SDRs & the Gold Standard – A Concept Note

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International money creation

Under the Bretton Woods system, the value of each currency was expressed in terms of gold (called value at par) and countries were obliged to keep exchange rates for their currencies within one percent of parity. In practice, most countries fulfilled this obligation by observing the par value against the US dollar and by buying and selling their currencies for US dollars, while the United States undertook to buy and sell gold freely for US dollars at $35 a fine ounce, the par value of the US dollar. This was also the official price of gold, at which all transactions of the International Monetary Fund (IMF) were conducted.

In the early post war years, the USA held about 60 percent of the world's official gold reserves and there was widespread concern over a dollar shortage as war-devastated countries sought to buy goods from the US. But by the late 1950s, the dollar shortage was replaced by a dollar glut and in the 1960s an increasing number of countries sought to exchange dollars for gold.

This was due to a widespread perception that the amount of dollar liabilities outstanding was in excess of the total gold held by the USA. So, in effect, a dollar was seen to be worth less than the equivalent official level of gold.

There was an inherent shortcoming in the design of the system as pointed out by Robert Triffin in a seminal paper published in 1961. Since the dollar was the main reserve asset, a growing volume of international trade meant that there was a need for an ever increasing supply of dollars. Since new mining of gold could not keep pace with this, this meant that the growing stock of dollars was backed by a relatively stable stock of gold. This led to official concern that their reserve holdings of dollar would be worth less in terms of gold. It was this that led to increasing levels of dollars being exchanged for gold.

One possible solution to this dilemma lay in creating an international reserve asset that would supplement dollars and gold, in official reserve holdings, and restore the balance between the demand and supply of reserve assets. This was the solution that was agreed at the Rio de Janeiro meeting of the IMF Board of Governors in September 1967 and an international reserve asset in the form of 'Special Drawing Rights' came into existence.

The operation of Special Drawing Rights

The IMF was given the authority to create additional reserve assets through general allocations of SDRs to its members in proportion to their quotas. The IMF was also given the authority to cancel SDRs although to date there has been no cancellation. The IMF cannot allocate SDRs to itself or to other holders it prescribes. Decisions on SDR allocations are usually taken on a five-year basis and follow a set procedure where the managing director makes a proposal to the executive board, which must approve it. At the last and final stage, the proposal needs to be approved by the governors by an 85 per cent majority.

The SDRs are then exchangeable for other country currencies that can be used as an international means of payment. The first SDR allocation was done in roughly equal instalments on 1 January 1970, 1971 and 1972, with the total amounting to SDR 9.3 billion. The second allocation, totalling SDR 12.1 billion took place in similar instalments on 1 January, 1979, 1980 and 1981. There have been no further allocations since. The fourth amendment of the IMF Articles of Agreement provides for a special one-time allocation of SDRs to IMF members who currently have no SDR allocation because they joined after the last allocation in 1981. But even this incremental increase, which was approved by the IMF board of governors in 1997, has languished as it still awaits approval from the US congress before it can come into effect.

The current situation

While there was broad support for the special one-time allocation of SDRs with a 77 per cent vote (excluding the USA) the political support for a broader regular allocation of additional SDRs is lacking, especially from the industrialised nations. This is partly because the original driving force behind the SDR idea – the provision of an additional reserve asset in a world of limited reserve asset supply – assets meant gold and dollar in the 1960s – no longer holds.

Since the breakdown of the Bretton Woods system and the advent of freely exchangeable floating exchange rate systems for the industrialized countries, the supply of reserve assets has not been limited.

As well as gold and the US dollar, the euro, pound sterling and Japanese yen are now widely held as reserve assets. Since these are all freely tradable in the markets, their supply is not constrained and countries can make decisions about the level of reserves to hold.

This at least is the theory.

Yet many developing countries find it hard to buy and hold reserve assets. There are two ways in which developing countries can build up reserves: either by running a balance of payment surplus (excess of exports and capital inflows over imports and capital outflows) or through borrowing in the international financial markets. Not only do both have large associated costs, but many developing countries find it difficult to build up reserves even if they are willing to pay the costs.

Countries can build up reserves through exporting more than they import but this can entail high costs in terms of foregone consumption and investment. These costs are especially significant for the least developed countries (LDCs). Having high capital inflows is another way of building up reserves but these inflows are concentrated in only a few countries such as China and other countries in East Asia and hence cannot be a dependable source of building up reserves for most developing countries.

Countries may borrow to build up reserves but these have large associated costs even in the cases where this is a viable option. Most developing countries do not even have access to capital markets and no private creditor would be ready to lend to most of the LDCs at anything less than extortionate and clearly unaffordable interest rates.

Even for countries like Brazil, which regularly access the capital markets, the costs of borrowing are extremely high. Throughout the 1990s, emerging market countries as a group had to pay an average of eight per cent in excess of the rates available to industrial countries. The costs originate from the difference between the low returns available on reserves and the high interest rates levied on borrowings necessary to build those reserves. In 2003 for instance, Brazil, held about $50 billion of reserves that yielded about two per cent annual return. At the same time, Brazil has needed to pay an interest rate of about 13 per cent to borrow. This translates into an opportunity cost of about $5.5 billion or one per cent of GDP every year.

Other countries face even larger opportunity costs. The opportunity costs of holding reserves have been calculated to be in the range of $120 billion – $270 billion annually for developing countries as a group. This is a multiple of current levels of overseas development aid, which have languished at about $50 billion annually for many years.

Hence developing countries continue to encounter serious problems in terms of building up sufficient reserves at reasonable costs.

Proposals for SDR usage[i]

There have been several proposals for reinvigorating SDRs in recent years for various purposes that range from reserve allocation to poverty reduction and the provision of global public goods.

In the mid-1980s, executive directors from India, Belgium and France each sponsored a slightly different plan under which creditor countries would lend to the IMF the SDRs allocated to them, for use by the IMF to lend to developing countries.

In 1988, President Mitterrand of France proposed that the developed countries contribute their shares in a new allocation of SDRs to a special fund in the IMF that would guarantee the interest payments on certain obligations issues by debtor countries.

More recently, ideas were put forward to use the SDR mechanism to enable the IMF to provide more credit under situations of financial stress for its members. A task force sponsored by the Council on Foreign Relations suggested the formation of a new "contagion facility" for providing funds to tackle the recurrence of a financial crisis of South East Asian crash dimensions. It suggested that this facility should be funded through a one-off, very large ($45-$100 billion) allocation of SDRs that was then donated to the facility by all the member countries.

Richard Cooper suggested that the IMF articles should be amended to provide it with sufficient resources to cover even the worst contingency. The amendment would need to confer the IMF with the right to create SDRs on a temporary basis as needed to deal with financial crisis and forestall creditor panic.

The Zedillo panel, chaired by former Mexican President Ernesto Zedillo under the aegis of the UN Financing for Development (FfD) Conference, argued for reinstating regular SDR allocations. The panel argued that unlike the industrial countries, developing countries cannot borrow additional reserves in the market on reasonable terms. It suggested that the IMF should resume SDR allocations to allow developing countries to hold reserves more cheaply, thus limiting the real costs now being imposed.

This position is broadly shared by IMF staff and was implicit in a proposal made in 1993 by the then managing director, who proposed a general allocation of SDR 36 billion for increasing the supply of reserve assets at reasonable costs. But the proposal did not get the required 85 per cent support. A recent IMF working paper suggests the resumption of regular SDR allocations for the above purposes. The financier George Soros has suggested that SDR allocations be used to provide global public goods. He argued that:

- The IMF articles of agreement, as they stand, only allow for SDR allocations that are distributed to all member countries – in other words, to developed as well as developing countries.
- If the Fourth Amendment were implemented, the developed countries should donate their share of $18 billion of the allocated SDRs to help finance development assistance through the provision of global public goods.
- An independent board would determine which programmes would be eligible to receive SDR donations, but the initiatives and programmes would be generated from developing countries themselves.

- SDR donations should be used in the first instance for the fight against communicable disease, particularly AIDS and TB, for education, judicial reform and initiatives to close the digital divide.

Other commentators have suggested that the IMF use SDR allocations to cancel some of the debt owed by poor countries.

All of these proposals have some merit and deserve further consideration. But it is important to distinguish the different motivations and impacts implicit in the different proposals.

The ideas put forward by the Council for Foreign Relations and Richard Cooper both call for the use of SDRs to deal with contingencies. Under normal circumstances, these do not entail any additional costs for the developed countries whose currencies are exchangeable for SDRs. This is because, under normal conditions of the world economy, the SDRs would not be exchanged for other currencies and would only constitute a nominal not real transfer.

But in a financial crisis, industrial countries may be asked to provide their currencies in exchange for allocated SDRs. This may expose them to some risks but in aggregate the costs for industrialised countries are likely to be insignificant. In effect, this would be similar to an extension of the current arrangements that the IMF has in place for borrowing under contingencies.

The ideas proposed by India, Belgium and France in the 1980s, to use SDR allocations for conditional lending or guaranteeing some debt obligations, are again likely to have few incremental costs for the industrialised countries.

Proposals by the IMF staff and the Zedillo commission are very attractive and entail significant savings for developing countries that may be as high as $100 billion per year. New allocations of SDRs would have to be re-directed to poor countries, with the agreement of the rich – under the current rules, new allocations will not go automatically to the countries that need them.

But once again, any financial impact on industrialised countries is likely to arise only under condition of financial stress and is not likely to be significant. These proposals would not only generate some additional resources in the world financial system but also help increase stability.

The use of SDRs for debt cancellation and providing global public goods are very worthy goals. But unlike the set of proposals discussed above, the use of SDRs for this purpose would entail costs for developed countries. SDRs are simply a promise by the developed countries to provide backing with their own currencies. That means that every dollar spent on debt cancellation or provision of public goods would have to be an additional dollar provided by developed countries. In this sense, this proposal is equivalent to increasing overseas development flows.

The main advantage of the proposal is to provide a formal mechanism for the allocation of additional development costs by using the ratios of IMF quotas to decide the contribution that needs to be made by each of the industrialised countries. This can help mitigate the inequities under the current system whern some countries such as Denmark provide up to one per cent of GDP for development assistance and others like the USA contribute a miserly 0.1 per cent.

But given that even the much more modest proposal for SDR allocations suggested in the fourth amendment has been awaiting approval from the US congress for seven years; there is little hope of Soros' proposal seeing light of day.

The proposal to use SDR allocations as a reserve asset however, the 1993 proposal by IMF staff, should face less opposition because it delivers significant benefits to developing countries at relatively limited additional costs to the developed countries. It would help increase development, world wide economic activity and financial stability.

The SDR as currently designed cannot be used as a currency in its own right. This could be changed, but US opposition makes such changes unrealistic at present and within the present system of global financial institutions, the reform of which goes beyond the scope of this briefing.

Should we go back to the gold standard?

Some commentators have called for a return to the gold standard. They say that this would help re-link the financial economy with the real economy and help reform the international financial system – usually on the grounds that the financial system under the gold standard was a more stable system and was characterised by levels of high overall growth.

There are two possible ways this could happen: either going back to the gold standard where all currency in circulation is backed by a deposit of gold or a halfway house like the Bretton Woods system that prevailed till 1968, when the US dollar was backed by gold and other currencies were fixed in terms of the dollar.

Both systems have problems associated with them. The gold standard would link money supply to the amount of gold and the only way of increasing it would be for new gold to be mined. New gold production has stagnated and even shrunk in some recent years. So this could lead to a global deflationary economy as growth in currency circulation fails to keep pace with growth in the world economy.

More than that, this could lead to severe problems of inequity. Countries with large current reserves of gold, such as the USA, Germany and Switzerland would be at an inherent advantage in the system and many developing countries would be even worse off than they are now. The system would also introduce sharp inequalities between the gold producing nations such as the USA and South Africa and the other non-gold producing ones.

A return to the Bretton Woods system is more likely and less complicated but still problematic. The Triffin Dilemma, which proved to be the downfall of the system, would still exist and inherently destabilise the system. The system would also strengthen the existing dominance of the US dollar, which has only started to diminish in recent years. This could make the world financial system even more inequitable than it is now.

An increased use of SDRs offers one possible way out of the Triffin Dilemma and can perhaps be used to keep the dominance of the US dollar in check. But since the SDR is nothing but a basket of dollars, euros, pounds and yen, this system would just enshrine the dominance of these four currencies rather than that of the US dollar alone. Again, this may not be a desirable outcome.

So while it is possible to return to a Bretton Woods type system, especially with the increased use of SDRs, it would not cure the significant problems of inequality in the world monetary system. An extension of the SDR basket to include more currencies would reduce some of the problems of inequality, but not do away with them.

Two more ambitious alternatives might be possible:

- To change the definitions of SDRs to include, for example, rupees and other currencies from developing countries. This would be limited by the demand for these new currencies for export.
- To introduce a new international currency, based on a basket of commodities like oil, tin or corn, which would automatically provide support for developing countries with stocks of any of these.[ii]

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[i] Clark and Polak (2002): *International Liquidity and the Role of the SDR in the International Monetary System*, IMF working paper, Washington.

[ii] See for example Bernard Lietaer's proposal for the *terra* currency: in Lietaer (2001): *The Future of Money*, Random Century, London.