for actually abolishing the SDR “because it might prove a valuable ‘safety net’ if the international monetary system got into serious difficulties” (IMF 1996).

Immediately prior to the current global financial crisis, attention to the SDR was largely focused around various creative proposals to use it to generate financing for international initiatives (for example, debt relief, development assistance, financing of IMF concessional lending, and climate change [Bredenkamp and Pattillo 2010]). Many of these proposals were based on a mistaken impression that the SDR was “free money” or were constructed in an attempt to circumvent domestic budgetary rules. The proposals also failed to garner broad support within the official community.

Why the Renewed Interest?

When the global financial crisis hit in 2008, U.S. dollar liquidity dried up, and international financial markets experienced

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4 In October 2000, the Board adopted guidelines that stipulated that the value of the SDR would be determined using the four currencies issued by IMF members (or monetary unions that included IMF members) whose exports over the previous five years had the largest value and had been determined by the IMF to be “freely usable,” which is defined by the IMF’s articles as those currencies (i) widely used to make payments for international transactions and (ii) widely traded in the principal exchange markets (IMF 1944, Article XXX, Section (f)). The IMF’s Executive Board is responsible for interpreting these “usability” criteria. This was last done in 1998, when the euro, Japanese yen, British pound sterling, and U.S. dollar were formally classified as freely usable currencies. The SDR itself is not a freely usable currency since it can only be used in transactions between designated official entities; the private sector, while it is free to use the SDR as a unit of account, is not authorized to hold or transact in SDRs.

5 Every five years, the composition of the SDR basket is reviewed to enhance its “attractiveness” as a reserve asset. Attractiveness in this context is not formally defined, but has, over time, come to be seen as a function of stability in the value of the SDR basket and the representativeness of the constituent currencies to those used in international transactions (IMF 2010b). The weight of individual currencies in the basket reflects their relative importance in the world’s trading and financial system. Today, the basket consists of the euro (37.4 percent), Japanese yen (9.4 percent), British pound sterling (11.3 percent), and U.S. dollar (41.9 percent).

6 The SDR’s usefulness as a reserve asset derives from the ability of the holder to exchange it for “freely usable currencies,” that is, those currencies that can be used for the settlement of international transactions. The exchange mechanism works as follows: the SDR holder approaches another designated holder (or the IMF directly) to exchange SDRs for freely usable currencies. This causes the seller’s SDR holdings (and associated remuneration) to drop while its SDR allocation remains fixed, resulting in a net charge paid to the IMF. The purchaser’s holdings (and associated remuneration) rise against its fixed allocation, resulting in an increase in net remuneration. The entire transaction is facilitated by the IMF.

7 While the IMF’s articles require that the policies of members “shall be consistent with the objective[s] of ... making the special drawing right the principal reserve asset in the international monetary system,” there is no consensus on when, how— or even if—this objective should be achieved.

8 Current Financial Crisis?

9 How Was the SDR Viewed prior to the Current Financial Crisis?

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widely. First to the scene was the U.S. Federal Reserve Board, pumping liquidity into the system and establishing a series of large-scale bilateral swap agreements with major central banks, including several in major emerging markets (Brazil, Mexico, and the Republic of Korea). The IMF followed with a number of programs for countries hit by the crisis and it adapted its financing toolkit to meet the demands of the crisis. For the first time in almost 30 years, policy makers looked to the SDR to provide much needed liquidity throughout the international monetary system (Truman 2009). Reflecting the gravity of the situation, an almost 10-fold increase in the stock of SDRs was approved in record time, following agreement in principle at the G-20 summit in London in April 2009. However, even with the pressure of the crisis, it still took four months (until August 2009) to ratify and implement the decision, highlighting an important shortcoming in using the SDR as a part of the “valuable safety net” envisaged in 1996. Nevertheless, the SDR allocation did provide many countries with a valuable source of liquidity as the crisis continued to unfold.

The origins of the crisis in the U.S. financial system set off a chorus of criticism of the U.S. dollar’s role as an international reserve currency, particularly from China, the most significant holder of U.S. dollar reserves.10 In a March 2009 speech, Zhou Xiaochuan (2009), Governor of the People’s Bank of China, called for a broadening of SDR use to enable it to “fully satisfy the member countries’ demand for a reserve currency.” Further critiques of a U.S. dollar–dominated international monetary system have since emerged, including from France,11 the Russian Federation, and Brazil, with the SDR seen by a few as a possible candidate to replace the U.S. dollar as the dominant international reserve currency.

Do We Need an Enhanced Role for the SDR?

To better understand the debate on whether or not the SDR should play a larger role as a global reserve currency, it is important to recognize that the U.S. dollar—while the dominant international reserve currency today—is by no means the only international reserve currency. Other currencies account for almost 40 percent of total global foreign exchange reserves (for example, including the euro, British pound sterling, Japanese yen, and Swiss franc).12

As argued by Eichengreen (2010, 2011), there is no compelling reason why the international monetary system need have only one dominant currency. Not only are today’s markets deep and liquid enough for more than one currency, but history has shown that more than a single national currency can perform the role of a reserve currency at any point in time. Moreover, one of the lessons of the global financial crisis may be the need to diversify reserve holdings and avoid reliance on a single currency.13

The U.S. dollar is the dominant reserve currency today, not as a result of official edict, but as a consequence of its attractiveness to markets. With the fall of the Bretton Woods system and the severing of a formal link with gold (and other currencies), the attractiveness of the U.S. dollar as a global reserve currency has been market driven, largely by the liquidity and depth of U.S. financial markets. Central banks do not hold U.S. dollars because they are required to, but because they choose to for policy and/or financial reasons. For example, in the case of China, which has been among the most vocal in calling for an enhanced role for the SDR, heavy accumulation of reserves was a clear consequence of policies to promote export-led growth. That those reserves were overwhelmingly denominated in U.S. dollars was, in large part, related to its policy decision to maintain a close link between the Chinese renminbi and the U.S. dollar.

One argument in favor of an enhanced role for the SDR is that it would provide a more stable store of value, independent of the macroeconomic policies of any single country. However, on closer inspection, the argument is less compelling. Given that the SDR is composed of the major currencies, its value would remain vulnerable to developments in constituent currencies. More importantly, achieving the currency diversification implicitly associated with SDR-denominated instruments need not require a single currency unit—it could be realized at a portfolio level if central banks chose to hold reserves that matched the SDR’s currency composition. Central banks desiring greater diversification (or an alternative to the U.S. dollar) are able to convert at least some portion of their U.S. dollar reserves into other currencies, and could mirror the composition of the SDR currency basket in their overall portfolio. In fact, given existing constraints on the transferability of SDRs and the lack of market liquidity for SDR-denominated instruments, portfolio diversification offers a superior approach14 and has the added benefit of enabling countries to avoid the much higher liquidity premium associated with SDR-denominated assets that are much less abundant than those denominated in its constituent currencies. It is worth noting that among the most vocal advocates for an expanded SDR role, only China holds more than its SDR allocation.15

There have also been calls to expand the currencies in the SDR basket to better reflect the role of emerging economies in the global economy; the renminbi is generally the first candidate mentioned. The IMF recently conducted its quinquenniel review of the SDR basket (IMF 2010b), and despite the fact that China was the third largest exporter between 2005 and 2009, its currency was rarely used in international transactions. For example, in the second quarter of 2010, overall use of the renminbi in trade was only about 1 percent of mainland China’s total exports and imports. On the financial side, only 0.06 percent of international bonds and notes were denominated in renminbi at end-2009. The reason the currency is not more widely used is largely the result of significant capital controls that China has in place. However, from this low base, the use of the renminbi for trade and financial transactions is growing fast and

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there is clear potential for the renminbi to play a more significant role in the global economy. How quickly this happens will be determined by the speed at which China’s capital account is liberalized and its currency made more flexible.

What More Can the SDR Contribute to International Monetary Stability?

Increased use of the SDR as it stands today, with all its constraints, will not significantly reduce instability in the world economy. The real question is whether or not, with reform, it could contribute to meaningful improvement. Various options have been suggested, including giving the IMF the power to more easily issue SDRs or creating an SDR substitution account at the IMF to facilitate a move away from U.S. dollar holdings by central banks not wanting to trigger a large-scale depreciation of the U.S. dollar. However, the feasibility of any option requiring institutional change must be assessed keeping in mind whether or not the option can attract the high level of support needed for adoption.

Many options, including broadening the transferability of the SDR to include the private sector, require amendment of the IMF’s articles, which is only possible with the support of 85 percent of the voting power and a supermajority of members. Proposals to give the IMF the power to issue SDRs more easily, for example, have historically failed to find wide support among members because they imply extending credit to members unconditionally, regardless of the quality of national policies or governance. That this concern was overcome in the context of the August 2009 US$250 billion SDR allocation was largely a function of the severity and systemic nature of the crisis and is unlikely to be replicated anytime soon. Similarly, the creation of a substitution account, which would have the effect of shifting currency risk away from the largest holders of U.S. dollar reserves onto the broad IMF membership, faces significant resistance, because it could eliminate a key incentive for large holders of U.S. dollar reserves to avoid a disruptively rapid depreciation of the U.S. dollar.

Increased SDR use by the official sector would also have to contend with the lack of sufficiently deep private markets in SDR-denominated assets. To date, the private sector has shown little interest in the SDR. In the late 1970s and early 1980s, the IMF Board adopted a number of decisions intended to enhance the attractiveness of the SDR as an asset (for example, permitting holders to use SDRs in swaps, forward transactions, loans, collateralization and grants by expanding the list of prescribed official holders and by permitting central banks to transact in SDRs directly with one another without IMF intermediation), but these efforts had little effect (Boughton 2001, 933–36). Eichengreen notes that, historically, composite currencies traded commercially have not offered attractive combinations of liquidity and return and that there is little reason for this to change without someone acting as market maker and subsidizing the operation of the market until it acquires scale and liquidity (Eichengreen 2009b; Dammers and McCauley 2006, 79–92; and Allen 1993, 97–110). If the IMF were to assume this role, the full membership would assume the cost.

That said, the SDR will continue to evolve to reflect the multipolar evolution of the international monetary and financial system. Diversification of foreign exchange reserves away from the U.S. dollar has been underway for some time and is likely to continue in the wake of the global financial crisis. The U.S. dollar share of allocated global reserves has already fallen from an average of 71.5 percent in 2001 to 61.3 percent in the third quarter of 2010. As part of its regular review of the composition of the SDR, the IMF recently reduced the U.S. dollar share from 44 to 41.9 percent, down from a high of 45 percent between 2001 and 2005. Inclusion of emerging market currencies such as the renminbi is likely inevitable; the issue is one of timing. Inclusion of a currency that is pegged or closely linked to a currency already in the basket would, in fact, have the effect of making the SDR a less stable store of value. Bringing the renminbi into the SDR before it—and China’s capital account—have been further liberalized would make the SDR less, not more, attractive as a reserve currency.

There is limited scope for enhancing the SDR’s role as a unit of account. Currently, a few international finance institutions (IFIs), including the International Development Association (IDA), the IMF and the Asian Development Bank (AsDB), denominate some or all of their lending in SDRs. However, as borrowers are encouraged to more actively manage their debt portfolios to reflect individual circumstances, many multilateral development banks are moving in the direction of providing flexibility to determine the currency in which loans are denominated, recognizing that IFIs are better placed to hedge currency risk than many of their clients. Requiring borrowing to be denominated in a particular currency or the SDR could work against this. Reporting financial data in SDRs, as is the case with the IMF, could be considered, but such a move would be largely cosmetic and would make the operations of IFIs somewhat less transparent to the public, who are not generally familiar with the SDR.

Given the overarching profit motive, there are important limits to promoting SDRs for use by the private sector. The market has shown little interest in SDR-denominated instruments to date. An attempt was made in the 1970s by private corporations and commercial banks to issue SDR-denominated liabilities, but these efforts did not catch on, dollar-denominated instruments being overwhelmingly more liquid (Eichengreen 2009a). Large-scale commercialization of the SDR will likely require financial inducements and a long phase-in period.

Where Does That Leave Us?

If the international monetary system was reinvented from scratch, it is possible that the SDR or some SDR-like instru-
ment would play a bigger role. But, as they say, “you can’t get there from here.” Considering how it might be possible to redesign the international monetary system so that the SDR would supplant the U.S. dollar as the dominant international reserve currency is an interesting intellectual exercise. But in the end, the myriad factors that have hampered regular and large-scale SDR issuance since the 1970s are still relevant and will continue to constrain rapid changes in the current framework.

This should not be seen as a defense of the status quo or an endorsement of complacency about current vulnerabilities. Change in the relative importance of individual reserve currencies (and therefore in the SDR) has begun and will continue. There is increasing recognition of the value of foreign reserve diversification.20 As financial markets in major emerging markets deepen, additional currencies will become increasingly more attractive for inclusion in reserves. The renminbi is likely to emerge as such a currency, with the timing largely in the hands of Chinese policy makers. History has shown that the dominant international reserve currency can change and that the existence of multiple reserve currencies can have a stabilizing effect. Indeed, competition between major reserve currencies has the potential to impose policy discipline on reserve currency issuers. In fact, rather than seeking to accelerate the evolution of substitutes for the U.S. dollar, the challenge for the international community may instead be to ensure that the move to a more diverse reserve currency composition is gradual to avoid the volatility that could result from a too rapid portfolio rebalancing. The IMF likely has an important role to play during this move toward increased diversification.

But ultimately, the stability of the international monetary system depends more on the consistency of economic policies among major economies than it does on the currency denomination of international reserve holdings. No self-correcting system will be immune from sustained policy incompatibility; no system that forces surplus or reserve-issuing countries to adjust, or punishes those that do not, is politically feasible. A reformed international monetary system will not compensate for the failure of major economies to accept their shared responsibility for fostering international monetary stability. While still evolving, initiatives like the G-20’s Mutual Assessment Process provide an important forum for discussion and reconciliation, but their potential can only be realized through good faith on all sides. Without the political will for greater policy coherence and consistency, everything else is a sideshow.

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Endnotes

1. More specifically, a long-term contingent liability (in the event that the IMF cancels the SDR allocation, as per Article XVIII of the IMF’s Articles of Agreement).

2. The exception to this was the “special” allocation of SDRs, approved by the IMF’s Board of Governors in September 1997, granting an SDR allocation to members that had joined the IMF after the previous allocation (1979) and therefore had not had the opportunity to participate in the SDR system. This special allocation, to only a subset of the membership, required an amendment to the IMF’s Articles of Agreement, a process that took almost 12 years to achieve.

3. This is a market-based rate, calculated weekly as a weighted average of the three-month Eurocyp rate, the three-month Japanese Treasury discount bills, the three-month United Kingdom Treasury bills, and three-month U.S. Treasury bills. Visit http://www.imf.org/external/np/fin/data/sdr_ir.aspx for a full description of the rate calculation. The use of short-term rates on high-quality securities implies that an SDR allocation has a positive value to members with less favorable access to international capital markets.

4. Once the peg to gold was abandoned, it was redefined as a basket of 16 widely used currencies. In 1981, this was reduced to five currencies; once the euro replaced the German mark and French franc, this was reduced to four currencies (see Boughton [2001, chapter 18] for a full accounting of the SDR’s evolution).

5. IMF Executive Board Decision No. 12281-(00/98), October 11, 2000.


7. Only IMF members and other designated official entities are permitted to hold SDRs (IMF Article XVII, Section 3).

8. 1 SDR = US$1 = 0.888671 grams of fine gold.

9. In many respects, today’s debate on the role of the SDR compared to the U.S. dollar as an international reserve currency mirrors closely that which took place in the 1970s. Boughton (2001, chapter 18) provides an interesting history of that debate.

10. China holds more than a quarter of total global reserves. The precise share held in U.S. dollars is not known because China does not report the composition of its reserves. Nevertheless, it is widely believed that a significant share is in U.S. dollars, some estimate about 70 percent (Kenen 2010).

11. French President Sarkozy, who will chair the G-20 Leaders’ Summit this year, has signaled his support for “an international reserve asset that is not issued by an individual country” (Sarkozy 2010).

12. IMF Currency Composition of Official Foreign Exchange Reserves (COFER) Database; U.S. dollar share of global reserves for which data on currency allocation are available.

13. Subacchi and Driffill (2010) conclude that “a multicurrency reserve system is appropriate for a world of regional trading blocs alongside a still preeminent dollar….Historical experience has shown that two or more reserve currencies can operate simultaneously.”

14. It is also interesting that the Articles of Agreement (IMF Article XIX, Section 3[a]) asserts that “a participant will be ex-
pected to use the SDR only if it has a need because of its balance of payment or its reserve position or developments in its reserves, and not for the sole purpose of changing the composition of its reserves" [italics added]. This suggests a clear desire by the drafters of the IMF’s articles for the SDR to be used to address concerns with the adequacy of reserves, rather than to stabilize the value of reserves through currency diversification.

15. China held 112.7 percent of its SDR allocation at end-April 2011. Russia held only those SDRs allocated to it, France held somewhat less than its full allocation (96 percent), while Brazil held only 90 percent of its SDR allocation.

16. For more on the substitution account, see Kenen (2010, 1–23).

17. A widespread reduction in the share of U.S. dollars in central bank reserves, were it achieved over a short period of time, would have a significant impact on the value of the U.S. dollar. Whether U.S. dollar–denominated assets are substituted with other currencies or SDRs, gradualism would be needed, much as when markets moved from using British sterling as the dominant reserve currency to the U.S. dollar, and as the U.S. dollar has been declining as a share of global reserves for much of the last decade.

18. This is recognized in a recent IMF Staff Position Note, which concludes that the creation of a global substitution account “may not be in the interest of the broader membership as it would socialize costs of adjusting a few large balance sheet positions concentrated in the dominant currency....Ironically, the status quo may offer better incentives toward orderly diversification, as the high costs of moving out of dollar assets too fast make such a move unlikely” (Mateos y Lago, Duttagupta, and Goyal 2009, 19).

19. Indeed, reference to a “monetary triad” composed of the U.S. dollar, Japanese yen and German mark, which marked the transition from the “monetary monopoly of the dollar to an oligopoly,” was seen to be changing the geographic distribution of seigniorage even back in 1996 (de Boissieu 1996, 130).

20. According to the IMF (2010a, 17), “a more diversified allocation across available and new reserve assets would reduce the system’s (and individual country’s) exposure to risks stemming from economic outturns and policies in a single country.”

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