Chapter – V

ROLE OF SDR IN THE INTERNATIONAL MONETARY SYSTEM

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CHAPTER-V

5.1 Introduction

This chapter deals with the study of the Special Drawing Rights (SDR) of the IMF. The basis for SDR creation and its evaluation is explained in the chapter. The allocations of SDR done by the IMF have been also explained. Just like other aspects of the IMF, there are also anomalies in the SDR basis of the Fund and these anomalies have been explained here. The reforms in the SDR structure to make it more efficient towards the need of the member countries have also been explained.

The methodology used in this chapter is a descriptive and analytical method. The database used for this chapter is all secondary data taken from the IMF database and the reports and papers done on the SDR.

5.2 Conceptual Clarification

The SDR is an international reserve asset, created by IMF in 1969 to support the Bretton Woods system of fixed exchange rates. The SDR was a mean to supplement the existing official reserves of member countries since the international supply of two key reserve assets at the time- gold and the US dollar- proved to be inadequate for supporting the expansion of world trade and financial development.

As mentioned in the IMF’s Articles of Agreement, SDR is neither a currency, nor a claim on the IMF. Basically, it is a potential claim on the freely usable currencies of IMF members.

The creation of an SDR is like creating a credit line. It involves the creation of both an asset and a liability. This doesn’t result in any increase to the net reserves of the recipient country. The liability is SDR “allocation”, which is a fixed line of credit. SDRs are allocated to members in proportion to their quotas, on which they are charged the SDR interest rate. Members are at the same time given “holdings” of SDRs, equivalent to their allocation, which increases their gross reserves. These SDR holdings are remunerated at the SDR rate.
5.3 Basis for SDR Creation

In 1969, the two key reserve assets were gold and the US dollar. The supply of these two reserve assets was very low. Apart from gold, any increase in demand for international liquidity could be satisfied only if the reserve center, which was the United States at the time, ran a payment deficit to supply the members with more dollars. These deficits could lead to undermine the confidence in US dollar and hurt the currency more. This was known as “Triffin Dilemma”. This theory was brought forward by the Belgian economist Robert Triffin. He stated that in this situation the world is confronting a choice between running short of liquidity and undermining confidence in the dollar, which was destined to produce a crisis sooner or later.

As a result, the solution was to create a reserve asset to supplement the supply of these two reserve assets especially the gold.

5.4 SDR Valuation

Value of 1 SDR was initially defined as equivalent to 0.888671 grams of fine gold, or equivalent to one US dollar. However, after the collapse of the Bretton Woods system, the SDR was redefined as a basket of major currencies in the international monetary system. Today, this basket consists of the euro, Japanese yen, pound sterling, and US dollar. SDR is valued daily in terms of US dollar and is posted on IMF’s website.

The Executive Board of the IMF reviews the basket composition of the SDR every five years, or earlier if the circumstances calls for earlier review of the formula. Latest valuation of the SDR was done in 2010 and became effective in 2011. The valuation was done based on the value of exports of goods and services and the amount of reserves denominated in the respective currencies that were held by other IMF members. Next review is expected in 2015. Based on the latest review; the weights are USD, 41.9 percent; EUR, 37 percent; JPY, 9.4 percent; GBP, 11.3 percent.

117 The Triffin dilemma or paradox is the conflict of economic interests that arises between short-term domestic and long-term international objectives when a national currency also serves as a world reserve currency.
5.5 SDR Allocation

SDRs are allocated to member countries in proportion to their IMF quotas, under the rules set in Articles of Agreement of IMF.\textsuperscript{118} The allocation gives the members an unconditional international reserve asset. Till date, three allocations of SDR have been done.

The first allocation of SDR was done in 1970-72 for a total amount of SDR 9.3 billion. The second allocation with a value of SDR 12.1 billion was distributed among members in 1979-81. A third round of allocations was done in 2009 to mitigate the effects of the financial crisis with a value of SDR 161.2 billion. These three allocations are also known as the general allocations of SDR.

As part of the Fourth Amendment to the Articles of Agreement of the IMF in 2009, a special one-time SDR allocation was set with a value of SDR 21.5 billion. This was done with the purpose of enabling all members of the IMF to participate in the SDR system on an equitable basis and rectify the fact that countries that joined the IMF after 1981 never received an SDR allocation.\textsuperscript{119}

**Table-5.1 General SDR Allocations of IMF**

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount (Billions of SDR)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970-72</td>
<td>9.3</td>
</tr>
<tr>
<td>1979-81</td>
<td>12.1</td>
</tr>
<tr>
<td>2009</td>
<td>161.2</td>
</tr>
</tbody>
</table>

Source: IMF Database, 2010

5.6 SDR as A Means of International Payment

Any IMF member holding SDRs can exchange its SDRs with another IMF member for a needed currency. This may be due to the difficulties the country faces, especially in the case of the balance of payments problems. The country offering SDRs will reduce its SDR balance and in turn increases its balance of its needed foreign currency; the country receiving the SDR will gain SDRs but loses an

\textsuperscript{118} SDR allocation, Articles of Agreement, (http://www.imf.org/External/Pubs/FT/AA/index.htm#a15s1)
equivalent amount of currency reserves. This process can be voluntary as many IMF members are volunteering to exchange SDRs with other countries in case they need any. If there are no volunteers, the IMF assigns a country to exchange SDRs with the other country. The assigned country is also known as the prescribed holder which is usually a country with sufficiently stronger balance of payments which is in charge of helping the troubled country. This is also called a “designation mechanism”. This mechanism was frequently used during the developing country debt-crisis period of 1980s.\(^{120}\)

This mechanism can be thought of as a reserve-pooling arrangement. A country, which needs hard-currency reserves, can have access from another country to them by just using its SDRs. This mechanism is very useful as it enhances the effectiveness of a given level of global liquidity. However, it does not generally create additional liquidity.

### 5.7 Role of SDR in International Monetary System

When the SDR was created, it was meant to supplement the gold and the US dollar in the international monetary system. The gold reserves were very limited and erratic. Plus, the dollar was posing potential threats to the international monetary system stability since it was piling up large deficits to satisfy high levels of dollar demand all over the world.

However, soon after the creation of the SDR, the Bretton Woods system collapsed and hence the whole rationale for SDR creation was also questioned, since with the collapse of the system dollar reserves exploded, the dollar-gold link was scrapped. Richer and more creditworthy countries adopted flexible exchange rates and took advantage of growing world capital markets, where reserves could be borrowed easily. Hence, countries continued using the US dollar as their reserves instead of using the SDRs. SDRs, however, remained useful for the less-developed countries which did make use of them. But between 1981 and 2009, no further SDR allocation was done. This resulted in lower fraction of SDRs relative to the total global reserves. (Figure 5.1)

Until the recent allocation of SDRs in 2009, the allocations were very infrequent. However, even the recent allocation failed to push the total stock of SDRs to be a large fraction of global foreign exchange reserves. SDRs have never exceeded 6 percent of total global reserves and that global figure declined steadily until the 2009 allocation. Before 2009 allocations, SDRs were less than 0.5 percent of global reserves.\textsuperscript{121} So, the SDR’s role in the international monetary system was very unclear and very limited as the member countries could not lean on these very limited levels of liquidity.

The limited role of the SDRs in the international monetary system was accompanied by accumulation of large levels of reserves especially by the developing countries as a mean to self-insure themselves against future threats and future crises.

This reserve accumulation was very harmful to the international monetary system. At the individual country level, it is very expensive. Plus, the systemic issues raised by large-scale self-insurance are also very dangerous. Reserve transactions can affect interest rates, and shifts in reserve portfolios between currencies could curse large and destabilizing exchange rate movements. If these reserves are accumulated through policy-induced current account surpluses, the resulting global imbalances could have adverse effects. All these problems were motives for the creation of SDRs in the first place. But with the collapse of the Bretton Woods system, the SDRs lost their role in the international monetary system until the recent renewed interest.

5.8 Renewed Interest in SDR

During the global financial crisis in 2008, the US dollar liquidity dried up and the international financial markets could no longer satisfy the needs of the countries in need of liquidity. The US Federal Reserve Board started pumping liquidity to the system by 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 countries started looking to SDRs to provide some of their needed liquidity. As a result of this new interest in the SDRs from the member countries, the third round of IMF allocation was started with an almost 10-fold increase in the stock of SDRs.

Apart from this, in 2009 the Governor of the People’s Bank of China, Zhou Xiaochuan, called for broadening the use of SDR to enable it to fully satisfy the member countries’ demand for a reserve currency. This was the origin of the critics of countries over the financial system of the US and the whole role of the US dollar in the international monetary system. Further critiques of a US dollar-dominated international monetary system have emerged since the speech, including France, Russia, the Brazil which have nominated the SDR as a possible candidate to replace the US dollar as the dominant international reserve currency.

5.9 Anomalies in SDR Allocation

IMF allocates the SDRs to its member countries in proportion to their quotas in the Fund. Each country receives an SDR based on its IMF quota share in the Fund that it can use in the future or exchange with other members of the IMF. However, since the IMF quotas and their distribution have been a serious case of reforms in recent years, it has been proved that the IMF quotas are not fairly distributed. Especially in the case of the emerging market economies and the developing countries, IMF quotas have not realized the recent developments of these member countries in the recent years and hence, these developments have not been reflected in their quotas. These countries are clearly under-represented in the Fund.

The recent two governance reforms in 2008 and 2010 have called for immediate changes in the IMF quotas and the formulas to reflect these changes. However, this has not been achieved yet and the unfair balance of power still exists in the Fund with having many advanced countries being over-represented and many under-represented countries on the other side.

As a result of defects in quotas, the SDRs are also allocated unfairly to the member countries. In April 2009, the IMF allocated USD 250 billion worth of SDRs as a response to the global crisis, and a further USD 34 billion in September as part of its special allocation to members that have never received any SDRs.124 But, the bulk of these allocations went to the advanced economies again. For the developing and emerging economies, this means less SDRs and hence less liquidity for future needs. Therefore, to achieve further role for the SDRs ad a possible replacement of existing reserves by the SDRs, there are first need for reforms. Table 5.2 represents the share of developed, developing and least-developed member countries of the IMF over the three general SDR allocations of the Fund. Share of each country group is also shown over each phase of SDR allocation in table 5.2.

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**Table-5.2 Share of SDR Allocations (Billions of SDR)**

<table>
<thead>
<tr>
<th>Year</th>
<th>Developed Countries</th>
<th>Developing Countries</th>
<th>LDCs</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970-72</td>
<td>5.115 (55)</td>
<td>1.779 (30)</td>
<td>1.395 (15)</td>
<td>9.3</td>
</tr>
<tr>
<td>1979-81</td>
<td>7.26 (60)</td>
<td>3.388 (28)</td>
<td>1.452 (12)</td>
<td>12.1</td>
</tr>
<tr>
<td>2009</td>
<td>111.228 (69)</td>
<td>33.852 (21)</td>
<td>16.12 (10)</td>
<td>161.2</td>
</tr>
</tbody>
</table>

Note: Figures in the brackets are percentage.

Source: IMF Database, 2010

**Figure-5.2 General SDR Allocations to Developed, Developing and LDCs (Billions of SDR)**

Source: IMF Database, 2010

As it can be seen in table 5.2, the share of developed country members of the Fund has increased over the three allocations of SDR. However, the share of the developing country members and LDCs has decreased. The reason is due to the anomalies in the quotas assigned to the members. Quotas are not a fair representative of the share of the global economy these countries are holding, and since they are clearly under-represented in terms of their quota representation, the SDRs allocated to them are as well not a fair share assigned. As a result, the trend can be observed that the share of developing and LDCs have decreased while on the other hand developed nations are receiving higher shares due to their higher quotas assigned to them.
irrespective of their share in the global economy. The anomalies in the governance structure of the Fund are clearly affecting the SDRs system of the IMF as well. Thus, no matter how many SDR allocations take place in the future, there will not be distributed fairly among the members unless the governance of the IMF and the quota structure of the Fund is reformed to be a fair representative of the members in the Fund.

5.10 SDR Reforms

After the global financial crisis, many officials called for an enhanced role of the SDRs and also called for reforms to make the SDRs more useful to the members of the international monetary system. The inadequacies of US dollar as the dominant currency and the threats it was posing to the stability of the international monetary system was also one of the reasons that called for the enhancement of the role of the SDR to replace the dollar as much as possible.

The SDR reform proposals focus mainly on:

- The reform of the IMF quotas as the main and first step
- The reform of the currency basket of the SDR
- Establishment of more regular and special allocation of SDR
- An SDR-based global reserve system

5.10.1 IMF Quotas Reform

Since the SDRs are allocated by the IMF and in proportion to each member’s quota share, the fair distribution of these SDRs is completely dependent on the fair distribution of the IMF quotas. This is something that does not exist today in the IMF quotas. No allocation of the SDRs can be successful until and unless the quota formula is reviewed and changed to reflect the global shift in power that the developing and emerging market economies have made during the last 3 decades. These countries are clearly under-represented and hence are very dissatisfied with the current arrangement and the effects it has on their SDR allocation, their lending and borrowing power and as a whole their share in the IMF. On the other hand, many of the advanced economies are over-represented in the Fund and are affecting the
decisions of the IMF because of their over-represented power, the decisions which will directly affect the less advantaged countries of the IMF.

No matter how many allocations take place in the future, the allocation will not be fair and the bulk of the shares will still go to these advanced countries, and the developing and emerging economies and even the low income countries will suffer. Therefore, the first step in making the SDRs play a more important role is to reform the IMF quotas.

IMF quotas review has been a very important part of the recent reform proposals in the last ten years. There has been a slight improvement in the IMF quotas to give higher power to under-represented members and the low income members not to lose their voice in the Fund. Most of these powers are being shifted from the over-represented members to these countries. However, these reforms have been very small compared to the actual goal. More reforms are on the way especially in 2010 review of quotas that has planned to shift more than 6 percent of the quota shares from some of the advanced members to the developing and emerging members. For these reforms to become effective there is a need for 85 percent of the voting shares to pass this reform proposal. This has not been achieved yet since these advanced economies especially the United States and some of the European countries are not willing to give up their power in the Fund. As a result, this decision along with many other important reform decisions are on hold due to the veto power these countries (especially the US) are holding and are in the way of further improvements.

5.10.2 The Reform of the Currency Basket of SDR

In 2009, the governor of the People’s Bank of China called for an enhanced role of the SDRs in the international monetary system and as a dominant reserve currency. In his speech, he mentioned that the SDRs should be represented to fully satisfy the member countries’ demand for a reserve currency. According to him, the current SDR basket does not fully reflect the role of the emerging economies in the global economy. The number of the currencies should be increased and their shares should also be adjusted for a better reflection.

After his speech, there have been many calls to expand the currencies in the SDR basket. The renminbi is generally the first candidate to be added into the basket.
In 2010, the IMF conducted a review of the SDR basket. Based on their review, although China was the third largest exporter between 2005 and 2009, its currency was rarely used in international transactions. In the second quarter of 2010, the overall use of the renminbi in trade was only about 1 percent of China’s total exports and imports. By the end of 2009, only 0.06 percent of international bonds and notes were denominated in renminbi. The reason for all these low numbers is the existence of significant capital controls that China is still practicing. However, renminbi’s use for trade and financial transactions is growing fast and there is clear potential for the renminbi to play a more significant role in the global economy.

Therefore, due to the low share of the renminbi in the international reserve, this currency is not yet an international reserve currency. So the rationale to index the SDR basket to renminbi is still unclear. Unless China becomes more liberalized in its policies and capital controls, there is no chance of including the renminbi in the SDR basket. However, if renminbi becomes part of the basket of SDR, one of its effects would be to reduce the SDRs variability of the US dollar, as well as the variability against the dollar of any currency pegged to the SDR.

Next in line to join the SDR is India’s Rupee. But at the moment, India’s sizes in exports and reserves are too small for it to aspire SDR membership anytime soon. However, with the current pact these countries have taken recently, the next review of SDR basket should definitely consider adding on new currencies to the basket.

5.10.3 Establishment of More Regular and Special Allocation of SDR

SDR allocation does not follow any special schedule. Since the establishment of the SDR, there have been only 3 general allocations and only one special allocation of the SDR. The first two allocations were done in 1970 and 1978, and the recent allocation was done in 2009. As part of the special allocations of SDRs, there was one which was done in 2009 to mitigate the effects of the global financial crisis of 2008. As seen in figure 1, the SDRs lost their share in total global reserves and hence lost their aiding role in the international monetary system. One of the reasons was due to no allocation especially during the 1980 to 2009.

125 Tweedie, Andrew, 2010, “Review of the Method of Valuation of the SDR,” IMF Finance Department, Washington, DC.
As part of the efforts to make the SDRs to play a larger role in the international monetary system as the countries themselves have called for, the SDRs should be allocated on a regular basis. The decision to how frequent these allocations should be is decided merely by the Executive Board of the IMF.

To avoid the inflationary effects of the regular allocation, the analysts are proposing for a substitution account. These proposals started in 1979-80, as critics of the dollar’s privileged reserve currency role sought to dislodge it, but these proposals were not approved. But with the renewed interest in SDRs, these proposals are once again on board.

Under a substitution scheme, a country might transfer some of its dollar reserves to the IMF, receiving SDRs of equivalent value in return. The country is now long SDRs, and might or might not want to readjust its portfolio in private markets. The IMF is now short SDRs and long on US dollars. However, to achieve this SDR-based system, IMF’s coordination and surveillance is playing a very important role.

Apart from these regular allocations, IMF can plan special allocations like the one which was done only once in 2009. These special allocations can be due to the occurrence of future crisis or then can even be precautionary so that the IMF makes sure the member countries can turn to the Fund for liquidity.

5.10.4 A Move towards an SDR-Based Global Reserve System

The exorbitant privilege enjoyed by the United States, since the US dollar is the dominant currency in the international monetary system and also the threats that the US dollar poses to the stability of the international monetary system as explained by the Triffin dilemma have caused many member countries to want to move away from a US dollar based monetary system and towards a more neutral currency, in this case the SDR.

Another important reason to do so is that in the last two decades, the developing countries have started accumulating high levels of reserves in assets issued by industrial countries, and particularly by the US government because of its low interest rates. This accumulation has worsened in recent years especially since the Asian crisis. Up to the 1980s, developing countries held reserves equivalent to about 3% of GDP, a similar level to that of industrial countries; by 2007, low income and
middle income countries (excluding China) held foreign exchange reserves equivalent to 20.6% and 16.2% of their GDP, respectively, and China has accumulated reserves equivalent to 46.7% of its GDP. Although these accumulations of reserves have helped many countries, they contribute to the generation of global imbalances. This contributes to the instability and volatility of the financial system and hence poses more threats to the system.

A move towards an SDR-based global reserve system where in the SDR replaces the US dollar as the dominant reserve currency gradually can fix many of the above problems. This again calls for regular allocations of the SDRs by the IMF to make sure that this currency is available to guarantee an adequate demand for it, and make sure that all countries maintain an increasing proportion of their foreign exchange reserves in SDRs when they are not borrowing from the IMF. Penalties can also be established to ensure these rules, for example by reducing the allocation to countries that do not meet them.

Another alternative towards a more SDR based system would be to allow the use of SDRs in private transactions, thus turning it into a true global monetary instrument. One reform could be to allow the deposit by financial institutions in central banks to be held in SDRs.

Another way to achieve the goal would be to design SDR-funded IMF lending. IMF lending during crises would create new SDRs, but such SDRs would be destroyed automatically once such loans are paid for. This is an entirely counter-cyclical financing mechanism, complementary to the counter-cyclical issuance of SDRs as reserve assets. These are part of the special allocations that can be done the IMF.

The substitution account is also another step towards this SDR-based system. The account would allow IMF members to substitute foreign exchange by Fund-issued SDR-denominated assets, and by encouraging strong regional monetary arrangements.

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5.11 Conclusion

The SDR will continue to evolve to reflect the multi polar evolution of the international monetary and financial system and even towards an SDR-based system. Diversification of foreign exchange reserves away from the US dollar has already started after the global financial crisis. The US dollar share of allocated global reserves has already fallen from an average of 71.5 percent in 2001 to 61.3 percent in 2010. In its recent review, IMF reduced the share of the US dollar from 44 percent to 41.9 percent in 2010. Inclusion of emerging market currencies such as renminbi and rupee is likely inevitable in the future. Renminbi will be included in the currency basket as soon as China’s capital account is liberalized and its currency is made more flexible.

SDR is gaining more and more attention in the international monetary system. Countries are even starting to peg their currencies against the SDR. More recently, Syria pegged its currency against the SDR. Other international organizations are also seen to be using SDR as their unit of account. They include: African development Bank, Asian Development Bank, bank for International settlements, Common Fund for Commodities, East African Development Bank, Economic Community of West African States, International Center for Settlement of Investment Disputes, International Fund for Agricultural Development, and Islamic Development Bank. Plus, SDRs are used to value penalties or charges in some international treaties and agreements. All of these show the increasing role of the SDR and removes any doubt or proposal to remove SDR as a whole.

However, to move forward and make SDRs more useful there is immediate need for IMF quotas reform. Without this, SDRs role will be very superficial and they will not either reflect the role of the emerging market economies or satisfy all members of the IMF.

Since many other emerging and developing economies have proved to be strong in the international monetary system in the recent years especially during the crisis, many of these countries are also calling for their currency to be included in the currency basket of the SDR. This should be considered very carefully in IMF’s review of the SDR basket expected in 2015 and in future reviews.
However, to say that the SDR will replace the US dollar is very ambitious at the moment. The position of the US dollar as the dominant reserve currency and high levels of US dollar reserves all the member countries hold at the moment are still very high to be easily replaced by the SDR. However, it can be said that the SDR is at least shifting the monetary system towards a multi-polar reserve currency system in which the US dollar has some serious competitions to stay as the dominant currency.