

# ■ Special drawing rights – oiling the wheels

BY ANNA-KARIN NEDERSJÖ

The author works in the International Department.

*The International Monetary Fund's (IMF) special drawing rights, or SDR, have come to head the agenda in the globalisation debate as a solution to the economic problems of poor countries. It is sometimes claimed that an SDR is "money for nothing". However, SDR are not "money for nothing". Nonetheless, they do offer members of the IMF a facility whereby they can convert assets into foreign means of payment, or money. In this article I would like to explain in broad outline how this can be arranged by describing the origins and function of SDR. Finally I will briefly comment on some of the problems to which the SDR debate gives rise.*

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It is possible to limit the presentation of SDR to a technical description. However, as SDR are not merely of technical interest but also have a distinctly political dimension, it is interesting to put SDR in a historical context that involves the conditions for trade between countries in general and for payments between countries in particular. A simple but concrete description of the IMF's special drawing rights is to say that they enable member countries to effect payments in foreign currencies, which is essential if they are to be able to trade with each other. The need arose in connection with the expansion of international trade. The countries that are nowadays in need of SDR are the poor and developing nations whose own currencies cannot be converted into an acceptable currency on a foreign exchange market.

**The IMF's special drawing rights enable member countries to effect payments in foreign currencies, which is essential if they are to be able to trade with each other.**

The bulk of the trading on modern currency markets takes place in the currencies of industrialised countries. The reason is that the value of a currency in all essentials reflects a degree of confidence in a country's economy and its government's policies, including economic policy. Without confidence in a country's economy it will be difficult for the country to borrow to fill up its currency reserves.<sup>1</sup> Access to SDR enables

**It is important for poor countries to have access to SDR.**

<sup>1</sup> In order to finance a temporary payment deficit in a foreign currency, the part that has to make the payment should either have built up its reserves in the foreign currency or be in a position to borrow the foreign currency. As a rule, in poor countries the domestic currency is exchanged at the central bank so that payments in foreign currencies can be effected, which requires the country to build up its own currency reserves.

a country to exchange SDR against a foreign currency at a fixed “exchange” rate. In effect, the country has obtained a “conversion discount” on its own currency’s exchange rate. Consequently, the country will be able to import goods, such as those needed for domestic investments. Having access to SDR is therefore of particular importance to poor countries.

## Confidence in international payments

**The formation of the IMF in 1945 was intended to organise access to means of payment at fixed prices to promote international trade.**

The value of a poor country’s currency is largely associated with the level of uncertainty. The current situation not only of poor countries but also of developing ones displays similarities with the situation faced by today’s industrialised economies at the end of World War II, when the conditions needed for modern currency markets were still very remote. The great degree of uncertainty – a consequence of the post-war weakness of the world’s economies and the collapse of the international payments system<sup>2</sup> – was an obstacle to the emergence and development of international trade. The formation of the IMF in 1945 was intended to organise the supply of means of payment at fixed prices to enable international trade to restart. The IMF was organised in the form of a co-operative bank that was funded by the member countries on the basis of their economic size and strength.<sup>3</sup> The American dollar, whose parent economy was the largest in the IMF, was designated as an international means of payment. It was around this time that the dollar became recognised as an international reserve currency. The value of the dollar was tied to the value of an ounce of gold. Other member countries’ currencies were given a value in relation to that of the dollar, which was decided by each country’s central bank in consultation with the IMF. The intention was that the exchange rates would then remain fixed. Each member country had immediate access to 25 per cent of its deposits with the IMF in the event of its own currency reserves being temporarily insufficient to exchange and use as payment of its imports. This exchange rate arrangement was retained until 1971.

However, as a result of the growth in global trade the bilaterally fixed exchange rates became a problem in those cases where a country did not have enough dollar reserves to finance its foreign payments. At this time, international capital movements were not permitted, and each country

<sup>2</sup> Today, the currencies of the industrialised countries are convertible, that is to say they can be readily exchanged into other currencies. At the end of World War II, they were not convertible, and their values rested on very shaky grounds.

<sup>3</sup> The IMF commenced operations in 1947. This organisational structure still serves as the foundation for the IMF’s activities. See Nedersjö (2001) and the IMF’s web-site.

could therefore only build up its reserves by limiting domestic demand as a means of generating an export surplus.<sup>4</sup> This could result in unemployment and falling prices. In such a deflationary spiral, falling prices represented a serious threat to economies that still had to develop and expand.

## Political incentives

In the aftermath of World War II, the USA was anxious to reconstruct Western Europe and its economies as means of attracting allies in its efforts to combat communism. It therefore provided economic support in the form of the Marshall Plan for the West European countries.

The USA invested in Western Europe and encouraged the European countries to export to the USA and add some of the export revenues to their reserves. Consequently, Western Europe's dollar reserves had tripled by the end of the 1950s, which the USA financed by printing more dollar bills, as a result of which these countries were able to generate current account surpluses, and could exchange their currencies for dollars to pay for their imports. Along with this, they imported inflation, which meant in practice that the dollar weakened against the other currencies.<sup>5</sup>

When the real value of the dollar began to be eroded in the 1960s the idea of the SDR was born. The theoretical and practical processes that resulted in the SDR system went on for more or less the entire 1960s, a decade when currency movements were tightly controlled for political reasons. The USA's payment deficit grew and at the beginning of 1960s President Kennedy announced that there were only two things he was afraid of: nuclear war and an international payment deficit. The USA then imposed its own version of the later Tobin tax (interest equalization tax) on foreigners who wished to borrow on the American bond market or from US banks. On the banking market, restrictions were also introduced on foreign investments by imposing a lending ceiling on bank loans intended to finance foreign investments via corporations (known as the Foreign Credit Restraint Program).<sup>6</sup> Despite this awareness of the weakness of the dollar, the American government pushed up the money supply even further as a means of financing existing and new political commitments, such as the Vietnam War.<sup>7</sup>

**The USA provided economic support for European countries in the form of the Marshall plan.**

**When the real value of the dollar began to be eroded in the 1960s the idea of the SDR was born.**

<sup>4</sup> Nor was it possible to exchange their domestic currency outside the country. The currency market as we know it today simply did not exist. The only chance of building up a country's currency reserves was to import capital goods that could be used to gradually build up a permanent export surplus, or at least one that would last for a reasonable period of time.

<sup>5</sup> The countries that had current account surpluses were Japan, Canada and Western Europe, excluding Britain, which tended to incur deficits.

<sup>6</sup> The propensity to innovate was high, and a eurodollar market also came into existence.

<sup>7</sup> It was mainly the USA's participation in the Vietnam War that pushed up its current account deficit (as services and materials for the war were mostly bought abroad and paid for in dollars) as well as the cost of financing a social program known as The Great Society Program.

**One of the objectives behind the planning of SDR was to entirely replace the dollar; this was a political motive.**

As far as Western Europe was concerned there were powerful political reasons for trying to change the monetary situation. On the one hand, Western Europe had become dependent on the dollar, while on the other the USA was imposing restrictions on its foreign financing. France's President, Charles de Gaulle, spoke out against the excessively strong monetary power wielded by the USA. His view was that the USA was privileged by comparison with other countries that could not make use of their payment surpluses (or rather their own currencies) in this way. A neutral reserve currency would therefore have to be invented. One of the objectives behind the planning of SDR was to entirely replace the dollar; this was a political motive. The French President also demonstrated his dissatisfaction in practice by selling the Banque de France's large surplus dollar holdings in return for gold. This was the first step that was ultimately to lead to the fall of the dollar and what was known as the gold standard. As the dollar really ought to have been devalued, gold was in particularly heavy demand.

#### Anecdotal box

As early as 1960, economist Robert Triffin<sup>8</sup> recognised the dilemma of the gold standard. He formulated this dilemma by observing that, on the one hand, although the global economy was dependent on the continuation of the USA's current account deficit, on the other hand, it meant that the ratio of the dollar to America's gold reserves rose, and thus reduced the value of the owners' reserves to their profound concern. What became known as Triffin's dilemma highlighted both quantitative and qualitative aspects of the supply of international liquidity at that time. The only solution that Triffin saw was for the IMF itself to be able to meet any legitimate demand for liquidity from a growing world economy.

In the USA Triffin's dilemma was acknowledged in 1962 when President Kennedy announced that one of the reasons for finding new sources of liquidity was that the country would no longer need to keep the rest of the world so amply supplied with dollars.

## Fixed exchange rate caused deadlocks

Thanks to the willing support of the USA the major economies in Western Europe had become so strong during the 1960s that their currencies had gained acceptance as international means of payment. They could trade amongst themselves using their own currencies. It was now permitted to exchange currencies, but only for the purpose of carrying out trading transactions. However their exchange rates were still tied to the dollar, which should in reality have been devalued. The real relative strengths of their exchange rates had been turned upside down. This meant that other

<sup>8</sup> Mussa, Boughton & Isard (1996) p. 27.

countries than the USA had to hold excessively high dollar reserves in order to maintain the bilateral value of their currency against the dollar, since the more the value of the dollar declined the more of these dollars were needed to maintain the real purchasing power of each member country's currency reserves.

Anecdotal box

An anecdote from a G10 discussion of the monetary system<sup>9</sup>, at which the French were taking the lead, tells of the way representatives of G10 attempted to analyse the problem by making a distinction between "happy" and "not so happy" holders of currency reserves. In order to avoid economic crises and in solidarity with the USA the "not so happy" ones refrained from converting their dollars into gold. In 1965 France converted all of its dollar reserves into gold and called for the abolition of the gold standard.<sup>10</sup>

The IMF once again faced the challenge of maintaining confidence in the international payment system.<sup>11</sup> There was a risk that the economies that were entirely dependent on the dollar would gradually experience problems in paying for their imports, as it was still not possible to raise currency loans. The only option would have been to limit domestic demand as a means of generating a current account surplus, which in itself was a way of causing deflation. In this way, the measures to prevent deflation became the second reason, the economic one, for developing SDR.

The decision to allot special drawing rights to the IMF's member countries was taken in 1967 in Rio de Janeiro, but the rights were not actually allotted until 1970. The SDR were to be used as a hard currency and valued in gold. The intention was to create an international reserve currency (paper gold) but the IMF was overtaken by events arising from the emergence of international financial markets.

It can be claimed that a political milestone was passed in 1973, by when the most important industrialised countries had introduced floating exchange rates.<sup>12</sup> This released central banks from their dependence on the IMF in its role as the central bankers' banker. In other words, they had become masters over their own monetary policy destiny. One consequence of this was that the IMF ceased to value SDR in gold and started to value them in the most important transaction currencies. The IMF's fundamental principle of maintaining a fixed price for the dollar was thus

**Countering inflation was the second reason – the economic one – for developing SDR.**

**SDR were to be used as a hard currency and valued in terms of gold.**

**The ability to borrow abroad and convert currencies has entirely eliminated the need of the industrialised economies to turn to the IMF.**

<sup>9</sup> The discussion related to the first systematic study made by G10 of the monetary system as it was at that time; see Mussa, Boughton & Isard (1996).

<sup>10</sup> Initially, when the Bretton-Woods system was established, gold accounted for more than three quarters of the total reserves. By the middle of the 1960s, the proportion of the reserves held in gold had fallen to one quarter.

<sup>11</sup> Previously, the IMF had overcome the shortage of dollars (means of payment) by raising quotas.

<sup>12</sup> In an attempt to retain the fixed exchange rate the dollar had been devalued by 10 percent in December 1970 in relation to gold, and some of the more important currencies have been revalued. It lies outside the scope of this article to discuss this in detail. It has been both analysed and published as a minute in de Vries (1988).

being watered down. As confidence developed in one currency after another as a transaction currency and as the dismantling of currency controls began, foreign exchange markets also started to emerge. The ability to borrow abroad and exchange currencies has entirely eliminated the need of the industrial countries to resort to the IMF as a means of gaining access to foreign currencies. But as we all know, the same conditions do not apply to poor countries.

## SDR redistribute money

**The SDR system was intended to solve the dilemma of the payment system, which by then was becoming a threat to global trade.**

The SDR system was intended to solve the dilemma of the payment system, which by then was becoming a threat to global trade. With the aid of SDR, foreign currencies could be made available to oil the wheels of foreign trade without this having any negative effects, such as stagnation or inflation, but also to restore the confidence of the member countries' central banks in the ability to hold international reserves. Article of Agreement XVIII in the IMF's statutes stipulates that SDR may only be allotted if this helps to provide long-term global liquidity for supplementing existing reserves in such a way as to further the IMF's objectives and prevent stagnation and deflation just as much as surplus demand and inflation. Formally, this article is still in effect, even though international capital markets are now free.<sup>13</sup>

## SDR – neither money nor market instrument

**A simple description is that SDR were created to oil the wheels for the movement of currencies within the IMF.**

It is often claimed that it is easier to say what SDR *are not* than to say *what they are*. SDR are not an asset with a redemption date that can be sold on a market. Nor are they a substitute for any of the international currencies, since it is not possible to pay with SDR outside the IMF. SDR are therefore neither a financial market instrument nor ready money. In general it cannot be denied that the terminology used within IMF circles is fairly complex, which makes it even harder to understand what the SDR system is really all about. In order to properly understand and form a correct picture of what SDR are, it is necessary to explain the technique they are based on. To put it simply special drawing rights were created to oil the wheels for the circulation of currencies within the IMF, to ease the

<sup>13</sup> In Mussa, Boughton & Isard (1996) in which the contributions to the IMF's anonymous conference have been published Mussa (page 80) and Williamson (pages 112-113) claim that this article no longer applies. As nowadays the supply of reserves always corresponds to the demand, the idea of being able to rationally handle a certain stock of international liquidity and arrive at a need an SDR requirement on this basis is no longer relevant.

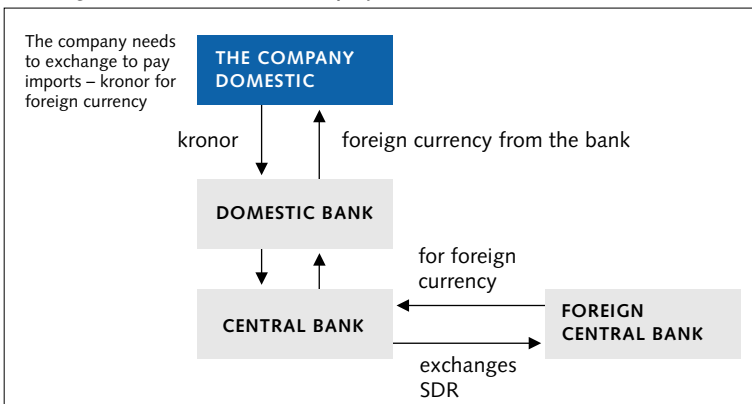
redistribution of currencies from member countries with payment surpluses to those with payment deficits.<sup>14</sup>

## Technique behind SDR – a closed system

The technique that SDR represents – a means of oiling the wheels – involves member countries giving an undertaking to provide currency at the moment they receive an allocation of SDR. The other side of the coin is that they are also entitled to draw upon this credit to meet a temporary payment deficit. This is a mutual agreement that is binding on all the countries that are members of the co-operative association, which is what the IMF actually is. In this way, countries with large currency reserves<sup>15</sup> can convert some of them into SDR, so that a country that needs currency reserves can then convert them into currency. Then, on an occasion when the country has a currency surplus, the currency can be paid back. The currency is usually the dollar (see fact box page 58). In addition the country with surplus reserves can once again convert foreign currency into SDR. It is clear that since it simply involves the conversion of SDR into a currency, SDR do not create any significant currency reserves.

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**Figure 1. SDR cannot be used as payment outside of IMF – exchange flow from one domestic company via the central bank**



Banks in countries without access to the international foreign exchange market must exchange with their central bank. If the central bank does not have sufficient foreign currency reserves, it exchanges SDR for foreign currency with the central bank abroad.

<sup>14</sup> The actual object was to convince surplus countries in the IMF to lend to countries that were running current account deficits. Nowadays, this function is provided by international currency markets for those countries that have access to them. In practice, SDR also correspond to a line of credit in a foreign currency between counterparties that is denominated in SDR.

<sup>15</sup> At present countries with access to the capital market really don't have to maintain large currency reserves at their central banks as they can readily borrow on the currency market and then pass the currency on to a country that does not have such access.

### Fact box

The IMF has allocated SDR generally to all member states in proportion to their quota on two occasions – in 1970 and 1978.<sup>16</sup> As several member states have joined since the last general distribution of quotas, a special allocation was agreed on in 1997. However, this has not been put into effect as the USA has not yet having ratified the Fourth Amendment. At the end of 2001, the amount of SDR in relation to the IMF's total reserves was around 10 per cent, which corresponds to some 215 billion Swedish kronor.

For the individual member country, an SDR allotment, i.e. the amount the country has undertaken to convert into currency in return for SDR, also means that the country's currency reserves will show a fictive increase. In the example below, the member state has been allotted – an obligation to convert – SDR corresponding to a value of 50 (passive side). This corresponds to a right – to convert currency into the SDR holding – for a value of 50. Consequently, the currency reserves will have increased by 50 in the member state.

When a central bank fulfils its obligation to buy SDR for the currency demanded direct from another central bank or from the IMF, the SDR are converted into the currency corresponding, say, to a value of 10. This means that the "real currency reserve" held by the central bank that accepts the SDR will decline by 10, which will increase the value of the central bank's holding of SDR by 10. The reverse is true if the country sells currency for SDR, that is to say it exercises its right to sell SDR. The country's total currency reserve after one transaction will thus be unchanged. The country's SDR allotment is only influenced by new undertakings.<sup>17</sup>

**TABLE 1. ACCOUNTING TREATMENT OF SDR HOLDING AT A CENTRAL BANK  
BILLION SDR**

Assets		Liabilities	
Currency reserve	400	Notes and coins	185
Gold	50	Other deposits	170
SDR holding	50 (60)	SDR allocation	50
Currency	300 (290)	Other liabilities	100
Other assets	250	Equity	45
		Result	100
Total assets	650	Total liabilities	650

### UNIT OF MEASUREMENT WITH A FLOATING VALUE

**An SDR corresponds to a basket of the most common currencies.**

The IMF has been using SDR as a unit of measurement since the middle of the 1970s. All bookkeeping is expressed in SDR. The value of the SDR was changed for the first time in 1973 when it approached the valuation of the most widely used transaction currencies. Today, an SDR corresponds to a basket of the most widely used currencies: the US dollar, euro, yen and sterling.<sup>18</sup> The values of the currencies are weighted to

<sup>16</sup> According to the IMF's statutes, SDR allocations shall be discussed as least once every five years to determine whether measures need to be taken (basic period).

<sup>17</sup> The members' allocation of SDR as such generates no interest, but when the SDR are converted into currency, interest is paid; or, vice versa, when a currency is converted into SDR, interest is received, which is administered by the IMF. The current rate of interest is around 2 per cent. Interest rates on SDR are based on market rates and they have gradually tended to converge with the short market rate of interest known as the interbank rate. This means that the IMF has been able to relax its rules for SDR and instead to let the member states' incentive to be partly based on the alternative cost on the currency market.

<sup>18</sup> The basket is reviewed every fifth year. The currencies included at present are those that are most widely used in international transactions.



reflect their relative share of global trade and the financial system. In effect, the IMF is hedging its activities in SDR as their value reflects the most liquid currencies (the most widely used transaction currencies). The IMF's loans to a member state are denominated and paid in SDR, as are the loan repayments to the IMF. Repayment in SDR, as on the ordinary currency market, involves a currency risk that the borrowing country has to accept, since the value of the loan changes in line with developments in the international economy. But if a country is capable of paying back its loan it is probably also likely that its economy is back on track again, and thus regarded as fit for acceptance by international financial markets.

## EFFECTIVE REDISTRIBUTION

In organisational terms, the processing and bookkeeping of SDR transactions are performed by a separate department within the IMF – the SDR Department. The IMF functions as an intermediary in more or less all SDR transactions. Initially, the IMF felt itself compelled to guarantee the liquidity of each transaction, and the member states were given direct instructions by the IMF either to sell or buy SDR. In order to ensure the liquidity of the system, a legal platform was provided in the form of Article of Agreement XIX, which lays down conditions for the use of SDR and the factors that determine whether or not a member state's economy is strong enough for the country to be able to offer to accept SDR for conversion into currencies up to given limits.

Using a procedure known as “Transactions by Agreement” the IMF agrees with a member state on how many SDR the country is ready to exchange for the currency in question. In the case of some members, there is a further agreement about how much of the stated currency the country is ready to accept. Since this agreement was introduced in 1987, member states have, in principle, been allowed to trade currencies against SDR directly with each other. However, the IMF also co-ordinates these transactions, probably both as a service for the central banks, and in order to maintain liquidity on the SDR market more effectively.

So that it can guarantee that a member state experiencing problems with its current account deficit will always be able to immediately exchange SDR against foreign currencies, the IMF makes a quarterly liquidity assessment of the SDR, known as the Designation Mechanism.<sup>19</sup> In broad outline the purpose of this is to adjust the holding of SDR so that the financially strong countries, on average, keep their allotment for a given period of time. In reality, SDR are really an enlargement of the facili-

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**SDR are really an enlargement of the facility for exchanging currencies over and above each member state's normal access to 25 per cent of its quota deposits.**

<sup>19</sup> For a more detailed description, see IMF (2001), page 94.

ty for exchanging currencies over and above each member state's normal access to 25 per cent of its quota deposits within the framework of the IMF's operative resources, known as the General Resources Account (i.e. the part that is not subject to conditionality conditions).<sup>20</sup>

## Hopes and fears for SDR

**SDR never became an international means of payment among the member states.**

SDR never became an international means of payment among the IMF's member states. If they had, the IMF would have evolved into a monetary union with a single monetary policy by virtue of its role as a source of funds – lender of last resort – in the same way as the European Monetary Union (EMU). In fact SDR were launched too late to become a reserve currency as the abolition of the gold standard and the growing acceptance of floating exchange rates for the largest currencies had already begun. As economies are becoming increasingly globalised, the dollar is still the largest reserve currency, even though other currencies, such as the euro, are now also widely used in international trade and are therefore included by central banks in their currency reserves. Now that we have free movement of capital and floating exchange rates the supply of these currencies is based on demand. However, SDR live on within the IMF and from time to time they become the object of both hopes and fears, probably owing to a failure to understand how they actually function.

**In the globalisation debate, discussions about SDR as a means to enable poor countries to overcome their problems have recently been returned to the agenda.**

In discussions on globalisation, most recently at the Monterrey Conference<sup>21</sup> in 2002, the groups covered by the term Non-Governmental Organisations (NGO)<sup>22</sup> once again raised the possibility of using SDR as a means of enabling poor countries to overcome their problems. Their proposals express in a variety of fairly loose ways an idea (none have been described in detail) about using SDR to achieve fairer financing (to redistribute financial resources). A common feature of all these proposals is that they are based, often implicitly, on the belief that by issuing SDR the IMF would boost its total reserves. This could be one factor behind the misunderstanding of the nature of SDR that might sometimes also have induced some people to claim that SDR are “money for nothing”. As I have explained above, nothing happens once the SDR have been issued as it is a strictly technical solution for entering an item that could be regarded as a contract to exchange a currency into/from SDR in a central bank's balance sheet.<sup>23</sup> It is only when the SDR are actu-

<sup>20</sup> For more about the IMF's lending arrangements, see International Monetary Fund (2001) and the IMF's web-site.

<sup>21</sup> The Conference on Financing for Development.

<sup>22</sup> NGO are the main interest groups questioning globalisation on grounds of injustice.

<sup>23</sup> The undertaking could be off-balance sheet, like an ordinary contract that corresponds to credit limits granted a bank but not yet drawn.

ally exchanged into a currency that a country gains access to the currency. At this point, several advantages for the various parties materialise. The members of the IMF all share the credit risk of a borrower country being able to exchange its currency back into SDR. Admittedly, the country that has received the currency is exposed to a currency risk, but as the value of the SDR is a weighted sum of the most widely used transaction currencies, this risk is limited (by comparison with exposure to a single currency).

Fears that SDR could be inflationary have been expressed repeatedly in connection with discussions on further SDR allocations. The allocation of SDR as such is not inflationary; on the other hand, “how” a country uses its SDR will determine whether they will cause inflation. Converting SDR into a currency could be inflationary in an individual country if the currency is then used for anything other than paying for imports of capital goods that the country can use to eventually eliminate its current account deficit. However, there is no immediately obvious, direct risk of inflation as the SDR are not a means of payment in the normal sense, circulating as they do exclusively within the IMF sphere. For each individual country (poor or not), the rule applies that has been developed on the international capital market, that each country itself determines its own fiscal and monetary policies. The same rules of the game, which are all about building up confidence in an economy, thus apply just as much to these countries as to other countries if they wish eventually to become accepted players on international currency markets. If the country imports consumer goods instead of capital goods, it could cause inflation, as the economy will then not grow fast enough to meet the increasing consumer demand. Within the limits of this argument, it is worthwhile highlighting the rule that an SDR allotment should be proportional to the borrower’s quota of the IMF’s assets, as this can limit not only its access to SDR but also the risk of inflation in the country in question.<sup>24</sup>

Another issue caused by the uncertainty that exists regarding SDR is the question of whether further SDR allotments can help to prevent a poor country’s economic situation from deteriorating even further in the event of a global downturn or recession. In this context, it is worth looking at some of the misunderstandings that have arisen regarding SDR, which often prompt debate on whether SDR allotments should be increased or not. The most fundamental misunderstanding is the question of anxiety about the threat of global liquidity crises. For the past 20 years or more, the financial market has functioned in a way that means there is

**The allocation of SDR as such is not inflationary; on the other hand, “how” a country uses its SDR will determine whether they will cause inflation.**

<sup>24</sup> Each country’s quota should broadly correspond to the relative size of its economy in the global economy. The definition of the quota formula is regularly discussed within the IMF, and the need to make adjustments to these quotas, individual or general, shall be reviewed at least every fifth year, according to the IMF’s statutes.

no shortage of liquidity at a global level. Capital markets are now free.<sup>25</sup> This freedom involves opportunities for financing currency reserves, which, however, always comes at a price.

The reserves were created in a way similar to when, under the Bretton-Woods System, the USA undertook to print dollar bills, but now it is the currencies of several countries that are regarded as strong enough to be used as reserve currencies. As the capital market has developed a variety of instruments, it is now always possible for a country to effectively counter the effects of an increased money supply. Central banks can now immediately sterilise this by withdrawing liquidity from the market again to prevent the increase in the money supply from having a counter-productive effect on monetary policy. This means there is really no need to increase the allotment of SDR.

**Lack of confidence in a country's economy means, as a consequence of the high risk, that its exchange costs will be excessive, even supposing that it can make the exchange.**

For a country to exchange currencies on the capital market it has to have access to the market. If the level of confidence is too low, which is the case for most poor countries, nobody is willing to accept the high level of financial risk that buying a poor country's currency involves. Lack of confidence in a country's economy means, on account of this high risk, that its exchange costs will be excessive, even supposing that it can make the exchange.

There are also misunderstandings about the problem of where the SDR and reserves go. Greatly simplified, the fact is that if the industrial countries, that is to say those that have SDR, were to convert their SDR into foreign currency to cover their own current account deficits, they would end up in the hands of the countries they are importing from or of the countries with which they exchange their currencies – in other words, the poor countries. However, ever since the end of the 1980s, the situation has been quite the reverse. It can be seen from Table 2 that 26 industrial countries generally held more than their SDR allotment while 103 borrower countries on average hold significantly fewer SDR than their allocation. In the debate this gives rise to allegations that the industrial countries are sitting on the SDR and, by implication, not sharing them with other more deserving countries.

**26 industrial countries have received more than their allotted SDR, while 103 borrowers have on average received significantly less than their SDR allotment.**

<sup>25</sup> By this is meant access to short-term credits, which are particularly common among foreign banks (known as inter-bank loans).

**TABLE 2. SDR HOLDINGS OF IMF COUNTRIES BY CATEGORY  
PER CENT OF TOTAL SDR ALLOTMENTS**

	No.	October 1983	October 1992 <sup>1</sup>	June 1998 <sup>1</sup>	June 1992 <sup>2</sup>	April 2000	April 2001
Lender country	26	86	123	115	107	101	105
Borrower country	103	10	18	41	34	40	29
Other <sup>3</sup>	54	58	59	75	60	80	82

<sup>1</sup> Before the increase in quotas at the 9th and 11th reviews.

<sup>2</sup> After the increase in quotas at the 11th review.

<sup>3</sup> This category shifts between lender and borrower, depending on circumstances.

Note. Five countries have not received SDR allotments as they became members of the IMF after the latest round of allocations in 1978.

Source: IMF – Financial Organisation and Operations of the IMF.

However, the industrial countries' large surpluses have arisen because large loan disbursements have been made in SDR. On these occasions, the industrial countries were responsible for exchanging SDR into foreign currency so that the borrowers could use the funds provided in their economies. The optimal solution, naturally, is for the SDR to circulate and for the industrial countries, the holders, to retain their allotment on average. When the borrower states have to service their loan commitments in SDR, i.e. they have either to pay interest or repay the loan, the interest/loan has to be converted into SDR before it can be paid to the IMF. In addition to this, the IMF pays the lender states (the industrial countries) interest in SDR.

**The industrial countries' large surpluses have arisen because large loan disbursements have been made in SDR.**

To sum up, it can be said that even though SDR have had little relevance as a means of international payment for a long time, and even though there is no lack of currency reserves in the international economy, poor countries can still benefit from using SDR, although they do not represent a financial solution for these countries. They do, on the other hand, provide a buffer stock of liquidity that could mean that poor countries can escape having to resort to the old, unfavourable means available (i.e. to curtail domestic demand) since they do not have access to the currency market to boost their currency reserves and cover their short-term currency requirements. Moreover, SDR are technically constructed so that a country can convert them at an average market price, as SDR are valued in terms of a weighted currency basket.

**Even though there is no lack of reserves in the international economy, poor countries can still benefit from using SDR.**

In principle, SDR complement the right of a member state to draw on 25 per cent of the capital it has deposited with the IMF as a means of temporarily covering a payments deficit. The distinction is not merely technical but also material in the sense that it costs a country to maintain reserves of 25 per cent, while it costs the country nothing at all until it

**SDR complement the right of a member state to draw on 25 per cent of the capital it has deposited with the IMF.**

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converts SDR into foreign currency. Despite their original purpose, SDR are a fairly flexible, easy to use, means of payment, as they share common features with other currencies that are traded on financial markets, even though they can only be used within the IMF system.<sup>26</sup>

The conclusion therefore is that SDR help poor countries that still do not have access to the currency market to engage in foreign trade. SDR serve as a sort of "ticket" (limited in number) for conversion into foreign currency for payments. SDR do not solve the problems of those countries that are more or less constantly running a current account deficit, as each country has limited access to SDR. But the SDR enable them to engage in foreign trade without accepting too high a currency risk or the risk of seeing their loans suddenly being called in if the borrowers start to get anxious about the level of risk exposure. Other means need to be adopted to build up a constant current account surplus and eventually build up enough confidence in their economy to enable them to gain access to international capital markets.

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<sup>26</sup> Just before the end of 2002, the IMF published a Working Paper entitled "International Liquidity and the Role of the SDR in the International Monetary System". Arguing from the perspective of free capital markets, the authors conclude that the advantages of satisfying the growing demand for international reserves by issuing more SDR include efficiency gains and lower system risks, the latter being a consequence of the fact that SDR are to some extent a substitute for reserves that have been borrowed on the open market, and which creditors often call in rather suddenly in the event of crises arising from the risk exposure they have taken on.

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