The IMF and the SDR: What to Make of China's Proposals?

Eric Helleiner

Special Drawing Rights (SDR) are suddenly an important issue in IMF reform debates. At past moments of US dollar weakness in the late 1960s, and early and late 1970s, the SDR also received a great deal of considerable attention. This time around a new voice – Chinese central bank governor Zhou Xiaochuan – played the lead role in placing the issue on the international policy agenda.

In a paper released a few weeks before the London G20 Summit in April 2009, Governor Zhou advocated strengthening the SDR's role in the international monetary system. The paper provoked some strong reactions. Some saw it as an unusually aggressive and blunt challenge to US power and an effort to replace the dollar with a global monetary union. At the other extreme, the paper was dismissed cursorily as an irrelevant attempt to deflect international criticism of Chinese economic policy.

Both of these reactions missed the mark. Zhou's proposals were not designed to revolutionize the world through some kind of world monetary union, but neither were they irrelevant. While Chinese officials no doubt have tactical political reasons for raising the SDR issue, they are offering some very practical policy proposals that deserve serious consideration in debates about the IMF's future. Some are in fact already being implemented and others are endorsed by some of the world's leading economists. Indeed, if anything, the Chinese proposals are more limited than those put forward by many others at the moment.

Determining the SDR's Value

Many of the reactions to Zhou's proposals lacked careful attention to the actual detailed content. His most straightforward and simplest proposal concerns the valuation of the SDR. At the moment, the SDR is valued according to a basket of four currencies: the US dollar (44 percent of the basket), the euro (34 percent), the yen (11 percent) and sterling (11 percent). Zhou proposed that "the basket of currencies forming the basis for SDR valuation should be expanded to include currencies of all major economies, and the GDP may also be included as a weight."

In any event, the SDR's value is due for review in 2010. At the time of the last review in 2005, the role of the four SDR currencies was justified on the basis that their countries had the largest value of exports and they were freely available (while weighting was determined by export value and the amount of other countries' reserves denominated in each currency). But the basket has changed over time; in the 1970s, for example, 16 currencies were involved.

Proposals for a wider and reweighted basket should be discussed in the upcoming review. It is important for the SDR to reflect changes in the relative importance of internationally used currencies. A wider basket might also enable the SDR to serve as a more stable monetary anchor at a time when the relative values of the world's major currencies may well become more variable.

The Allocation of SDRs

Zhou also called for a new SDR allocation and for the approval of the 1997 Fourth Amendment of the IMF Articles of Agreement which allowed for a special one-time allocation of SDR 21.4 billion (in order to bring the cumulative allocation of SDRs of each member in line with its quota share). Both goals are already being realized. In June, the US Congress approved the Fourth Amendment, paving the way for its implementation. The next month, the IMF's executive board approved a new SDR allocation and on a much more ambitious scale than Zhou probably anticipated: approximately SDR 150 billion (US$250 billion).

This new allocation is the largest allocation of SDRs ever (the previous allocations in 1970-1972 and 1979-1981 totaled SDR 21.4 billion) and it will raise the share of SDRs in the world's non-gold official reserves from less than 0.5 percent to about 5 percent. One of Zhou's rationales for a new SDR allocation was similar to those that motivated other G20 leaders: it will help buffer countries from balance-of-payments shocks in the context of the severe global financial crisis.

Zhou also put the case for more SDRs in the broader context of the Triffin dilemma that justified the SDR's creation in 1969; that is, the dilemma that the reserve currency country must provide liquidity to the world while ensuring the stability of its currency. Reiterating this case, Zhou noted that a "super-sovereign reserve currency" like the SDR could be managed "according to a clear set of rules" in order to "ensure orderly supply" without reference to any individual country's distinctive domestic goals or balance-of-payments situation.

A limitation of Zhou's proposal is that he does not follow up this point with any discussion of the content of possible "rules" for SDR allocation. The UN's Stiglitz Commission has been more ambitious, suggesting that SDRs could be allocated either on a regular (for example, annual) and automatic basis, or counter-cyclically with allocations concentrated during crises (or IMF crisis loans could be made in SDRs that would then be removed when the loans were repaid).

Zhou also failed to address the equity issue that SDRs are presently allocated in proportion to countries' IMF quotas. Many developing countries have objected to the very large share of new SDR allocations going to wealthy industrialized countries that need them least. The Stiglitz Commission discusses alternative allocation principles on the basis of GDP or some measure of need, as well as the possibility of investing SDRs in the bonds of multilateral development banks.

An IMF Substitution Account

Zhou's only comment concerning SDR allocation rules is that they could "be shifted from a purely calculation-based system to a system backed by real assets, such as a reserve pool, to further boost market confidence in its value." This recommendation seems to reinforce his broader proposal that the IMF manage a portion of countries' reserves by setting up "an open-ended SDR-denominated fund based on the market practice, allowing subscription and redemption in the existing reserve currencies by various investors as desired."

Proposals for an IMF fund of this kind are not new. Between 1978 and 1980, policy makers discussed in detail the creation of an IMF "substitution account," which

would allow national monetary authorities to exchange dollar reserves for SDR-denominated reserves. Because the exchange was off-market, it would have enabled a diversification of reserves without provoking a dollar collapse at the time. This outcome appealed not just to many dollar-reserve-holding countries, but also to many US officials who feared the "dollar overhang" and the risk of a dollar crisis.

Some experts dismiss Zhou's attempt to revive the substitution account idea as simply an effort to get the IMF and/or world community to share the exchange rate risks that China has assumed by accumulating such large dollar reserves. But the important question from the standpoint of other countries should be whether the initiative will also provide benefits to them and the global system as a whole; that is, whether the proposal is positive sum. Prominent economists such as Fred Bergsten make a strong case that the substitution account will indeed benefit other countries and speak to some systemic needs in the current global predicament.

Bergston highlights the risks to the US and the world as a whole if the large, dollar-holding countries choose to dump their dollar reserves unilaterally. Echoing the case made in the late 1970s for a substitution account, Bergsten argues that disorderly selling of dollars by large reserve holders could generate a sudden dollar collapse that is in no one's interest, including the euro zone whose currency would likely rise dramatically in that event. Indeed, from a political economy standpoint, the risks may be even higher today than in the late 1970s when the key official dollar holders were all close US allies.

The political dilemma, however, is how to share the exchange rate risk that a substitution account would assume if the dollar sinks in value. This question ultimately sank the 1978-1980 negotiations, but it is not insurmountable. If the account lost money, Bergsten notes that the difference could be made up by the IMF's gold reserves or even by new SDR allocations. Given the mutual benefits to be reaped, one could also imagine the US, the large-dollar reserve holders, and Europe reaching a deal on sharing the exchange rate risks assumed by the Fund.

More generally, Bergsten argues that creating a substitution account may provide the opportunity for a broader tripartite deal on IMF reform. He suggests that US endorsement of a substitution account could be accompanied by a greater Chinese contribution to the Fund and a European acceptance to give up some of its quota share to China. It would also be useful to try to include in such a deal provisions to strengthen IMF surveillance of major economies (as a way of minimizing the exchange rate risk to the Fund).

Making the SDR a More Attractive Reserve Asset

The IMF's decision in June to issue non-marketable SDR-denominated bonds to the BRIC countries provides them with an alternative tool for diversifying their reserves in an off-market manner. But, of course, these bonds are not a very liquid form of reserves for national monetary authorities. Neither are SDRs more generally, a situation that Zhou, in his final recommendation, suggests should be addressed.

Zhou recommends broadening the "scope" of the SDR's use at both the official and private levels through initiatives such as issuing of SDR-denominated bonds; estab-

lishing "settlement system between the SDR and other currencies"; and generally promoting SDR use "in international trade, commodities pricing, investment and corporate book-keeping."

These are perhaps the most ambitious of Zhou's proposals. Past efforts to make the SDR a more liquid reserve asset have achieved few results. There is still no private market for SDRs. Various economists have made proposals similar to Zhou's over the years. Barry Eichengreen has suggested the IMF needs to take on the active role of a market-maker, buying and selling SDR claims at narrow spreads that are competitive with those for dollars. These various ideas are worth discussing, but it is important to recognize that the goal of making the SDR a more attractive reserve asset will not be achieved quickly or easily.

Taking Zhou's Proposals Seriously

Governor Zhou's various proposals deserve serious consideration not just on their merits, but also because they have broader political significance. China's frustrations with the existing international monetary system are resonating with many other countries at the moment, including many key powers in the G20. These frustrations could be channeled in several directions, some of which could result in a much more disorderly and unstable world economy. In this political context, it is desirable that pressure for change is directed towards multilateral solutions involving the IMF and help to restore that institution to a more central role in the governance of the international monetary system.

Zhou's proposals for the SDR are very much in this spirit. His thinking follows a tradition of multilateralists from Keynes to Triffin, and sets out some practical ways to work towards the goal laid out in the Second Amendment of the IMF's Articles of Agreement of making the SDR the "principal reserve asset in the international monetary system." Zhou's paper should thus be welcomed as a signal of China's growing willingness to embrace multilateral solutions to global monetary issues. Foreign dismissals of his ideas risk pushing Chinese policy makers in other directions and diminishing the prospects that the IMF will remain an important forum for discussing these and other international monetary reform issues.

Recommendations:

1. Encourage the IMF to engage Governor Zhou's proposals relating to Special Drawing Rights (SDR) valuation, establishing a substitution account and broadening the scope of the SDR's use.

2. Link debates about an IMF substitution account to broader discussions about IMF quota reform, new funding for the IMF, and strengthening IMF surveillance of major economies.

3. Ensure that the IMF remains an important forum for discussing other proposals for international monetary reform, including those put forward by the Stiglitz Commission and others.

Further Reading

Bergsten, Fred (2009). "We Should Listen to Beijing's Currency Idea," *Financial Times.* April 9.

Eichengreen, Barry (2009). *Out of the Box Thoughts About the International Financial Architecture*, IMF Working Paper WP/09/116, May. Available at: http://www.imf.org/external/pubs/ft/wp/2009/wp09116.pdf

Helleiner, Eric and Jonathan Kirshner (eds.) (2009). *The Future of the Dollar.* Ithaca: Cornell University Press.

United Nations (2009). *The Preliminary Draft of the Full Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System*, May 21. Available at: http://www.un.org/ga/president/63/interactive/financialcrisis/PreliminaryReport210509.pdf

Williamson, John (2009). *Understanding Special Drawing Rights*. Peterson Institute for International Economics. June.

Xiaochuan, Zhou (2009). *Reform the International Monetary System.* People's Bank of China, Beijing, May 24. Available at: http://www.pbc.gov.cn/english/detail.asp?col=6500&id=178