Special drawing rights, the dollar, and the institutionalist approach to reserve currency status

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REVIEW ESSAY

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(I) INTRODUCTION

The dollar’s role as the leading international reserve currency has been called into question by the global financial crisis. In response to concerns about the dollar’s long-term value, discussion has turned to a possible alternative international reserve currency. One of the most prominent proposals has come from the Governor of the People’s Bank of China, Zhou Xiaochuan. Zhou has argued that the global economy should shift away from the dollar, and instead use International Monetary Fund SDRs or ‘Special Drawing Rights’ (Zhou, 2009). The SDR proposal has been endorsed by the United Nations Commission of Financial Experts, chaired by Joseph Stiglitz (Stiglitz, 2010: 157–90). An expanded role for SDRs has also been suggested by a former Managing Director of the IMF and by President Sarkozy of France (Sarkozy, 2010; Strauss-Kahn, 2011). The IMF’s Articles of Agreement have stated since 1978 that it shall be the ‘objective’ of all members to make ‘the special drawing right the principal reserve asset in the international monetary system’ (International Monetary Fund, nd). This paper asks whether the SDR will emerge as the new reserve currency,
or whether, contrary to its proponents, it currently lacks the institutional support to challenge the dollar.

The books under review help to place the SDR proposal in the context of four approaches to reserve currency status. The first three – the market, instrumental, and geopolitical – are taken from The Future of the Dollar, edited by Eric Helleiner and Jonathan Kirshner. The fourth approach, what I call the ‘institutionalist’, is exemplified by Barry Eichengreen’s Exorbitant Privilege. The institutionalist perspective claims that institutions can enhance the reserve status of a currency by creating liquid markets and by intervening quickly in financial crises.\(^1\) Since the Federal Reserve issues the prevailing international reserve currency, I will use it to illustrate the institutionalist approach. To motivate my analysis of how the Federal Reserve acted as an institution to enhance the reserve status of the dollar, I will discuss a recent example from the 2007–2009 financial crisis and a historic example from Eichengreen.

The importance of institutions raises the question of whether SDRs are backed by sufficient institutions to become a dominant global reserve currency. Could the IMF promote SDRs, the way the Federal Reserve bolstered the international status of the dollar after its founding? Could the IMF act as a lender of last resort, providing the kind of liquidity in a financial crisis that the Federal Reserve did after 2007? I argue in this paper that the institutionalist approach identifies key limits that may prevent SDRs from replacing the dollar in the near or foreseeable future. Unlike the Federal Reserve, the IMF does not presently have the power as an institution to create liquid markets in a currency or to support a currency’s reserve status by intervening quickly in financial crises. However, I will suggest in my conclusion that the institutionalist approach may guide reforms to the IMF that have the potential in the longer run to increase the international status of the SDR.

(II) FOUR APPROACHES TO RESERVE CURRENCY STATUS

(a) The institutionalist approach to reserve currency status

I will first outline Helleiner and Kirshner’s three explanations for currencies’ reserve status, and compare them to the institutionalist approach. While these explanations are not mutually exclusive, they are distinct in underscoring different determinants of reserve status. The first, market-based approach is taken by economists who emphasize the importance of private actors, as opposed to governments. This approach assumes that private actors – such as investors in the bond market, export-importers, or commodity traders – make decisions to use a currency based on its economic attractiveness compared to other currencies (Helleiner and
Kirshner, 2010: 7). The economic attractiveness of a currency depends on (1) its stability as a store of value; (2) its liquidity or how easily it can be bought or sold without changing prices; and (3) its network externalities or the fact that many other market actors are already using the currency, making transactions in it more convenient (Helleiner and Kirshner, 2010: 7–11). Confidence in the dollar, under a market-based approach, would be undermined by rising current account deficits and government debt.

While the market-based approach emphasizes private actors, the second, instrumental approach instead focuses on the decisions of foreign governments as they pursue economic goals (Helleiner and Kirshner, 2010: 12). According to the instrumental approach, the dollar’s reserve status would strengthen if foreign governments decided to peg their own currencies to the dollar, or if they continued to purchase dollar debt. Foreign governments may be motivated to support the dollar, based on the monetary peg theory of Ronald McKinnon, or the Bretton Woods II theory of Michael Dooley, David Folkerts-Landau, and Peter Garber. The Bretton Woods II theory argues that countries like China and Japan buy US treasuries with the economic goal of preventing their national currencies from appreciating. A lower value for the renminbi and yen makes Chinese and Japanese exports cheaper and more competitive in the US market (Helleiner and Kirshner, 2010: 12). An alternative instrumental account of reserve currency status is given by McKinnon’s monetary peg theory. It claims that countries peg their currencies to the dollar as a means of stabilizing their price level, preventing significant inflation or deflation (Helleiner and Kirshner, 2010: 13; Ronald McKinnon, 2010: 45–68, esp. 64).

A third approach that seeks to explain why currencies gain or lose international reserve status focuses on geopolitical factors. While the instrumental approach highlights the decisions of foreign governments to support a currency based on economic goals like promoting exports or stabilizing the price level, the geopolitical approach bases the decisions of foreign governments on considerations of security, political power, and military alliances (Helleiner and Kirshner 2010: 15–7). For instance, Kirshner claims that Western Europe and Japan supported the dollar in the Cold War, because of their alliance with the US. But now that the Soviet threat is gone, the alliance has weakened. In Kirshner’s view, Western Europe and Japan are less likely to bolster the dollar, and are more interested in expanding the international status of the euro and yen (Helleiner and Kirshner, 2010: 15–6; Kirshner, 2010: 195).

An ‘institutionalist’ approach argues that a currency’s reserve status may be bolstered by the institutions that issue the currency. This institutionalist approach differs from the instrumental and geopolitical perspectives in focusing on the decisions of the institution that supplies the currency, and not the decisions of the foreign governments that potentially demand the currency. It also contrasts with the market-based approach, because it shows
how confidence, liquidity, and network externalities are not determined solely by private actors in the market. Rather these market factors can be supported or undermined by institutions. After describing in greater detail the institutionalist approach, I will then apply the institutionalist approach to debates over the IMF Special Drawing Right.

(b) How the Federal Reserve, as an institution, enhanced the dollar’s reserve status

To see how institutions might enhance the international role of a currency, consider the Federal Reserve’s actions to increase dollar liquidity after the recent financial crisis. Since the dollar is the international reserve currency, it is crucial for foreign businesses and banks to be able to borrow funds in dollars. For example, when a South Korean company imports goods from Thailand or services its bonds, it generally does not pay in South Korean won, but in dollars. Most exports from South Korea and Thailand (80 per cent) are priced in dollars, even though only 20 per cent of those goods go to the US (Eichengreen, 2011: 2, 168). For businesses and banks to service their obligations, they need access to dollars. The problem is that in a financial crisis, banks and financial markets are unwilling to loan dollars, causing a severe shortage of dollar liquidity. If it persists, both foreign and domestic businesses may default.

The key institutional role of the Federal Reserve in a financial crisis is to ease the shortage of liquidity by lending dollars on a vast scale. As Ben Bernanke, the Chairman of the Federal Reserve, declared in a speech, ‘serving as a “lender of last resort” has been central banks’ key weapon against financial panics for hundreds of years’ (Bernanke, 2010a). Although foreign central banks may loan dollars out of their foreign exchange reserves, there is a danger that their reserves may be exhausted in a financial crisis. If a foreign central bank’s dollar reserves drop below a safe minimum, there may be a run on the currency and an even deeper financial panic.

The Federal Reserve’s solution to this problem was to meet the world’s demand for the dollar liquidity by establishing ‘central bank liquidity swap lines’, beginning in 2007–2010, and extended from 2010–2012 (Bernanke 2010b). The swap lines provided dollar liquidity for 14 central banks, including the European Central Bank, the Bank of England, the Bank of Korea, and the Bank of Japan (Board of Governors of the Federal Reserve System, 2011). Drawing on the swap lines, a foreign central bank could sell its national currency to the Federal Reserve in exchange for dollars. The dollars could then be loaned to a country’s banks and businesses, easing the dollar liquidity shortage and stemming the threat of default. After an agreed-upon time period, 1 to 84 days later, the foreign central bank is obligated to buy back its currency at the same exchange rate,
returning the dollars and paying a market-based interest rate to the Federal Reserve.

The largest amount of dollars that the Federal Reserve extended at any one time in swaps was $580 billion in December 2008 (Fleming and Klagge, 2010). But what is less widely known is that the cumulative value of the 569 swap lines extended from 2007–2010 was over $10 trillion ($10,057,401,900,000) (Board of Governors of the Federal Reserve System, 2011).² Admittedly, this money was lent over three years and not simultaneously, and it was all paid back with interest. But the total size of the swap lines, amounting to $10 trillion worth of transactions, indicates the major institutional role of the Federal Reserve in promoting the international reserve currency status of the dollar. The Federal Reserve supported the dollar’s reserve status by guaranteeing sufficient dollar liquidity during the financial crisis.

This institutional role is not new. One of the notable contributions of Eichengreen’s *Exorbitant Privilege* is to show that the Federal Reserve pioneered the international reserve currency status of the dollar by supporting the currency’s liquidity soon after its founding. For a currency to be liquid, there must be a large market in assets denominated in that currency, so that they can be rapidly bought or sold, and converted into cash, without significantly changing their price. A large market requires many buyers and sellers who are willing to trade in those assets. But when a currency is in the early stages of taking an international role, that market might not exist, or the buyers and sellers might be too few to provide sufficient liquidity. Since the assets are less liquid and are relatively novel, investors must be paid a premium to hold them. This interest rate premium makes it more expensive and less appealing to raise funds in bonds or commercial paper denominated in that currency.

The market-based approach acknowledges that liquidity is one of the key qualities required in a reserve currency. But it does not explain how liquid markets in a currency originate. Perhaps one potential explanation is that, once an economy grows sufficiently in size, investors will create a large and liquid market themselves. However, this explanation is belied by how the US had surpassed Britain in GDP by 1870, but lacked an international market in dollar assets until 1913, when the Federal Reserve was created. The insight of the institutionalist approach, I contend, is that it shows how liquid markets in a currency can arise. Institutions can increase the size and liquidity of a market in two ways. First, they can trade large quantities of assets denominated in a currency like the dollar, reassuring investors that they can easily find a buyer or seller. Since the market is liquid, investors do not need to worry that selling would be difficult, or that it would reduce the price of their remaining assets. Second, institutions can also work to educate investors about a new asset. Investors who are more familiar with an asset will then reduce the risk premium of raising funds in it, and this
encourages the market to grow further. As the market grows, its liquidity increases, attracting more investors in a virtuous circle.

The institutionalist account of how institutions can create liquid markets, expanding a currency’s international status, is illustrated by the Federal Reserve’s efforts to promote the dollar trade acceptance market, as described by Eichengreen. Acceptances were crucial in funding trade, since exporters needed funds to pay for shipping and other bills before the exported goods arrived overseas (Eichengreen and Flandreau, 2010: 3). To provide credit to exporters, banks created financial instruments called ‘trade acceptances’. Before the Federal Reserve Act of 1913, American merchants could only acquire trade credit overseas in a foreign currency, most often pounds sterling in London (Eichengreen 2011: 14–5). This greatly limited the international role of the dollar in financing trade. The Federal Reserve Act changed US financial law, permitting American banks to create dollar trade acceptances, but the market was initially small and illiquid.

At this stage, the Federal Reserve stepped in to increase the liquidity of the dollar trade acceptance market as educator and market maker. It aggressively promoted dollar-denominated trade acceptances to expand US trade and to increase the dollar’s international influence (Eichengreen, 2011: 29). The Federal Reserve pursued these aims by educating investors about dollar trade acceptances and their attractiveness as investments. It also expanded the market by buying trade acceptances on a large scale. Within a few years, ‘the Federal Reserve Banks were the dealers’ dominant counterparty’ (Eichengreen, 2011: 29). The Federal Reserve’s purchases stabilized and lowered the discount rates of dollar trade acceptances, making the market more attractive. As liquidity increased, the market grew quickly. Although no US trade was financed by dollar acceptances before 1913, ‘by the second half of the 1920s, more than half of all US imports and exports were financed by bank acceptances denominated in dollars’ (Eichengreen, 2011: 30).

Advocates of the market approach might reply that US exporters would have turned to dollar trade acceptances without the Federal Reserve. Replacing sterling with dollar acceptances had the advantage of removing exchange rate risk for American traders. However, this criticism of institutionalism overlooks how the market in trade acceptances grew much more rapidly because of the Federal Reserve’s intervention. As Eichengreen writes, the dollar rose to rival sterling in the mid-1920s ‘as a result of some very concrete actions by the Fed to promote the dollar’s international role’ (Eichengreen, 2011: 6). In particular, he calculates that Federal Reserve purchases of trade acceptances led banks to increase their holdings of acceptances twice as quickly as they would have without government action (Eichengreen and Flandreau, 2010: 18). Banks were more willing to deal in dollar trade acceptances, knowing that the market was liquid and
that they could rely on the Fed to purchase acceptances. By increasing the liquidity of the trade acceptance market, the Federal Reserve acted as an institution to enhance the international status of the dollar.⁴

The institutionalist approach raises the question of whether SDRs are backed by sufficient institutions to become a dominant global reserve currency. In the next section, I begin by defining SDRs and outlining proposals to expand their use. I then follow Eichengreen in expressing skepticism about whether SDRs can replace dollars as a global reserve currency in the near or foreseeable future. The main problem, I will argue, is that the IMF as an institution currently lacks certain key powers possessed by the Federal Reserve. However, I will conclude the paper by suggesting the possibility that if the IMF makes major institutional reforms in the much longer term, it could increase the international role of the SDR.

(III) WHY SDRS ARE NOT CURRENTLY A VIABLE ALTERNATIVE TO THE DOLLAR: AN INSTITUTIONALIST CRITICISM

(a) What are SDRs?

Since SDRs are an unusual asset, with several properties that distinguish them from a freely usable currency, it is important to start by defining what SDRs are and how they are valued, before explaining why Zhou and Stiglitz have sought to expand their role. I will argue that Eichengreen overlooks two crucial properties in his definition of SDRs – first, they are not claims on the IMF, as he believes, but potential claims on the freely usable currency of IMF member states. Second, he does not discuss how countries must pay interest on the SDRs they have sold. Because Eichengreen overlooks this property of SDRs, he does not mention a key disadvantage associated with their misuse: the rising debt burden from SDR interest payments.⁵ This disadvantage may grow if the general allocations of SDRs greatly increase. After clarifying the definition of SDRs, I will outline Zhou’s and Stiglitz’s proposals to expand the role of SDRs as an international reserve asset. I will then suggest the limits of these proposals by using an institutionalist approach.

SDRs are a composite reserve asset that was first created by the IMF in 1969. Its value was initially set at one SDR = .888671 grams of gold, then equivalent to one dollar (IMF, 2010a). After the replacement of the Bretton Woods system with floating exchange rates, the IMF redefined the SDR in 1973, basing its value on a basket of sixteen currencies. At first, the basket’s inclusion of many minor currencies made it excessively complex (Eichengreen, 2011: 138–9). To simplify the asset and encourage its use, the IMF in 1981 narrowed the SDR’s basket to five currencies: the German mark, French franc, British sterling, Japanese yen, and US dollar. Today
the SDR basket is composed of four currencies, with the euro taking the place of the mark and the franc. The Executive Board of the IMF reviews the percentage of the currencies in the SDR basket regularly every five years to reflect their importance to the world economy, as measured by the currencies’ share of global exports and foreign exchange reserves (IMF, 2010a, 2010b). After the latest revaluation in 2010, the basket of currencies is now 37.4 per cent euro, 9.4 per cent yen, 11.3 per cent sterling, and 41.9 per cent dollars (IMF, 2010b).

To avoid misunderstanding, it should be emphasized that the basket serves only as a basis to calculate the SDR’s value. The SDR is not literally a bundle of currencies, such that, when a country holds SDRs, it automatically possesses a certain amount of euro, yen, sterling, and dollars. Nor is the SDR backed by currencies held by the IMF. Rather, SDRs are potential claims on the freely usable currencies of other IMF members. For SDRs to be exercised, a state must first sell SDRs to another state in exchange for dollars, euros, or other currencies (Eichengreen, 2011: 138). SDRs cannot be used directly in transactions involving private parties, such as market intervention and the financing of international trade (Eichengreen, 2011: 7, 57; IMF, 2011a: 7). This is because private parties are not authorized to hold SDRs under Article XVII of the Articles of Agreement (IMF, 2009a: 13). Only states that are members of the IMF and certain international organizations can hold SDRs.6

Since SDRs are not privately held or traded, states cannot rely on banks or the open market to convert special drawing rights. Nor can states sell their SDRs to the IMF. The role of the IMF is limited to facilitating the conversion through either one of two means – voluntary trading arrangements or the designation mechanism. Under the voluntary trading arrangements, the IMF can match two states that want to conduct a voluntary exchange of SDRs for a freely usable currency (IMF, 2009a: 14–5). If Australia wants to sell SDRs for dollars, it would contact the IMF, and the voluntary trading arrangements would find a suitable exchange partner (say, China), that would purchase the SDRs. This process typically takes 5 to 10 business days. If there are no countries that want to voluntarily purchase SDRs in the amounts needed, the IMF can activate its designation mechanism. The IMF would designate a country with a strong external position to buy the SDRs in exchange for dollars or other freely usable currencies.

The designation mechanism has not been activated for nearly a quarter century, and the IMF is reluctant to invoke it (IMF, 2009b: 23). However, the designation mechanism may be more problematic in the future if SDR allocations were to increase greatly. States might then seek to exchange their SDRs for freely usable currency on a scale exceeding the capacity of the voluntary arrangements. Under the designation mechanism, other states could be required non-voluntarily to purchase much larger amounts of SDRs. Although Eichengreen does not discuss this issue, the IMF admits
the problem when it reports that ‘expanding the volume of SDR allocations would increase the contingent claim on all other participants in the SDR department, who could be required under the designation mechanism to provide freely usable currencies’. The IMF notes that ‘this requirement could quickly become burdensome’ (IMF, 2011a: 7). Given the possibility that the designation mechanism could become burdensome, a number of surplus account states may refuse to vote for future SDR expansions. States seeking to sell their SDRs may be unsure whether they will be able convert their holdings reliably into freely usable currency. This difficulty may make states more reluctant to replace the dollar with SDRs in their reserves.

(b) A criticism of Eichengreen’s definition of SDRs

While Eichengreen is clear in explaining how SDRs are valued, and how they cannot be used in transactions with private parties, he introduces some confusion in defining SDRs themselves. He defines SDRs as ‘bookkeeping claims on the IMF’ (Eichengreen, 2011: 137). The problem with defining SDRs as ‘claims on the IMF’ is that it may mistakenly suggest the IMF is obligated to exchange SDRs on demand for the currencies in the basket or for their equivalent value in dollars, the same way that the US Treasury was obligated to exchange dollars for gold on demand during the Bretton Woods era. In fact, the IMF explicitly states that the SDR ‘is not a currency, nor a claim on the IMF’ (IMF, 2011b). Instead, it is ‘potentially a claim on freely usable currencies of IMF members’ (ibid.). An exchange of SDRs for freely usable currencies does not draw on the IMF’s own resources, but depends on states buying SDRs through either the voluntary trading arrangements or the designation mechanism. Rather than defining SDRs as ‘bookkeeping claim on the IMF’, it would be more accurate to define SDRs as a composite reserve asset, which is potentially a claim on freely usable currencies of IMF members.

In defining Special Drawing Rights, Eichengreen also overlooks the important fact that a state’s SDRs have two components – one of which is an asset, and the other a liability. The asset consists of a state’s holdings of SDRs. The holdings can change, increasing when the state buys SDRs or decreasing when it sells SDRs. It is an asset, because the IMF pays every member state interest for its SDR holdings. The second component is a state’s allocation of SDRs. A state’s allocation is assigned by the IMF, and does not change when a state buys or sells SDRs. It is a liability, since a state is charged interest on its SDR allocation. The SDR interest rate charged on allocations is the same as the rate paid on holdings. The interest rate is calculated ‘based on a weighted average of representative interest rates on short-term debt in the money markets’ (IMF, 2010a).
Normally, states do not earn or lose any money on SDRs, as long as their SDR holdings and allocations are equal. States are credited for quarterly interest on their SDR holdings, but they are charged the same quarterly interest on their SDR allocations, leaving no net interest payments. When the IMF creates SDRs, making what is called a ‘general allocation’, it simultaneously raises a state’s holdings (assets) and allocation (liabilities) by the same amount. Suppose that the IMF creates 100 billion SDRs in a general allocation. It distributes one billion SDRs to Australia, and one billion SDRs to China. Australia now has one billion SDRs in holdings, and one billion SDRs in allocation. The interest that the state pays on its allocation is equivalent to the interest it receives from its holdings, resulting in no net interest payments for Australia.

This situation changes when a state sells part of its SDR holdings. Suppose that Australia decides to sell its entire SDR holdings, converting them to dollars. It invokes the IMF voluntary trading arrangements, and sells one billion SDRs to China in exchange for dollars (about $1.6 billion at current rates). After the sale, Australia’s holdings or assets in SDRs have dropped to zero, and earn no interest. However, its allocation of SDRs remains the same, at one billion SDR, and Australia must pay interest on its liability. The country now has a net interest payment, which it is charged every quarter until it ‘reconstitutes’ its SDR holdings. Australia would reconstitute its holdings if it bought back enough SDRs to match its allocation.

When Australia incurs an SDR deficit, the interest payment goes to the IMF, but it is ultimately transferred to China. This occurs because China’s SDR holdings doubled after it bought SDRs from Australia. China then earns interest on two billion SDR of holdings/assets, but it pays interest on only one billion SDR in allocation/liabilities. The general rule is that states earn quarterly interest when their SDR holdings exceed their allocations. States are charged quarterly interest when their SDR holdings fall below their allocations (IMF, 2011b). In this process, the IMF does not need to make interest payments from its own resources. The interest earned by SDR surplus states is paid exclusively by the interest charged to SDR deficit states, though the IMF does serve as an intermediary (IMF, 2009a: 13).

The dual nature of SDRs as both an interest-earning asset and interest-charging liability is highly relevant, because it raises concerns about the potential misuse of SDRs, which Eichengreen does not discuss. Low-income countries (LICs) or states that are financially unsound might sell enough of their SDRs to incur interest charges that they may not be able to pay. These states may not be in a financial position to buy back their SDR holdings and end their interest payments. Even if they can pay the quarterly interest, the charges may be high enough to consume a large portion of a government’s budget, reducing economic growth. As the IMF warns, the misuse of SDRs may ‘[contribute] over time to an unsustainable
debt burden (e.g., as the SDR rate rises)’ (IMF, 2011a: 8). In this case, ‘not only may macroeconomic stability be compromised, but also potentially the member’s ability to pay charges on their allocations or eventually reconstitute their holdings’ (IMF, 2011a: 8).

Some might contend that debt sustainability is not currently a problem with SDRs, due to the low SDR interest rate. The SDR interest rate is only 0.42 per cent (IMF, 2011c), and it might be argued that the low rate makes SDR debts sustainable. The total number of SDRs in circulation is also limited to 204 billion, comprising ‘less than 4 per cent of global reserves’ in 2011 (IMF, 2011a: 6). Since the number of SDRs is small, the scope for their misuse is thought to be narrow. The difficulty with this argument is that the SDR interest rate is only temporarily low. The SDR interest rate is based on the three-month treasury bills of the US, UK, and Japan, and the three-month Eurepo, a representative interest rate in the European money market (IMF, 2011c). Interest rates on these bonds are unusually low due to the recession. The SDR interest rate has traditionally averaged 5.5 per cent (IMF, 2009a: 7–8). At these higher interest rates, the debt burden on low income countries would be heavier if they sold their SDRs.

While low income countries may not incur large debt burdens as long as their allocations are relatively small, the Zhou and Stiglitz proposals would greatly increase the number of SDRs. The size of the general allocations needed to make a meaningful change in the compositions of reserve assets, as the proposals envision, would be staggering. Even if the IMF were to increase the share of SDRs in global reserves from 4 per cent to only 13 per cent, the expansion would require the IMF to allocate the equivalent of $200 billion (about 133 billion SDR) every year for the next 15 years (IMF, 2011a: 6). In that event, the SDRs in circulation would exceed two trillion. Low income countries would have much larger SDR holdings, and if they sold them, they could incur unsustainable debts burdens. This problem would be exacerbated by the fact that the IMF Articles of Agreement give states the unconditional freedom to use their SDRs (IMF, 2011a: 9).

(c) Why Zhou and Stiglitz want to expand the role of SDRs

Given the issue of debt sustainability, why would Zhou, Stiglitz, and the UN Commission of Financial Experts propose that SDRs replace the dollar as the leading international reserve currency? The primary reason they cite is the instability of the current international financial system. Since the end of Bretton Woods, there have been an increasing number of financial crises, with the 2007–2009 financial crisis being the most severe.7 A major cause of financial instability is the growing imbalances that have been created by the use of a national currency, the dollar, as the dominant international reserve currency (Stiglitz, 2010: 157). The dollar’s dual functions as both a national and international currency raise a crucial
problem, called the ‘Triffin Dilemma’. Named after the economist Robert Triffin, the dilemma is that the United States must run a large current account deficit to satisfy the global demand for liquidity in the international reserve currency. On the one hand, if the US supplies sufficient dollars, the rising current account deficit will undermine long-term confidence in the dollar, threatening its value. On the other hand, if the US does not supply the demand for dollars, the world’s money supply will shrink, causing deflation, reducing economic growth, and slowing global trade and finance (on the Triffin dilemma, see Blyth, 2003: 240; Eichengreen, 2011: 50–4; Stiglitz, 2010: 157–8; Zhou, 2009: 1).

Both Zhou and Stiglitz believe that the Triffin Dilemma could be avoided if the global economy relied on a super-sovereign reserve asset (Stiglitz, 2010: 158). The asset would not be issued by a single state, or function as a national currency. Instead, it would be an international asset issued by the IMF. The Fund would regulate the supply of global liquidity according to a clear and orderly set of rules (Zhou, 2009: 1). This would eliminate the problem, found in a dollar dominated system, of the United States producing too little or too much global liquidity. The US produces too little liquidity when the Federal Reserve reduces the money supply to fight domestic inflation, as it did in the early 1980s under Paul Volcker. This lack of liquidity places deflationary pressure on the world economy. The US produces too much liquidity when the Fed expands the money supply to counter domestic recessions, as it arguably did in the 2000s after the dot com crash. This places inflationary pressure on the world economy. In either case, the problem is that the issuer of the reserve currency might pursue national economic goals that are at odds with broader global needs. If a super-sovereign reserve asset replaced the dollar, the global supply of liquidity would match global demand more closely, leading to a more stable international economy. Zhou claims that ‘the SDR has the features and potential to act as a super-sovereign reserve currency’ (Zhou, 2009: 2; see also Stiglitz, 2010: 158).

Besides providing a more consistent source of liquidity, expanding the use of SDRs, according to Zhou, could address the problem of maintaining the value of international reserves. This is particularly an issue for China, which has built up vast dollar reserves by exporting goods to the United States. It is estimated that ‘65 percent of China’s $2.5 trillion of reserves are in dollar-denominated assets’, and China controls ‘nearly half of all US treasuries in the hands of official foreign owners’ (Eichengreen, 2011: 135). China is worried that its dollar reserves might drop sharply in value as a result of US debts (Stiglitz, 2010: 164). The United States is running enormous fiscal and current account deficits, partly to supply the world with liquidity (as predicted by the Triffin Dilemma), and partly to finance wars, tax cuts, and anti-recessionary spending. The US might be tempted to inflate away the real value of its debt by expanding the money supply.
Investors fearing inflation would respond by selling their dollar assets, and the value of China’s dollar reserves would plunge.

While China might preemptively sell its dollar assets before their value eroded, it would be a costly strategy. To alter its reserves, China would have to sell a massive number of treasuries, triggering the very sell-off it wants to avoid (Eichengreen, 2011: 135). The solution that Zhou proposes to this difficulty would be for China to exchange its dollars for another reserve asset slowly, away from the market. An IMF ‘substitution account’ would allow China to trade its dollar treasuries for SDR-denominated bonds. China could then diversify its reserves outside of the market, and reduce the risk that its portfolio would be harmed by dollar depreciation (Zhou, 2009: 3).

The substitution account, however, would be an imperfect solution to dollar reserve depreciation. I would caution that if China resorted to a substitution account, investors might lose confidence in the dollar, and sell it off. The problem might not be as sudden as in the case of China selling its dollar assets on the open market, but investor confidence is in part based on what others are doing, and if the largest holder of dollar assets were to divest through a substitution account, investors would take it as a sign that the dollar could not be trusted to maintain its long-term value.

In addition to supplying a reliable source of global liquidity and attempting to stabilize the value of international reserves, another reason to expand the use of SDRs, cited by Stiglitz but not Zhou, is the issue of equity or fairness. Under a dollar reserve system, states must maintain sizeable dollar reserves to guard against capital outflows during financial crises. States need dollars to pay for imports, commodities, and international loans, which are largely priced and settled in dollars. During a financial crisis, banks and the bond market may be unwilling to loan dollars, except at punitively high rates. States could turn to the IMF, but the loans are subject to pro-cyclical conditions that would impose austerity, force drastic cuts in expenditure, and prolong recessions (for a criticism of austerity policies, see Blyth, in press). Rather than depending on the IMF or the market for dollars during an emergency, states learned the lesson after the 1997 East Asian financial crisis that they should hold large dollar reserves (Stiglitz, 2010: 161–2). As a result, exporting states have accumulated nearly $800 billion of additional reserves a year, close to tripling their dollar reserves from 5.6 per cent of world GDP before the East Asian crisis, to 13 per cent of world GDP at the end of 2009 (Stiglitz, 2010: 162).8

Stiglitz argues that the dollar dominated system is unfair, because it forces countries to accumulate large dollar reserves instead of investing domestically. The dollar reserves are then lent to the United States, typically at very low interest rates. Adjusted for inflation, the return on US treasuries is negative (Stiglitz, 2010: 163). The poorly paying loans amount

353
to a transfer of resources – $3.7 trillion worth in 2007 – from developing surplus countries to wealthy deficit countries. The money that flows from the developing world allows the United States to spend a trillion dollars more than it produces, and it fuels asset bubbles (such as in real estate and the stock market) that lead to financial crises. The unfairness is that developing country resources could have been invested domestically to finance economic growth and greater consumption for the poor, but instead it must be invested overseas in dollar assets to safeguard against capital flight.\(^9\) In fact, according to the UN Commission, the ‘transfer of resources to the reserve currency countries . . . exceeds in value the foreign assistance that developing countries receive from the developed countries’ (Stiglitz, 2010: 163).\(^{10}\) A reformed system might avoid this problem by giving developing countries greater access to a reserve asset – the SDR – that can be used as a source of emergency liquidity during a crisis. In an SDR dominated system, countries would spend less on accumulating large dollar reserves, and more on domestic investment, economic growth, and human development. The result would be a more equitable system.

A fourth reason for SDRs, according to Stiglitz, extends beyond the well-being of developing countries, and includes the interests of wealthier countries. Developing countries must amass enormous dollar reserves to protect themselves against financial crises and unpredictable capital flows. These reserves can only be accumulated by building current account surpluses and saving the proceeds. The level of reserves reached 13 per cent of global GDP and 32 per cent of emerging market GDP by the end of 2009 (IMF, 2010c: 6). But if developing countries are saving on a massive scale, they are not spending trillions of dollars a year. This non-consumption depresses global aggregate demand and slows economic growth for both developing and developed countries (Stiglitz, 2010: 162). The reduction in global aggregate demand from developing country savings is, to an extent, offset by the spending of developed deficit countries, like the United States. However, this arrangement, besides being inequitable, may not be sustainable. Deficit countries are reducing their spending in the aftermath of the financial crisis. If both deficit and surplus countries are trying to save, the result is lower economic growth for all. Stiglitz proposes that SDRs could reduce the need for developing countries to accumulate massive reserves, freeing money to be consumed and increasing global aggregate demand (Stiglitz, 2010: 162–3).

(d) An institutionalist criticism of SDRs

While accepting the criticism that the dollar system may be unfair, unstable, and lower-growth, I would ask whether the SDR proposal is backed by sufficient institutions to succeed. On this ground, there is understandable skepticism about the near-term efficacy of SDRs from an institutionalist
perspective, as Eichengreen suggests. However, I will conclude, contrary to Eichengreen, that there is greater room for institutions to change or for new ones to be created. Institutionalism can guide, in the very long-term, reforms in the IMF that would allow it to promote a greater international role for the SDR by supporting the asset’s liquidity.

One of the functions of an international reserve currency is to provide emergency liquidity in a financial crisis. The dollar has the twin advantages of (1) being backed by the Federal Reserve, which can act quickly in crises; and (2) being freely usable, as it does not have to be converted into other currencies before being used in transactions with private parties. By contrast, it would be much slower to rely on SDRs (Eichengreen, 2011: 145). Since SDRs are not freely usable in private transactions, foreign central banks would have to activate the voluntary arrangements of the IMF, waiting 5 to 10 business days before their SDR holdings could be converted to freely usable currency, like the dollar (IMF, 2009a: 14). Given that central banks often have to act in hours when intervening in currency markets, a 5 to 10 day delay would be ‘an eternity in a crisis’ (Eichengreen, 2011: 138). The damage to foreign currencies and businesses could be irreparable by that time. The IMF acknowledges the delay of converting SDRs when it writes: ‘with their use limited to the official sector, official SDR holdings provide an imperfect reserve asset, as they cannot be used directly for market intervention or liquidity provision’ (IMF, 2011a: 4).

If a country needed more SDRs than it possessed in its holdings, there would have been an even longer wait as the IMF approved a new allocation of SDRs. Before any SDRs can be issued, 85 per cent of IMF members by voting power must agree to the allocation, further slowing action in a financial crisis (Eichengreen, 2011: 57, 141). Because the IMF requires an 85 per cent super-majority before issuing SDRs, as well as 5 to 10 business days before converting SDRs, the Fund as currently structured is institutionally unsuited to support the SDR as a reserve currency.

Another institutional difficulty with SDRs is the proposal for the substitution account. One reason for expanding the role of SDRs, discussed above, is that it could enable China and other countries with large dollar reserves to exchange their dollar treasuries for SDRs-denominated bonds through a substitution account. This would allow China to diversify its reserves outside of the market, and reduce its exposure to dollars. The problem with a substitution account is that the IMF does not have the power to determine who would bear the exchange risk. Who would suffer the loss if the dollar assets in the exchange account were to depreciate in value? As Eichengreen recalls, the idea of the substitution account was proposed in the past, during a previous episode of dollar weakness in 1978 (Eichengreen, 2011: 65). It was not implemented, due to the refusal of both the United States and the other IMF member states to bear the losses from a decline in the value of the account’s dollar assets. The IMF admits that
this problem remains (IMF, 2011a: 12; see also Eichengreen, 2011: 142). Although a substitution account might work if the IMF as an institution was able to impose a binding risk-sharing agreement to distribute the losses, the Fund has no such power.

A third institutional problem is that there may be insufficient agreement among the IMF member states to allow the Fund to issue enough SDRs to make a meaningful change in the composition of the world’s reserve assets. Even if agreement could be reached on the amount of the SDR allocations, their distribution could be more divisive. The question of who would get the SDRs could be more controversial once the amount of SDRs greatly increases. Currently, they are distributed according to states’ IMF quotas, which are set according to the size and openness of economies. The criteria favor the rich countries receiving the most SDRs. For example, in the 2009 general allocation of SDRs made in response to the financial crisis, the IMF distributed 182.6 billion SDR, then equivalent to $250 billion. The general allocation was largest ever made, seven times larger than the number of SDRs that had been created up to that time. Before then, the IMF had only created 21.4 billion SDR, then equivalent to $33 billion, in the entire period from 1969 to 2008 (IMF, 2009c). But the majority of the new general allocation of SDRs went to wealthy countries. Emerging market and developing countries received less than $100 billion worth of SDRs, of which only $18 billion were assigned to low-income countries (IMF, 2011b). Once future allocations become much more sizeable and frequent, countries could be dead-locked over how SDRs should be divided (Eichengreen, 2011: 141).

It might be argued that some of the shortcomings of SDRs could be overcome if they became freely usable. Suppose that the IMF and member states issued SDR-denominated debt on a large scale, the way the United States government issues treasury bonds. Private investors would then be able to buy, sell, and hold SDR-denominated debt. These SDR bonds would be denominated or valued in SDRs, promoting the use of SDRs as a unit of account and store of value. But they would not pay out SDRs to their holders or enhance the use of SDRs as a means of payment (IMF, 2011a: 11). A more radical reform would be to amend the IMF Articles of Agreement, allowing private investors and banks to hold and trade official SDRs (IMF, 2011a: 10). SDRs could then be used in private transactions as a means of payment, and states would no longer have to wait to convert their SDRs to dollars or euros before intervening in the market or financing international trade. Zhou and Stiglitz would approve of these developments, since they would remove one of the main disadvantages of SDRs (Zhou, 2009: 3).

I would reply, however, that there is currently an institutional problem with issuing SDR-denominated securities. The Articles of Agreement do not authorize the IMF to issue SDR debt on the scale necessary to create a liquid market and to replace US treasuries as the main store of value.
in the international financial system. In the IMF’s words, ‘expanding the issuance of notes in regular intervals ... would entail a large shift in the role and financial structure of the Fund, requiring an amendment to the Articles of Agreement’ (IMF, 2011a: 12). Issuing IMF debt securities would be even more controversial than SDR allocations, since it would be unprecedented. I would add that it is unclear how the IMF would raise funds in order to meet its expanded debt obligations. Unlike the United States, the IMF has no tax income on which to draw. Perhaps the IMF could pay for its obligations by investing its borrowed money, but that would require an enormous institutional transformation to manage trillions of SDRs in investments. Given that the IMF has institutional limitations that prevent it from issuing enough SDR debt to create a liquid market, it is difficult for the SDRs in the near term to become a freely usable currency that can substitute for the dollar.

(IV) CONCLUSION

In this review paper, I have offered an institutionalist approach that seeks to explain why currencies gain or lose reserve status. It argues that institutions can enhance a currency’s reserve status by creating liquid markets and by intervening quickly in financial crises. The institutionalist approach adds to the market, instrumental, and geopolitical perspectives on reserve currency status. The instrumental and geopolitical perspectives examine the decisions of foreign governments that demand a currency. Governments demand a currency as a means of pursuing economic goals (the instrumental view) or to promote their security, power, or military alliances (the geopolitical view). The market based approach focuses, not on governments, but on whether private actors support a currency, based on its liquidity and stability. By contrast, the institutionalist approach differs from the instrumental and geopolitical views, since it looks at the institutions, like the Federal Reserve or IMF, that supply a currency. The institutionalist approach also differs from the market perspective, because institutionalism explains how liquid markets in a currency originate in the first place. They are created, not solely by private actors like bond investors, commodity traders, and import–exporters, but with the initiative of the public institutions that issue a currency.

Consistent with the institutionalist approach that I develop, this paper suggests that the IMF does not currently have the institutional powers to support SDRs sufficiently for the asset to challenge the dollar. The IMF faces key limits as an institution in providing SDR liquidity and acting as a lender of last resort. Eichengreen treats these institutional limits as fairly permanent, writing that ‘the SDR proposal will go nowhere’ (Eichengreen, 2011: 143). However, I want to conclude by offering a more qualified assessment. In the near to medium term, SDRs will not gain much ground.
But I would point out that in the longer run, institutions can change. Just as the Federal Reserve was founded and then was able to enhance the international role of the dollar, the IMF could be reformed to give it greater scope to promote the international influence of the SDR. The IMF itself sees expanding the use of the SDR as a very long-term project that may take ‘years or decades’ (IMF, 2011a: 21). The IMF acknowledges that the US dollar ‘can be expected to remain the most important global reserve currency for the foreseeable future’ (IMF, 2011a: 3). Yet there are important reasons, as this paper has explained, from Zhou Xiaochuan and the UN Commission of Financial Experts, to criticize the dollar dominated system and to change it gradually over the longer-term. The status quo may be unstable, unfair, and lower-growth.

The suggestion that the IMF could undergo significant institutional reform to support the SDR may seem utopian. The cooperation of the United States would be required, as it exercises an effective veto over major IMF decisions, including changes to the Articles of Agreement. Why would the US cooperate with an institutional change that would reduce the dominance of the dollar as the international reserve currency? In reply, I want to give two reasons why the US may support reform.

First, there is a growing problem with the accumulation of dollar reserves by countries with current account surpluses. Surplus countries like China and Japan have sought to protect themselves from financial crises by building enormous reserves of the dollar, which they can use to supply liquidity for their banks and businesses, buffer capital flow volatility, and service their international obligations when private lending dries up (IMF, 2010c: 5–7). But these dollar reserves pose a growing danger to the US and the stability of the international financial system. Reserves have tripled in only 10 years to 13 per cent of global GDP in 2009 (IMF, 2010c: 4). The rate of reserve accumulation averaged 15.4 per cent growth a year from 1999–2008. Even if the rate slows steadily, the IMF projects global reserves to reach 120 per cent of US GDP by 2015 and 200 per cent of US GDP by 2020. At this rate, global reserves will surpass 690 per cent of US GDP by 2035 (IMF, 2010c: 6). The United States will not be able to afford the current account deficits and treasury debt that are necessary to fund reserves amounting to multiples of its gross domestic product. As the former US Treasury Secretary, Lawrence Summers, has warned, ‘international debt accumulation at these rates cannot go on forever’ (Summers, 2006).

The problem might be partly ameliorated with the growth of SDRs as a reserve asset that can supplement the dollar. The IMF could pursue institutional reforms that would address a number of the problems described earlier in this paper. Its members could vote to amend the Articles of Agreement, making it easier to issue SDRs and lowering the 85 per cent super-majority requirement. The IMF could make regular allocations, so that SDRs could comprise a larger portion of reserves, reducing the
pressure on the US to supply the majority of reserve assets. If the Articles are reformed, the IMF could target allocations to countries that are accumulating reserves, so that they would not rely so unsustainably on dollar assets (these reforms are suggested by IMF, 2010c: 23). The process of converting SDRs to freely usable currencies could also be streamlined to make the Special Drawing Right a more perfect substitute for dollar reserves. The IMF would then be better placed as an institution to support the international reserve currency status of the SDR.

The second reason why the United States could support these institutional reforms to the IMF draws on a historical precedent. The US allowed the SDR program to be founded in 1969, during a previous period that threatened a shortage of dollar liquidity. The US also approved a sizable SDR allocation in 2009, equivalent to $250 billion, in response to the liquidity shortage created by the financial crisis. Similarly, the US may increase its support for SDRs if it finds that global demands for dollar reserves and liquidity are becoming financially unsustainable.

If the US allowed the role of SDR to be expanded, and in fact had an incentive to do so due to the escalating reserve problem, how could the international influence of SDRs be enhanced? To conclude this paper, I want to point out that the IMF’s own proposals for increasing the international role of SDRs draw heavily on the institutionalist approach to reserve currency status (though without mentioning it explicitly by name). The institutionalist approach argues that public institutions can act to increase the liquidity of a currency, making it more attractive for private investors and enhancing its international role. A 2010 survey of reserve managers, central banks, and international financial institutions found the widespread view that ‘adequate liquidity is the most important and critical feature for SDR to be an attractive reserve asset’ (IMF, 2011a: 23). When faced with the question of how to make the SDR more liquid, the IMF implicitly takes an institutionalist approach. The Fund proposes that it could encourage the growth in a market for SDR-denominated assets by acting as a market maker, re-discounting SDR-denominated bonds. As the Fund notes, ‘public sector’s initiative would be critical in building the necessary infrastructure for market development. The private sector would be reluctant to take the lead in creating an SDR market without public sector initiative and support’ (IMF, 2011a: 25).

I would argue that this proposal recalls the actions of the Federal Reserve in encouraging the market for trade acceptances, as the paper described. The Fed made dollar-denominated trade acceptances more liquid by ensuring that holders of acceptances could reliably find a willing buyer. The Federal Reserve had to take the initiative, because other investors demanded an interest-rate premium to buy a new, unfamiliar, and less liquid asset. To lower the interest rate premium on dollar-denominated trade acceptances, the Fed educated the market about their desirability, and made
the market by offering to buy and sell vast numbers of trade acceptances, increasing their liquidity. Similarly, the IMF will have to lower the interest rate premium on SDR-denominated bonds by buying and selling them on a large scale. In the Fund’s words, ‘public sector and/or IFI [international financial institution] liquidity support would be necessary at least initially. An obvious way for such development would be for official institutions to commit to act as market makers, i.e., provide two way prices’ (IMF, 2011a: 26). The IMF, as an institution, could act to support the liquidity of the SDR, increasing its viability as an international reserve currency. The institutionalist approach described in this paper would then be crucial to guiding the possible long-term expansion of the role of the SDR, which could supplement the dollar as the demand for reserves grows.

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NOTES

1 Although the terms sound similar, the institutionalist approach to reserve currency status differs from ‘neoliberal institutionalism’. This paper’s institutionalist approach seeks to show how institutions, like the Federal Reserve, that issue a currency can enhance the currency’s reserve status by increasing the liquidity of markets or by intervening in financial crises. In contrast, neoliberal institutionalism is concerned with how international institutions can promote cooperative outcomes by solving collective action problems.

2 The $10 trillion is taken from summing ‘column F’ entitled ‘amount extended’ (measured in millions of dollars) in the site’s Excel table, ‘Central Bank Liquidity Swap Data’.

3 Trade acceptances are a form of double-name commercial paper, or short-term corporate debt instrument. They allow exporters to be paid immediately for goods that have shipped, instead of waiting for the goods to arrive overseas and be sold. See Broz (1997, 37–8).

4 That is not to say that domestic financial institutions consistently enhance the international role of a currency. They can make mistakes, as some economists believe the Federal Reserve did during the 1930s, when it contracted the money supply, prolonging the Great Depression. See Bernanke (2004).

5 Eichengreen, however, does highlight insightfully other limits with SDRs, such as their lack of liquidity and their inability to be used in transactions with private parties.

6 The international organizations that can use SDRs are listed in IMF (2009a: 13, n. 23).

7 According to Mark Blyth, the rate of financial crises during the 1990s was 4.5 times greater compared to the rate during the preceding 200 years; see Blyth (2003: 239, n. 4).

8 I have updated Stiglitz’s reserve figures using IMF (2010c).

9 Lawrence Summers has also pointed to the enormous opportunity cost for developing countries of accumulating dollar reserves; see Summers (2006).
This raises a major but understudied problem for political philosophers – the justice of the global financial system.

NOTES ON CONTRIBUTOR

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