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Financial Crisis Revives Interest in Special Drawing Rights

by Simona E. Cociuba

While the dollar's supremacy isn't likely to fade soon, a substantial allocation of SDRs in 2009 brought them back into the spotlight.

The financial crisis that began in mid-2007 brought renewed calls for an alternative to the U.S. dollar as the dominant reserve currency in international transactions. Several developing countries suggested greater use of special drawing rights (SDRs).[1]

SDRs were created in 1969 under the first amendment of the International Monetary Fund (IMF) Articles of Agreement to supplement member countries' international reserves.[2] Nine years later, the IMF set the long-term objective of making the SDR "the principal reserve asset in the international monetary system."[3] To date, the SDR hasn't fulfilled that lofty aspiration. While the dollar's supremacy isn't likely to fade soon, a substantial allocation of SDRs in 2009 brought them back into the spotlight.

A Brief History of SDRs

Special drawing rights were designed to support the Bretton Woods international monetary system. Under this system, the U.S. pegged the value of the dollar to the price of gold, while other countries pegged their currencies to the dollar. To maintain the peg, countries needed to hold reserves—gold or U.S. dollars—to purchase their domestic currencies in foreign exchange markets. Although advanced economies performed well under Bretton Woods, it was short lived.[4] The system required the U.S. to achieve two mutually inconsistent objectives: maintain balance-of-payments deficits to satisfy growing world demand for dollars while preserving the currency's fixed exchange rate to gold. Persistent U.S. deficits in international transactions during the late 1950s boosted concerns about a dollar–gold convertibility crisis as dollar liabilities rose relative to U.S. gold holdings.

Some recommended creating a new source of liquidity. This was a difficult task. Years of negotiations culminated in the creation of the first amendment to the IMF's Articles of Agreement. During drafting of the document, great effort was spent on terminology acceptable to all negotiating countries. Terms such as reserve assets, reserve drawing rights or special reserve drawing rights—although used in early versions of the draft—were avoided amid heated disputes over whether the new instrument would be a reserve asset. The term ultimately agreed upon—special drawing rights—was in some ways ambiguous in order to reconcile opposing views.[5]

Since the IMF's early years, "drawings" or "drawing rights" have been informal expressions commonly used to refer to currency a member country could purchase from the IMF to meet balance-of-payments needs. As a result, it was necessary to add the word "special" to special drawing rights to indicate their novelty and distinguish the term from the old meaning of drawing rights.[6] Significantly, SDRs are not an IMF liability, but rather a potential claim on widely used currencies such as the U.S. dollar, Japanese yen, euro and pound sterling.

By the time special drawing rights debuted, disputes that had shaped the name abated and SDRs were recognized as reserve assets.[7] Later, the IMF decided to make the acronym SDR an official term.[8]

What's 'Special' About SDRs

After the Bretton Woods system collapsed in 1971, major countries shifted to floating exchange rates, and the need for SDRs diminished. Today, there are 204 billion SDRs in circulation, all created through a few allocations. General allocations of SDRs, based on long-term global needs to supplement reserves, occurred in 1970–72, 1979–1981 and August 2009. The special allocation in September 2009 distributed SDRs to countries that joined the IMF after 1981.

SDRs in the post-Bretton Woods era fulfill some of the functions of money—for example, they serve as a unit of account and a store of value—but have only a limited role as a medium of exchange. Therefore, SDRs aren't money. They can be used only in specific transactions involving other holders of SDRs. If a country wishes to use some of its SDRs, it finds another participant in the SDR system to receive them and provide currency in exchange.[9] In this way, SDRs give a country the ability to obtain major currencies.

SDRs serve as a unit of account for the IMF and other international organizations. Originally, the value of a special drawing right was 0.888671 grams of fine gold, which then equaled $1. In 1971, when the dollar was devalued, the SDR maintained its nominal gold value and became known as "paper gold."[10] Later, as the importance of gold in the international monetary system diminished, the value of the SDR was determined by reference to a basket of IMF member-country currencies. The basket—currently composed of the U.S. dollar, the Japanese yen, the euro and the pound sterling—may be expanded later this year when a five-year review of SDR valuation occurs.[11]

As a store of value, SDRs are equivalent to foreign exchange reserves. An allocation of SDRs gives each country access to an unconditional line of credit. When a country draws on its line of credit, exchanging SDRs for currency,

Table 1

SDR Allocations and Holdings, by Participant

(1981 to 2008, percent of total SDR stock)

	Allocations	Average SDR holdings
Advanced economies		
Major advanced economies		
U.S.	22.9	32.1
U.K.	8.9	2.4
Germany	5.6	6.2
France	5.0	3.0
Japan	4.2	8.4
Canada	3.6	2.7
Italy	3.3	1.5
Other advanced economies	15.7	12.5
Developing economies		
Africa	6.5	1.3
Developing Asia	9.1	4.2
Of which: China	1.1	2.4
India	3.2	0.5
Western Hemisphere	9.6	5.0
Of which: Argentina	1.5	1.4
Brazil	1.7	0.1
Middle East	4.1	5.8
Economies in transition	1.2	1.0
IMF and other holders of SDRs		13.7

NOTES: Country aggregates are based on the International Monetary Fund (IMF) World Economic Outlook classification. The outstanding stock of SDRs and the allocations to specific countries were unchanged between 1981 and 2008. Countries whose average holdings over this period exceed their allocations are net creditors into the SDR system.

SOURCE: IMF's International Financial Statistics.

it pays interest. The SDR interest rate is computed as a weighted average of interest rates on three-month government debt of the countries whose currencies are in the SDR basket. This calculation is a bit arbitrary because the SDR itself has no maturity. Moreover, the interest rate obtained may be below the rate that would be determined in an open market for SDRs (if such a market existed) because they are generally viewed as less liquid than government instruments. Nonetheless, SDR allocations are especially beneficial for countries that can't readily access international capital markets or for which access is expensive.

Role in Global Monetary System

By some metrics, the SDR's importance has grown over time. Its acceptance as a reserve asset has increased since the early 1980s, when advanced countries raised SDR holdings above their allocations, allowing developing countries to obtain currency with ease. While initially, countries were compelled to hold a minimum level of SDRs, the requirement ended in 1981.[12] Since then, developing economies such as Brazil and India have used most of their SDR allocations as a source of credit for extended periods (*Table 1*).

Still, the SDR hasn't achieved the dominance its creators envisioned. The IMF's attempts to broaden market use of the SDR during the 1980s—by promoting it as a financial asset and allowing other institutions, such as development banks, to hold SDRs—didn't meet with much success. There was little demand to use the SDR in more sophisticated transactions, such as currency swaps or forwards, or as collateral for loans. As an international reserve asset, the SDR has also played a limited role. Each new allocation brought a temporary surge in the share of world reserves denominated in SDRs. Nonetheless, due to limited allocations and growth in world reserves, SDRs accounted for less than 1 percent of world reserves by the mid-2000s (*Chart 1*).

Reasons for the SDR's limited role include poor liquidity, lack of market pricing and the relatively small amount outstanding. But perhaps most significant is that once worries regarding a U.S. dollar crisis fade, SDRs simply fall out of fashion.

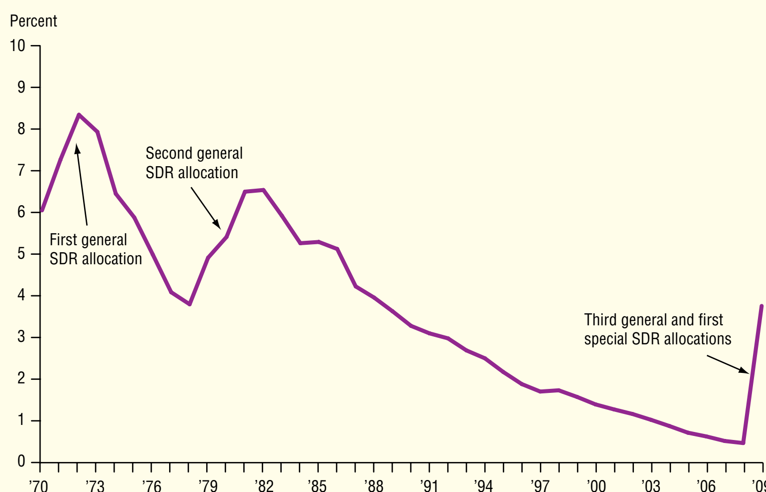
It isn't surprising that proposals for an SDR-based international monetary system were dusted off during the recent crisis as countries with large U.S. dollar reserves—seeing the U.S. monetary base expand—feared the value of their holdings would be undermined. Talk of an orderly diversification of reserve assets from dollars to SDRs resurrected the IMF's plans to establish a substitution account. Such an account would enable central banks to swap excess reserves for SDRs but would leave the IMF with a mismatch between U.S. dollar-denominated assets and SDR-denominated liabilities. Efforts to create this reserve-diversification account failed—first in 1974 and again in 1980—because there was no agreement on how to apportion exchange-rate risk.

Today, increasing the SDR's popularity would require more regular

Each new allocation brought a temporary surge in the share of world reserves denominated in SDRs. Nonetheless, SDRs accounted for less than 1 percent of world reserves by the mid-2000s.

Chart 1

SDRs: A Small Share of World Reserves



NOTE: The measure of world reserves used is total reserves minus gold.
SOURCE: International Monetary Fund's International Financial Statistics.

allocations and agreement on the same difficult issues that stalemated previous negotiations. It remains to be seen whether recent SDR allocations were a short-term response to the global crisis or the first of many steps in monetary system reform.

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Notes

[1] See "Reform the International Monetary System," speech by Zhou Xiaochuan, governor of People's Bank of China, March 23, 2009. Brazil, Russia and India supported China's call.

[2] International reserves are assets denominated in a foreign currency held by a country's central bank. These reserves can be used to finance international transactions.

[3] See Article VIII, Section 7, and Article XXII of the Second Amendment to the Articles of Agreement of the International Monetary Fund, effective April 1, 1978.

[4] For a detailed discussion of the Bretton Woods system, see, for example, "Monetary Policy Regimes and Economic Performance: The Historical Record," by Michael D. Bordo and Anna J. Schwartz, in *Handbook of Macroeconomics*, John B. Taylor and Michael Woodford, ed., Amsterdam: Elsevier, 1999, pp. 149–234.

[5] For discussions of the choice of language in negotiations that led to the creation of SDRs, see "Special Drawing Rights: The Role of Language," by Joseph Gold, International Monetary Fund (IMF), Pamphlet Series, no. 15, 1971, and "The International Monetary Fund: 1966-1971: The System Under Stress," by Margaret Garritsen de Vries, IMF, 1976.

[6] For more details, see note 5, Gold.

[7] At the annual meeting of the IMF's board of governors in 1969, the managing director spoke of "deliberate creation of reserves by the international community," and the governor for France referred to SDRs as a "new reserve asset of an unconditional type, designed to supplement gold and foreign exchange in the holdings of central banks" (see IMF's Summary Proceedings, 1969, p. 9 and p. 58).

[8] See Rule B-6 of the IMF's Rules and Regulations, adopted in 1983.

[9] Originally, the IMF designated a country with strong balance of payments and reserve position to be the receiver of SDRs and provide currency to a country in need. Later, several countries volunteered to buy and sell SDRs as necessary, eliminating the need for designation.

[10] See "Silent Revolution: International Monetary Fund, 1979-1989," by James M. Boughton, International Monetary Fund, 2001, pp. 924–62.

[11] The basket originally consisted of 16 currencies but was reduced to the currencies of the five countries with the largest exports of goods and services over the previous five years. The basket included the U.S. dollar, Japanese yen, Deutsche mark, French franc and pound sterling. In 1999, the mark and the franc were replaced by the euro.

[12] Countries in the SDR system were initially required to partially reconstitute their holdings of SDRs. Before 1979, average holdings of SDRs over a period of five years had to be at least 30 percent of the allocated amount. This floor was brought down to 15 percent in 1979 and to zero in 1981.

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