Comment

How to improve the attractiveness of the SDR?

G-24 Virtual Roundtable Discussion on "Options to Enhance the Role of Special Drawing Rights (SDRs) in the Global Reserve System"

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Dear Conference Participants

I'm most grateful to the conference organisers for the opportunity to present to you today. The covid-19- induced crisis has reinvigorated calls for the IMF to mobilise more resources. Many IMF members want this to include another SDR allocation. I share the urgency of raising additional resources but I'm sceptical as to the utility of another SDR allocation in large part due to the fact that the value of SDRs used is simply very small. The risk is that a lot of scarce political capital will be spent with little if any practical effect. I will therefore focus on what changes are needed to make the SDR more attractive as a reserve asset and will argue that those should have priority over or at least accompany any new allocations.

The SDR is a fascinating and unique instrument. It is an unconditional credit line that can be used to obtain foreign exchange. Like a bank is creating money by issuing a loan, the IMF issues SDRs by allocating an asset and a liability in the same amount to participants in the IMF's SDR Department that is contingent only in the event the IMF cancels SDRs. Unlike a loan, in principle an SDR never has to be paid back. It is the ultimate form of money creation.

The SDR has evolved in its intended role. SDRs are valued on the basis of a basket of currencies and pay interest at market rates. The composition of the SDR valuation basket itself is a reflection of how the IMF's views have shifted as to what the SDR should be. The basket has changed from 16 currencies in 1974, to 5 in 1981, to 4 in 1999 with the adoption of the euro and in 2016 to 5 again with the inclusion of the renminbi. The SDR started as an asset that should be representative of the number of economies in different parts of the world and not be unduly influenced by the currencies of the largest countries.[1] It later became, amid controversy, an asset meant to compete with the major reserve assets and become a unit of account for the private sector.[2] It never became a serious competitor to any main reserve asset.

The relevance of the SDR is questionable. The SDR has been around since 1969 and has remained mostly insignificant as an international reserve asset. While SDRs increase foreign assets and for some countries may indeed matter, with SDR204 billion total SDRs outstanding

the global economics and financial crisis, looking at net uses of SDRs ,
that is, a reduction in net SDR holdings, of the 2009 SDR allocation of SDR183 billion only SDR1.2 billion was converted into foreign exchange. Since December 2019 to mark the emergence of the covid-19-induced crisis, declines in holdings of SDRs through May 2020 were SDR2.6 billion , of which emerging markets excluding E.U. member countries reduced their holdings by only SDR1.7 billion.

The SDR had a troubled history. The idea to issue more SDRs should be accompanied by a review of what went wrong. In 1989, IMF Executive Director Alexandre Kafka famously noted, "as long as the Fund membership does not have more enthusiasm for the SDR than it has shown recently, the Fund's own basket currency can only remain a 'basket case'."[3] The remarks followed renewed considerations to enhance role and attractiveness of the SDR during the 1980s including through a substitution account.[4] The 2009 allocation has not changed that.

There are obvious well known obstacles to the SDRs' utility. Allocations are small and obtaining needed majorities for allocations is cumbersome and lack flexibility. The SDR can only be used for transactions within the IMF and some designated agencies, so-called prescribed holders, and trading is archaic and liquidity hugely constrained. For the valuation of SDRs, the currency basket composition appears arbitrary and its price is not subject to market forces. The IMF relies on voluntary trading arrangements to offer SDR liquidity with a capacity of only about SDR83 billion.[5] The market and it is my impression central banks are struggling to view SDRs as usable foreign assets implying that any signal effect from holding SDRs is very small at best.

What could be done to make it more attractive? The IMF has led repeated debates about improving the attractiveness of the SDR notably during the 1980s. The proposed changes included adjusting the SDR interest rate and valuation method so that the SDR can be marked to market notably by allowing continuous exchange rate and interest rate fluctuations to be reflected in the price, increasing liquidity by simplifying transactions and allowing brokerage activities, enlarging the number of SDR participants possibly including commercial banks, encouraging central banks to accept SDR-denominated deposits from commercial banks, allow the Fund to maintain a buffer of SDRs and usable currencies to adjust demand and supply and act as market maker, the IMF to issue debt denominated in SDRs, increase promotional steps as the "SDR is shackled with an unfortunate name."[6] In 1982, the IMF staff concluded: "[F]or the SDR to achieve a broader role envisioned by the Second Amendment [of the Articles of

At the time though, only very few of the proposals were adopted. Some may require amending the Articles of Agreement and while possible it would require a considerable effort. Nonetheless, many very good proposals have been around for some time and the debate about improving the SDR should start there.

To enhance the attractiveness of the SDR, three conditions I believe, very much based on earlier proposals, need to be met: i) the SDR basket should be increased to hold a large number of currencies to position the SDR as a highly differentiated reserve asset; ii) the SDR should be marked to market; iii) commercial banks and other financial sector intermediaries should become prescribed holders of SDRs. A broad SDR valuation basket would make the SDR more difficult to replicate and as such adds value towards foreign exchange reserve diversification. Rather competing with reserve assets, the SDR would complement them. If it contained several smaller currencies, some of which may be more difficult to access and less liquid, it would add value. A valuation based on current market exchange rates would help its use as unit of account and enhance its value as a financial product. The increase in SDR participants would strengthen prospects for greater market liquidity and spur interest by the private sector.

To conclude, an SDR allocation does not come for free and risks undermining or diverting from more effective initiatives to raise needed resources. But to make the SDR matter, some proposals that were considered too radical in the past should be revisited today. Some though like large and repeated allocations seem simply very unlikely to succeed. Yet without changing several of its key features, the attractiveness of the SDR will remain mute. The focus therefore should be on doable change.

References

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[2] See Alternate Price, U.K. (IMF, 1980a).

[3] Minutes of the Executive Board Meeting 89/10 (IMF, 1989). Reference found in Boughton (2001).

[4] See for example IMF (1980b, 1982a, 1982b); IMF, 1985)

[5] 2017.

[6] See IMF (1982b).

[7] Idem.