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# Is the SDR a Monetary Dodo? This Bird May Still Fly

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Special drawing rights (SDR), a monetary reserve asset created by the International Monetary Fund, is widely regarded as defunct. However, a case can be made that in the event of a crisis in the world's most important reserve currency, the US dollar, the SDR might still play a useful role by allowing the IMF to provide emergency global reserves that would help liquidity-constrained emerging-market countries that would be suddenly shut out of global capital markets as dollar interest rates soared. An SDR allocation could help to limit the damage from the global economic slowdown many economists and the IMF itself predict would result from a dollar crisis.

SDR was created by the IMF in l969 to make it possible for the Fund to issue a supplemental reserve asset to member states should the availability of reserve currencies or gold be insufficient to meet global liquidity needs. At the time, exchange rates were fixed, the dollar was pegged to gold, and the US currency was the primary reserve holding. Economists worried that a persistent US current account deficit was undermining confidence in the Bretton Woods system of fixed exchange rates. Other central banks would not be willing to hold unlimited quantities of dollars and demand for gold instead might deplete US gold stocks. Lack of confidence in the dollar and a limited gold supply would limit international

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financing for trade, investment, and currency intervention. This liquidity constraint would in turn dampen trade and growth. Under the amended Articles of Agreement, the IMF was permitted to create ("allocate") SDR to meet the need for global liquidity. The IMF can also cancel SDR. SDR is allocated to members on the basis of quota shares.

The evidence is clear that the shareholder governments of the IMF never truly embraced the SDR. Members paid lip service to the idea that SDR would become the principal reserve asset in the international monetary system, as stipulated in the amended IMF Articles of Agreement, Articles VIII and XXII. Actual allocations—a first series in the early 1970s and a second in 1979–81—never came close to making the SDR a principal, let alone the principal, reserve asset. There have been no allocations since, and as Peter Clark and Jacques Polak (2004, 50) note in their paper on international liquidity and the role of the SDR, the approximately $30 billion in SDR holdings are now only about 1 percent of global reserves.[1]

International economists have written off SDR as no longer relevant to the global financial system. The US move off gold in l971, the gradual dismantling of controls on the international movement of capital by the major industrial economies that started in the late l970s, the explosive growth of commercial cross-border loans after the first oil shock, and the move to floating exchange rates have allowed international liquidity to expand with global trade, investment, and demand for reserves. Persistent US current account deficits have meant an ample supply of dollars to the rest of the world. Individual economies have been liquidity constrained from time to time, but since l981 the IMF's periodic reviews of global liquidity have not found global trade or growth to be constrained by the supply of global reserves. Hence, there has been no finding of "long-term global need" as required by the IMF Articles of Agreement to supplement international reserve assets with a new SDR allocation.

Although Michel Camdessus, while managing director, took mischievous pleasure in reminding the Executive Board that the membership was bound by the Articles to make the SDR the primary global asset, I do not believe either of his successors ever mentioned it. The Executive Board has not seriously considered a general allocation since the bloody fight over the resumption of SDR allocations at the annual meetings in Madrid. The Fourth Amendment notwithstanding, I believe it is fair to say that if, by the time I left the Executive Board, the SDR provisions had simply been erased from the Articles, few of my colleagues would have shed a tear.

Yet no one has actually proposed deleting the SDR articles, and the SDR continues to function as the IMF's unit of account. The existing stock of SDR is used routinely in transactions among Fund members.

1. The dollar-SDR exchange rate fluctuates, so this number is approximate.

## Still Alive and Kicking

While the original function envisaged for the SDR in the Articles of Agreement—to meet global liquidity needs—is widely deemed moribund, proposals have been floated by governments and by academics and others from time to time to use SDR allocations to supplement the reserves of particular groups of countries, especially the poorer members. Because the Articles require that allocations must be to all members in good standing on the basis of quota shares, this could be done only through a general allocation followed by a loan or a gift from members not needing the reserve supplement to those that do. Ted Truman, in his overview (chapter 2 of this volume), summarizes these proposals and the objections to them.

The Clinton administration decided to get around the general allocation requirement by championing an amendment that would allow a one-time special allocation of SDR. The Board of Governors approved the Fourth Amendment in 1997 to double the amount of SDR outstanding but used a special distribution formula for the new allocation. It was called an equity allocation, and it allowed members that had joined the Fund after the preceding allocation to catch up with the holdings of older members. The actual goal was to boost the reserves of a group of postcommunist transition countries with weak balance of payments positions. The amendment awaits ratification by the US Congress.

The Fourth Amendment, which has been ratified by 77 percent of the voting power of the IMF membership, and the other proposals to allocate more SDR indicate that the SDR still has some legitimacy as a reserve asset. Ted Truman argues that none of these proposals to invent a new use for SDR will materialize, and he may well be right. But the SDR's utility as an important supplement to global reserves may yet come to be recognized. The moment for a large general allocation may not be as remote as many believe.

## A Looming Dollar Crisis?

Many economists believe that a meltdown of the world's dominant reserve asset is inevitable, that it is just a matter of time. If that were to happen, it would be premature to declare the SDR extinct and its original purpose invalid.

It is true that many currencies now float and gold is no longer a critical reserve asset. Triffin's Dilemma does not come up because there is no obligation on the part of the US Treasury to defend the exchange rate or to sell gold to foreign central banks whose appetite for dollar reserves has been satiated. The availability of gold does not constrain the amount of dollars the United States can emit and has no effect on global liquidity. And yen and the euro are alternative reserve currencies augmenting dollars.

But the more things change, the more they stay the same. Countries still want foreign exchange reserves, and the availability of reserves—earned and borrowed—remains critical to global trade, investment, and growth. The disappearance of Triffin's Dilemma does not mean that the dollar-centered global imbalances do not pose a threat to global liquidity and global growth. Now, as in the 1960s when the SDR was created, the role of the dollar as a reserve asset and the persistent and growing US current account deficits are causing deep anxiety among analysts and policymakers. Despite the recent depreciation of the dollar vis-à-vis the euro and the yen, the US current account deficit is more than 6 percent of GDP. US deficits are absorbing two-thirds of the rest of the world's savings. Private capital inflows are not sufficient to finance this deficit, and foreign central banks are accumulating dollar balances of unprecedented magnitude. The world is awash in dollar liquidity.

Many leading economists argue that the current global imbalances are unsustainable and that a discontinuous adjustment is likely. The IMF's 2005 Article IV Consultation with the United States (IMF 2005a, 4) states that "while the near-term outlook is favorable, the potential for a sharp correction in financial markets in the medium term makes it all the more important to address global imbalances." The needed corrections cited by the IMF and others are (1) increase savings in the United States, (2) boost growth in Europe and Japan through structural measures, and (3) increase exchange rate flexibility in Asia. The likelihood of any one of these happening, much less all three at once, is not great.

The personal saving rate in the United States is at a historic low, and it continues to decline. Far from offsetting this decline, the government sector under the Bush administration has contributed to the national savings deficit with an explosion in public spending and massive tax cuts. Although the fiscal deficit has begun to shrink somewhat in recent months thanks to higher employment and strong corporate profits generating increased revenues, this may be temporary. Higher oil prices are expected to take a toll on growth and profits in the United States, and the immediate costs of Hurricane Katrina and the longer-term expense of rebuilding New Orleans and the Gulf coast will add more red ink to the federal budget. The Iraq occupation continues to drain public coffers while President Bush pledges not to raise taxes to pay for either the war or the hurricane cleanup.

The news is equally discouraging on the others-must-grow-faster front. The IMF's most recent projection for the European Union is 1.2 percent growth in 2005 and 2 percent growth in 2006. The IMF suggests that implementing the European Commission's Services Directive, increasing labor-market competition and flexibility, and lowering tax wedges and social benefits in the largest EU economies would spur Europe into a higher growth path. However, the French rejection of the European constitution and the election impasse in Germany show that popular support in these countries is insufficient to bring about dramatic policy shifts on the structural front. The Japanese economy is showing some signs of picking up but not enough to make a global difference. Japan's growth, like Europe's, remains heavily dependent on US demand.

China has recently opened the door to exchange rate flexibility, but to date the adjustment it has allowed vis-à-vis the dollar has been microscopic. The rest of emerging Asia will not move without China. The Asian currencies essentially remain pegged to the dollar; because of these countries' share of US trade, the depreciation of the dollar will remain too small to make a dent in the US trade deficit unless the Asian countries make adjustments. Emerging markets plus Japan account for nearly half the weights in the Federal Reserve's exchange rate index (40 percent including Japan, 29 percent excluding Japan.)

In short, the corrections to date are far too modest to change the fundamental global payments imbalances. Very large adjustments on all fronts would be needed to overcome the dynamic of the US current account and, hence, to begin to rebalance global accounts. Trade is one problem. The elasticity of US demand for imports is higher than the income elasticity of foreign demand for US exports. As leading economist and former US treasury secretary Lawrence H. Summers (2004) put it: "[O]ur growth sucks in more imports than their growth sucks in exports. . . . Balanced growth means a deteriorating current account deficit."

Global growth is not projected to be balanced. The US growth rate seems likely to continue to exceed the growth rates of Europe and Japan, spelling more trouble on the trade account. The pattern on the income balance is equally troublesome. The net foreign asset position of the United States turned negative around 1989 and is now equal to about 25 percent of GDP. The huge stock of US debt securities in foreign hands means that higher interest rates in the United States will be reflected in the current account. The IMF (2005c) projects that the US current account will continue in deficit at about 6 percent of GDP, and US net external liabilities will reach 50 percent of GDP by 2010.

The US administration dismisses the risk of a disorderly dollar adjustment, and currently even the IMF, noting the slight appreciation of the dollar and recent increase in portfolio investment inflows, sees no immediate threat. A Selected Issues paper for the 2005 Article IV consultation finds that global investment portfolios are not overweight dollar assets, suggesting that private-investor flight from the dollar is not imminent. Pricing in the options markets gives a dollar meltdown low probability. Foreign official holders have their own interests to protect—mainly avoiding currency appreciation and thereby maintaining a competitive edge in selling goods and services to US consumers. Former treasury secretary Lawrence Summers refers to the "balance of financial terror involved in the magnitude of US dependence on foreign central bank holdings" (Ahmad 2005).

Nevertheless, even those most bullish on the US economy do not dismiss entirely the risk of a shock to the system through a sudden reversal of investor sentiment. Many leading economists agree that the US deficits are unsustainable: If the current trend continues, which seems likely, it is just a matter of time before there is a correction. Markets regularly overshoot on the confidence side—irrational exuberance—and then overshoot in the other direction. Any signal to the markets that some significant dollar investor, such as the central bank of China or Korea or an oil exporter, is adjusting its portfolio to down-weight the dollar could trigger a broad market flight from the US currency.

Summers (2004) argued in the Per Jacobsson Lecture that the situation was unsustainable; his views have not changed. In a recent interview (Ahmad 2005) he reiterated, "Whether it's a 25% risk or a 75% risk is hard to say, but I think that we are running a real risk and that the unwinding of the US current account deficit will be associated with substantial disruption."

## Does the SDR Have a Role in a Meltdown Scenario?

What would a substantial disruption involving a sharp depreciation of the dollar mean for the global economy? The IMF tried to answer that question in its September 2005 *World Economic Outlook,* using its Global Economy Model (GEM) to calculate impacts on the United States, the euro area, Japan, emerging Asia, and the rest of the world. The model projects that flight from the dollar would lead to a sharp contraction of world trade and output. A spike in inflationary pressures would require both US and European monetary authorities to tighten, reinforcing the contractionary impact on global output.[2] Growth would slow in all regions.

The *World Economic Outlook* (IMF 2005c, 78) cautions that the GEM does not incorporate private-investor reactions to these shocks, but it says that in this scenario "there is also significantly greater risk of financial market disruption . . . with further negative implications for global stability and growth." No one can predict what role the $220 trillion (notional) derivatives market, including $4.5 trillion in credit derivatives, would play in this scenario. The IMF warns that the rapid expansion of credit derivatives may have increased the possibility of leveraged losses for investors. Federal Reserve officials have also worried publicly about the unknowns of the derivatives market and risks of derivatives amplifying any market shock.

In the past, the response to severe international financial shocks had been for the monetary authority of the main reserve currency, that is, the

2. According to the GEM, protectionism in Europe would increase in response to the dollar collapse, creating room for domestic price increases. This is the explanation for the seemingly contradictory projection of inflationary pressures within the European Union accompanying an appreciating euro.

US Federal Reserve, to increase liquidity in the markets as it did in 1998, and for the IMF to provide temporary and conditional liquidity to individual member countries experiencing a payments crisis. In a dollar shock scenario, however, neither of these responses can be used to prevent a global economic contraction. The Federal Reserve will have no choice but to raise interest rates to keep the inflationary pressures unleashed by a steep dollar depreciation under control. The Federal Reserve will be contracting dollar liquidity, not expanding it, regardless of the impact on other countries. The GEM projects that the European Union will also experience a brief spike in inflation. Appreciation of the euro will help to counteract price pressures, but the European Central Bank (ECB) will hardly be in an expansionary mood, regardless of the global liquidity need. The ECB is unlikely to take on the Federal Reserve's mantle as global lender of last resort.

In today's world, it is the financial markets that ensure the distribution of global liquidity. The dollar has been the vehicle of choice, not just because the United States runs balance of payments deficits, but because of the size and superior openness and efficiency of the US capital market. In the event of a dollar crisis, no other currency can readily substitute. The markets will not distribute global liquidity, and a generalized liquidity crisis may ensue. The impact on emerging markets will be immediate and dramatic.

Despite better fiscal and monetary management as well as stronger balance of payments positions in many emerging-market countries in recent years, they remain vulnerable to market pressures. Emerging-market countries have taken advantage of low market interest rates during the past few years to step up their capital-market borrowing. Bond issuance surged last year as investors looking for yield piled in and risk spreads narrowed. Euro-denominated issues were approximately 25 percent of the total, according to the IMF, but most of the debt is still dollar denominated. Although the reserve position of many emerging-market countries is significantly better than during the 1990s, the overall debt profile of that group of countries is hardly robust. Even as it projected continued strong financial flows on the order of $300 billion to emerging-market countries in 2006, the Institute of International Finance (IIF 2005) struck a cautionary note that "the sustainability of such a high level of flows is now subject to greater downside risks" including "the risk of disorderly exchange rate movements with consequences for interest rates. . . ." The IMF's *Global Financial Stability Report* (IMF 2005b) warns:

> At some point, markets may become impatient with the pace of change [in global imbalances], and asset prices will start to play a more forceful role in bringing about the needed adjustments. In that event, U.S. government bond yields and credit spreads on corporate bonds would likely increase sharply. . . . Higher yields and spreads in the U.S. fixed-income markets would also likely spill over to emerging market bonds, contributing to a deterioration of the external financing environment for emerging markets.

According to the GEM disaster scenario, US interest rates will have to rise dramatically, driving up emerging-market debt servicing and borrowing costs at the same time that US demand for emerging-market exports is shrinking.

The fact that a deep dollar depreciation will reduce the real weight of these countries' external debt—this may have been the wrong time to take on euro-denominated liabilities—will not help in the near term. History tells us that the first response of international investors to global uncertainty is to dump emerging-market securities and to tighten if not halt lending. Run first and do the analysis later. In the dollar shock scenario, liquidity for emerging markets is likely to dry up and a number of countries may face an immediate financial crisis. Even the stronger emerging-market economies will have to dampen domestic demand and that, in turn, will deepen the global economic contraction. If credit dries up, the emerging markets will have to contract as much as or probably more than the United States. Demand in the emerging markets will not help to offset the decline in demand in the United States. Given the greater weight these countries now carry in the global economy, their problems could contribute to a very deep and perhaps extended global slump.

In their recent paper on SDR, Clark and Polak (2004, 51) summarize the worries that led to the creation of SDR: If countries could not obtain reserves adequate to meet their balance of payments deficits, they would "feel the need to throttle down the growth of their economies. And if many countries adopted precautionary measures of this nature, the world economy might become stagnant." Even in the absence of Triffin's Dilemma, a dollar shock is likely to create economic conditions that come as close as any to the circumstances for which the SDR was created. If the IMF's disorderly-adjustment scenario plays out, a significant number of countries will be liquidity constrained and, absent outside intervention, will have no choice but to adopt policies that will be deleterious to the global economy. These are the conditions the IMF was created to address.

Conditional lending is the only tool the IMF has chosen to use in recent years to respond to international financial crises. But conditional lending would not be the right response to a generalized global liquidity contraction caused by the dollar falling out of bed. First of all, a quick response will be needed. Traditional adjustment programs take weeks or months to negotiate, particularly if a large number of countries have to be covered simultaneously. Second, it is not clear that the IMF's quota resources, backstopped by the New Arrangements to Borrow, would be sufficient to meet the liquidity needed to forestall a global recession in the conditions posited in the IMF's disorderly adjustment scenario. Finally, and most important, the traditional adjustment program is just the medicine the doctor should not order if the main goal is to head off a global slump rather than respond to individual countries' financial strains. IMF adjustment programs are almost by definition contractionary. The IMF makes its resources temporarily available while a country "adjusts" to lower exports and reduced access to international credit and investment by reducing imports and increasing national savings.

In domestic circumstances, when economic conditions threaten to trigger widespread credit defaults, the normal policy response is not to arrange emergency financing for individual borrowers but for the central bank to inject liquidity into the markets. The dollar meltdown scenario calls for a similar response. Obviously, dollar liquidity cannot be injected directly, but the IMF has a tool at its disposal that enables it to act in place of the Federal Reserve to ease global market conditions: It has the SDR. There is much emphasis on the word "global" in the literature and articles about the SDR. Surely "global" as in "global illiquidity" or "long-term global need" should not be taken to mean universality or all countries in the world at once. In the disorderly-adjustment scenario, a sufficiently large number of countries are likely to be liquidity constrained so that one can say a "global" need for a response exists. If other reserve assets are not available to provide the needed liquidity, why not use the SDR, which was created for that purpose?

A very large SDR allocation would provide an immediate and cost-free infusion of owned reserves for countries, reducing their need to borrow reserves and helping to reassure markets about countries' creditworthiness.

To spend SDR, countries would have to purchase national currencies with their SDR. If they bought dollars, it would have the effect of increasing the global supply of dollars, which might not be desirable at the time. However, the basic purpose of the SDR emission would be to give countries a cost-free reserve cushion—that is, reserves to hold—while currencies earned or borrowed could be spent.

SDR reserves can be held, used to service official debts, or converted and spent. Clark and Polak (2004, 63) argue, "[R]eserves supplied by SDR allocations would tend to reduce systemic risk and thereby tend to reduce default risk on the part of individual countries." In conditions where systemic and default risk would be at red-alert levels, an SDR allocation could be the best response. The augmentation of reserves with SDR would also reduce the need for countries to try to accumulate their own reserves by running current account surpluses at a time the global economy would benefit from countries other than the United States running deficits.

The impact of a general SDR allocation would obviously be improved if one of the reforms being discussed at this conference had already been adopted—that is, a redistribution of quotas to align quota shares with countries' actual share of global trade and output. The current gross misalignment of quotas means that the bulk of SDR in a general allocation go to the United States, Europe, and Japan—countries that would benefit the least. Consequently, in the circumstances described above, the SDR allocation would have to be very large to have the desired impact on global financial stability and growth. With a better distribution of quota shares in place, a smaller allocation could have the same beneficial effect.

The SDR tool is also more likely to be considered in responding to a global disruption if small, regular SDR allocations have already begun. Polak and Clark (2004) and Boyer and Truman (2005) support the resumption of allocations and the maintenance of a regular schedule. They argue that the existing means of accumulating reserves, whether by saving or borrowing, are unduly burdensome for poorer countries. Returns on borrowed reserves are lower than the cost, and owned reserves divert resources that should be used for investment and consumption. In short, poorer countries could support a higher level of domestic demand and growth if they were allocated SDR reserves, at no cost, to supplement other sources.

I do not disagree. The case for small, regular allocations in normal circumstances and the case for a large, general SDR allocation in response to global financial instability and contraction is essentially the same. In both cases, SDR provide a low-cost financial cushion and can help lower-income IMF members maintain higher growth, to the benefit of the global economy as well as themselves.

## Conclusion

Ted Truman says in his overview chapter that "[t]he issue of SDR is not as central to the reform of the IMF as some of the other issues that have been reviewed in this chapter." This is probably true because it already exists in usable form and would become even more useful if other reforms are carried out.

But it would be wrong to write off the SDR as irrelevant to the international financial system. It may yet come in very handy. This bird may still fly.

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