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Why SDRs Could Rival the Dollar

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In a recent Cato Institute paper, Swaminathan S. Anklesaria Aiyar (2009) asserts that the International Monetary Fund's special drawing rights (SDRs) cannot rival the US dollar, as suggested by the Chinese central bank governor (Zhou Xiaochuan 2009). "The SDR is not a currency and never can be," Swami declares confidently in the first paragraph of his paper. He presents two arguments, which are presumably supposed to be proofs of this proposition. In the next paragraph, he tells us:

> …its value is defined as the value of a weighted basket of four currencies…. Its value fluctuates with the value of its constituent currencies. This should make it clear that the SDR is not a currency in its own right. Rather, it is a derivative of four national currencies. A derivative is not a currency.

How interesting. The value of the pound sterling used to be defined as equal to a weight of gold under the gold standard. The value of the dollar was so defined until 1971, although it is true that in the later years there were certain difficulties in accessing the gold. The value of the renminbi was defined in terms of the dollar until July 21, 2005. Are we to understand that Swami does not consider the pound, dollar, and renminbi to have been currencies? Did the willingness to accept the currencies have nothing to do with their moneyness? Or is it the fact that an SDR is defined in terms of more than one currency that makes it a non-money? Is the ruble then a non-money since it is defined as a basket of the dollar and euro (admittedly it has some margins)?

Toward the end of Swami's paper, one finds another proposition, which looks intended to be a proof:

> The dollar is a hard currency because the United States has a huge GDP and the capacity to tax its citizens to satisfy all currency requirements. The IMF has no GDP and no taxing capacity, and so lacks the fundamental requirements for creating a currency. U.S. and European politicians may occasionally agree to an expanded role for SDRs, but will never surrender money-creating power to the IMF.

Wait a minute. When I accept a dollar bill, I do so not because I expect to hand it over to the US Treasury in return for some taxes on the US GDP. I accept it because I do not doubt that someone else will accept the dollar bill. It is money because it is universally and without hesitation accepted in settlement of debts. This was recognized when the SDR was created. Fritz Machlup (1968, 65–66) wrote:

> The new facility established by the Rio Agreement… disposes of the old myth of backing. In so doing, the officials of the Fund and of the negotiating governments showed a far greater courage than the academic economists have had. Not that any reputable economist of our time has believed the old myth; but they were convinced that all bankers and other practical men of the world of finance believed in the myth and could not possibly be "enlightened." Thus, the academic economists had not dared to recommend schemes that would do away with the trappings of backing. …All that matters for the

> acceptability of anything as medium of exchange is the expectation that others will accept it. If over a hundred central banks or national monetary authorities including those of the major trading nations of the world agree to accept SDRs from one another in exchange for convertible currencies, this is all that is needed to establish the moneyness of the SDRs in inter-central bank transactions. Money needs takers, not backers; the takers accept it, not because of any backing, but only because they count on others accepting it from them.

Swami is asserting that money has to be backed by taxing capacity rather than creditworthy assets, but the fallacy is the same.

It is true that SDRs are only central bank money, because only central banks accept them in settlement of debts. But to the extent that they are so accepted, they are money. The fact that they are created by a political decision in the IMF, which involves US and European politicians (as well as some others), does not prevent the IMF from creating money. It just means the politicians continue to control the process of money creation, which is hardly news.

THE MONETARY DOMAIN

In recent writings, both Richard Cooper (2009) and Barry Eichengreen (2009) have asserted that a major expansion in the role of the SDR depends on making it an asset that is held by the private sector. This would obviously be necessary for the SDR to rival the dollar in private use; one can hardly have a currency that competes with the dollar in private use if private parties are not even allowed to hold it. And I agree that it is not obvious that private agents would rush to hold a great volume of SDRs if only they were not prohibited from holding them.

The SDR could nevertheless play a far more central role in the international monetary system than it has done so far without changing the proscription on its holding by the private sector. The fact is that countries with substantial dollar holdings have accepted an obligation to convert SDRs into dollars when a monetary authority needs them to transact with the private sector, and so far these countries have not hesitated in fulfilling that obligation when asked to do so by the IMF. That is, as Fritz Machlup observed many years ago, what is needed to establish that SDRs are money so far as central banks are concerned. The question is whether SDRs are a better asset for central banks to hold given this minor inconvenience in using them when one wants to intervene in the exchange market.

There appear to be four differences from the viewpoint of a non-reserve-currency country. First, there is this inconvenience. Second, unless a central bank has views at variance with those of the private sector, the expected yield of the SDR is the same as that of any of the currencies that compose it. However, the variance is different: Given that the SDR is defined as a basket, the variance of an SDR will be less in terms of the liabilities of a typical country. (Countries whose transactions are predominantly with the dollar or dollar bloc countries are the important exception here.)

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The third difference is in terms of what economists call "seigniorage," which refers to the profit that accrues to whoever issues money. If one had to buy gold and then issued gold money of an equal value, there is no seigniorage. If, on the other hand, one has the right to print paper money at essentially zero cost, then seigniorage is the issue value of the money printed. (That is why many of us believe that central banks need to be given an objective like 2 percent inflation to guide their money creation.) The usual view is that the seigniorage of running a reserve currency arises from an ability to borrow more cheaply than would otherwise be possible. The seigniorage from SDR creation is very differently distributed, in proportion to IMF quotas (which determine the proportion of allocations). Doubtless this too is imperfect, but it seems closer to what most people would consider reasonable than alternatives.

The fourth difference relates to securing consistency in the payments objectives sought by countries around the world. Over the quinquennium 2003–07 inclusive, payments outcomes were roughly those shown in table 1. Developing countries (including emerging markets) built up substantial reserves, financed slightly over 50 percent by current account surpluses and slightly under 50 percent by capital inflows. In the coming quinquennium, reserve build-up by developing countries will hopefully prove somewhat smaller, since a number of countries have now achieved any reasonable estimate of required reserves. On the other hand, many developing countries have surely learned the lesson from the Great Crisis of 2007–09 that it is prudent to build up substantial reserves in anticipation of possible crises. Hence it would be unwise to rely on reserve accumulation by these countries being much less in the future. If the past is any guide to the future, the bulk of this accumulation (in the absence of substantial SDR allocations) will take the form of current account surpluses, which will require either a

Table 1 Payments imbalances, 2003–07
(trillions of dollars)

	United States	Other advanced countries	Developing countries
Current account	–3.3	1.8	2
Capital flows	3.3	n.a.	1.5
Change in reserves	0	1.2	3.2

n.a. = not available

Notes: The East Asian newly industrialized countries are now classified as advanced economies and accounted for $0.3 trillion of their reserve accumulation. US capital inflows include the acquisition of assets by other countries that these countries count as reserve increases. The US reserve change recorded is the change in US holdings of reserve assets.

Sources: International Monetary Fund, *World Economic Outlook* and *International Financial Statistics*.

continuation of the large current account deficits of the United States or a move toward deficit on the part of the collectivity of other advanced economies. Since the former is undesirable and the latter improbable, it is apparent that large SDR allocations could play a key role in ensuring that payments objectives are consistent. Indeed, the surprise revealed by this approach is just how large the scope for SDR allocations would be—several times the size of that agreed by the Group of 20 (G-20) in April 2009 in London, which itself multiplied the SDR stock by almost ten. (Creation of a substitution account may be regarded as an ex post way of reaching the same end.)

CHINESE INTERESTS

The serious issue that needs to be addressed in assessing whether to replace the dollar's reserve role is whether it is in the national interest of major countries. Both Swaminathan Aiyar and my colleague Arvind Subramanian (2009) have argued that it is a mistake for China to urge an increase in the role of the SDR instead of waiting until the renminbi can become a reserve currency. The issue seems to me to be a lot less clear-cut than they assert. They argue that countries that become reserve-currency countries have historically run current account surpluses for a substantial period, which makes them creditor countries, establishes their credibility in the markets, and enables them to continue enjoying hard-currency status even after they start running deficits. These countries are able to do this in part by virtue of the "exorbitant privilege" of running a reserve currency, since foreign official holders demand their currency. The question is how much of a privilege this is and whether it might be outweighed by the danger of a run on the currency and the constraint this places on national economic policy.

Let us try and look at costs and benefits from the standpoint of China. In the short run, the Chinese would lose less from a dollar depreciation if they switched a large part of their reserves into SDRs, e.g., because the rest of the world agrees to the proposal for a substitution account. Of course, they would benefit less from a possible dollar appreciation as well, but presumably they regard this possibility as less likely. Assuming there is indeed a net dollar depreciation in the coming years, someone has to bear the cost. The normal rule is that a country's accounts with the IMF are denominated in SDRs. If this were perpetuated in the case of a substitution account, then the United States would bear the cost of a dollar depreciation. A second possibility is that the substitution account would hold dollars and that all the members of the IMF would make up any losses (and take any profits) that might result from the dollar changing in terms of the SDR, e.g., by having the IMF utilize part of its gold stock. A third possibility is that the IMF would aim to maintain a balanced book, so that when its substitution account acquired dollars it would (doubtless gradually) sell 56 percent of these in exchange for euros, yen, and sterling. In that event the substitution account would not give permanent relief against the pressures resulting from a run out of the dollar, though it would presumably prevent acute pressures from sudden shifts in expectations. But in each of these three cases China would lose *less* by a dollar depreciation if it had previously placed its dollars in the substitution account (or acquired SDRs that had been part of the allocation process) than if it was still holding dollars.

In the medium run, before the renminbi could become a reserve currency, a policy of SDR allocations would give China the benefit of sharing in the seigniorage that results from reserve creation. This is the only way that China can obtain a share of the benefits of reserve creation in the medium term. Once again, it is apparent that SDR allocation dominates a policy of resisting the SDR and continuing to rely on reserve currencies. This is true even if one dismisses the likely costs of global instability from moving toward a multiple reserve currency system[1] and

1. Those who dismiss this danger as fantasy may be interested to hear of one never-consummated research project that was started at the Institute for International Economics in the early 1980s. We sought to establish whether there had indeed been (net) destabilizing reserve switches in the 1970s. I concluded that there had been and presented the evidence with some satisfaction and mild amusement at a seminar in one of the mid-sized European central banks. To my surprise, I was greeted by a stony silence. A friend explained to me afterwards that the central bank in question had moved a large stock of reserves into the yen just before it peaked and lost a bundle in consequence. Central bankers are not good speculators, perhaps because that is not among their terms of reference. They nevertheless speculate if given the opportunity. Against this it is sometimes argued that the consequence of competition among potential reserve-currency countries may be healthy competition that promotes better policies. Even if this is what drives the reserve switches, that hardly guarantees that they are stabilizing.

the likely costs of an ongoing global imbalance from continuing to rely on the dollar as the dominant reserve currency.

But it is the ability to run a larger deficit in the long run if the renminbi became a reserve currency that Swami and Subramanian see as the advantage to China. It is overwhelmingly likely that China could finance a larger deficit if the renminbi became a reserve currency, and this should indeed be scored as an advantage for China. The fact that some people have seen net disadvantages in their countries' reserve-currency roles—and that countries with the potential for becoming reserve currencies have on several occasions actively resisted their acquiring this role—should, however, cause one to stop and think whether there may be another side to the case. The reasons for resisting a reserve-currency role (as classically laid out in Bergsten 1975) are

The interests of major reserve-currency countries, like the United States and potentially China, can be disputed, but they too might benefit from an enhanced role of the SDR.

- dislike of the prospect of becoming a large gross short-term debtor, because of the instability that peremptory withdrawal of those debts could create. Dislike of the cost of building up large short-term assets to completely eliminate any such threat;
- dislike of the likely instability of a multiple reserve currency system, as monetary authorities switch between reserve currencies in search of enhanced yield; and
- the leverage over debtor-country policy that indebtedness gives to creditor countries, who at the same time accuse the debtor country of enjoying exorbitant privileges.

Perhaps China would avoid such dangers. It is conceivable that the build-up of renminbi reserves would be accomplished exclusively through capital outflows, with a creditor position being maintained throughout (like pre–World War I Britain, unlike contemporary America). Perhaps the fears of a multiple reserve currency system being unstable are a myth, or perhaps the Chinese believe that the renminbi might achieve a monopoly position. Perhaps China would avoid giving foreigners leverage over its policies and be indifferent to the opinions of other countries about it. But even if it sees net advantages down the road in the renminbi becoming a reserve currency, its position is still defensible if it judges that the discounted net advantages of this do not outweigh the clear net advantage of replacing or at least supplementing the dollar by the SDR in the short and medium terms.

Another possibility is that China actually believes what the governor of the People's Bank of China said about the virtues of an international order. Perhaps, perish the thought, he actually means what he said about how an international money should have a stable value, rules-based issuance, and manageable supply, rather than that the supply of reserve assets should be governed by the economic conditions and sovereign interests of a particular country. I think he overestimates the extent to which it is conceivable that an international money can abandon the practices that have been cultivated in the past 40 years, but nonetheless he seems to me to exhibit a better grasp of present-day realities than some who consider themselves economic realists.

US INTERESTS

It is often supposed that the United States has a strong national interest against seeing any extension in the role of the SDR, because such an extension will inevitably come in the short run at the cost of curtailing the dollar's international role. Of course, this implies that the US leadership role in creating the SDR and urging its activation was misconceived. In fact the calculus seems to be quite ambiguous: It is the obverse of that outlined for China's long-run interests. The United States gains by virtue of the ability to finance somewhat more cheaply its foreign debt (technically known as the "seigniorage" benefit) and by being assured that deficits will be financed under normal circumstances by foreign monetary authorities. But it loses by virtue of its susceptibility to sudden large-scale capital outflows caused by past build-up of liabilities (Bergsten 2009). Note that measures of large-scale indebtedness may alarm not just foreigners but also local investors, who have historically often been the first to engage in capital flight, driven by informational advantages.

The world may be destined to see a multiple reserve currency system in the coming years, irrespective of whether or not the role of the SDR is expanded. The euro is now sufficiently widely accepted and held that an effort to avoid reserve-currency status by the European Central Bank (ECB) seems unlikely to be attempted and, if attempted, to succeed.

However, a larger SDR role in such a system might help to stabilize it, at least if there were also a substitution account. Assuming that this role were one-way (i.e., a dollar holder would have the right to present dollars to the account and receive SDRs in exchange but not to exchange those SDRs for a reserve currency), the substitution account would enable surplus dollars to be disposed of without pressuring exchange markets, while taking some of the reserves out of the pool that might contribute to such pressures.

Of course, what happens to the dollars placed by other countries in the substitution account is of importance in assessing US national interests. As outlined in the earlier section, there are three possibilities:

1. The United States abides by the normal rules of the IMF and acquires an SDR-denominated liability. Richard Cooper (2009) asserts that such an arrangement would be a "show-stopper" for the United States, since "no Congress would provide an unconditional guarantee of value for assets, which, though issued by the US government, were issued in US dollars and voluntarily acquired by foreign parties." One wonders for how long the US Congress would stop the show if the bottom were falling out of the dollar in the foreign exchange market.
2. The IMF allows the substitution account to be unbalanced, issuing SDR-denominated liabilities and holding dollar-denominated assets, with the membership as a whole making up any difference in value (e.g., by exploiting the IMF's gold holdings). This arrangement seems at least as likely to be a show-stopper for the rest of the world. Fred Bergsten argues (in a conversation with me) that the rest of the world should be prepared to accept some risk since the substitution account would be providing the global public good of stability, but other countries might focus on the fact that such an arrangement would enable the United States to inflate away its debts more readily.
3. The IMF aims to work gradually toward a situation in which the assets of the substitution account matched its SDR-denominated liabilities, by selling dollar assets and purchasing those denominated in euros, yen, and pound sterling. This would merely postpone the pressure on the dollar that a substitution account is intended to avoid.

The question of denominating a substitution account seems destined to be once again the most difficult item in the negotiation of any such account. Given that the expected present values of assets in the different currencies that compose the SDR are presumably held equal by arbitrage in the private market, it would be a quarrel exclusively about who holds the risk.

However, the fact that the United States would have a liability whose real value was decreased by a self-induced inflation would be regarded by some as providing it with an incentive to inflate. Such an incentive could be eliminated by indexing the dollar debt to the excess of US inflation over the weighted mean of that in the other currencies in the basket.

REST OF WORLD INTERESTS

The rest of the world needs to be divided into countries or regions that can hope to attain reserve-currency status and those that do not have any realistic hopes of this. The interests of the former countries—those that share the euro, perhaps Japan and the United Kingdom, conceivably Switzerland, one day maybe India—are again ambiguous, involving weighing benefits of seigniorage and more automatic financing of payments deficits during normal times against enhanced dangers of a run and the consequential disruption of monetary policy. The benefit of more automatic financing of a payments deficit becomes more questionable the more marginal the reserve currency: It can be disregarded for Switzerland (which anyway does not have payments deficits to be financed) and probably for Japan and the United Kingdom. For the United Kingdom, and maybe also Japan, the dangers of a run surely outweigh whatever seigniorage benefits the countries still derive from use of their currencies as reserve currencies. The attractions of gaining a share of the seigniorage benefits through SDR issue seem less problematic.

> **Large regular SDR allocations could play a key role in ensuring that payments objectives of countries are consistent.**

Most countries, however, do not have any realistic expectation that their currency may some day become a reserve currency. For them there is a clear advantage in boosting the role of the SDR and achieving a portion of the seigniorage gains, as outlined in the section on "The Monetary Domain," unless, at least, they still hanker after a money that is "backed" by something. One wonders what else lies behind the evidence of reluctance to back an SDR solution that their behavior has revealed. Could it be that the officials lauded by Fritz Machlup were unique and that the average official is (like Swami) as wedded to fallacious doctrines as he imagined them to be?

CONCLUDING REMARKS

SDRs were created to be a central bank money and are well-designed for that role. Large regular SDR allocations would be a mechanism to reduce the inconsistency of payments objectives, one that involves a far fairer distribution of seigniorage than otherwise seems conceivable. The interests of major reserve-currency countries, like the United States and potentially China, can be disputed, but they too might benefit from an enhanced role of the SDR.

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