



An International Monetary Fund Currency to Rival the Dollar?

Why Special Drawing Rights Can't Play That Role

by **Swaminathan S. Anklesaria Aiyar**

Executive Summary

To alleviate the global recession, the G-20 group of nations recently agreed to authorize the International Monetary Fund to allocate \$250 billion worth of Special Drawing Rights—the IMF's unit of account—to its member states. This sparked much discussion on whether the SDR could become a new international currency, rivaling the U.S. dollar. Speculation was further fueled by the suggestions of Chinese officials that SDRs could displace the dollar in foreign exchange reserves. However, the SDR is not a currency and has no chance of becoming one.

Today the SDR has two roles: as a unit of account, and as a line of credit between IMF members. Neither role makes it a currency. The SDR's value is defined as equal to that of a basket of four currencies: the U.S. dollar, the euro, the yen, and the pound sterling. Member-states occasionally agree to issue SDRs to themselves, and these serve as

mutual lines of credit, providing needy countries access to hard currency. SDR allocations represent purchasing power through a credit facility, not through creation of a new currency.

Chinese officials and some leading economists want a greater role for SDRs in foreign exchange reserves. This would shift currency risk away from China to the IMF. But other IMF members would have to pick up that risk, and there is no reason for them to subsidize China. Underlying the SDR issue is a global struggle for political power. But China has a large and growing GDP and tax capacity, which may overtake that of the United States one day. Before then, the Chinese yuan will probably become convertible, and become a highly sought-after reserve currency in its own right. The real currency challenge to the dollar will come from the yuan, not the SDR.

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Introduction

To help alleviate the global recession, at its meeting in Great Britain in April 2009, the G-20 decided, as part of an overall stimulus plan of \$1 trillion, on a fresh allocation of \$250 billion worth of Special Drawing Rights by the International Monetary Fund to its member states. This immediately raised public interest in the question of whether the SDR will evolve into a new international currency that supplements, and eventually rivals, the dollar. Many politicians and economists want an enhanced role for SDRs in foreign exchange reserves. However, the SDR is not a currency, and never will be. It may play other roles, but not that of a currency.

Currently, the SDR plays two roles. First, it is a unit of account. Its value is defined as the value of a weighted basket of four currencies. The SDR basket has weights of 44 percent for the U.S. dollar, 34 percent for the euro, and 11 percent each for the yen and pound sterling. The value of an SDR at current exchange rates is around \$1.50. 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.

The SDR can be used as a unit of account. Transactions, loans, and contracts are usually designated in a single currency, like the dollar. But they can also be designated in SDRs, so that the currency risk of the contract is diversified among four currencies. Some SDR-denominated contracts and transactions do indeed take place on a limited scale. The IMF is currently planning to issue bonds worth up to \$500 billion that will be denominated in SDRs. This would increase the global reserves denominated in SDRs until the bonds mature a year later. But the bond issuance will not make the SDR a separate international currency; it will simply mean the SDR is being used more widely as a unit of account for bonds and other transactions.

The second role of the SDR is as a mutual line of credit for members of the IMF. The

IMF has so far allocated a total of 21.3 billion SDRs to its members in proportion to their shareholding. If a needy country like Turkey has a balance of payments deficit, it can ask the IMF to convert, say, 100 million SDRs of its allocation into dollars (or yen or any other currency). The IMF will debit Turkey's SDR account by 100 million, and credit the SDR account of the United States by the same sum. In return, the United States will hand over the dollar equivalent of 100 million SDRs to the IMF, which will hand that over to Turkey. So, the IMF acts as a middleman for credit lines from SDR-surplus to SDR-deficit countries. The credit and debit balances carry interest, at rates linked to rich-country bonds. Debtor countries would normally pay much higher rates, so the SDR line of credit can be viewed from the borrower's viewpoint as being subsidized, although it is not explicitly subsidized by the lender. SDR allocations add to the purchasing power of needy IMF members, who view it as especially valuable since it is not subject to the conditionalities of normal IMF loans. But clearly this limited role of the SDR, providing modest quantities of unconditional financial assistance, does not make it a new currency.

However, many countries and economists feel that the existing system of international reserves has deep flaws, and that remedies might include a substantially expanded role for the IMF and SDRs. To understand these new reforms, a brief history of the evolution of reserve currencies and of the SDR is helpful.

Historical Background: The Evolution of Reserve Currencies¹

Before World War I, most countries were on the gold standard: their currency issue was tied to the gold held in their reserves. A country whose gold holdings fell had to shrink its money supply too. Such stiff discipline meant that inflation was close to zero—a clear benefit. But the gold standard deprived countries of the monetary flexibility to combat adverse

conditions: they could not print currency to meet politically urgent expenses.

Governments wanted to spend enormous sums in World War I and so gave up the gold standard for the printing press. Besides, the bulk of gold production came from Russia and South Africa, and others were not happy at the notion that they were at the mercy of those two countries for future money supply, or that those two countries should have such a huge advantage over all others.

Some countries sought to reinstate the gold standard after World War I, but the effort was short-lived. Use of the printing press by governments became standard practice. This led to higher inflation, and in a few extreme cases to hyperinflation. This led to calls from some economists for a more disciplined system, and maybe even a return to the gold standard. But the political consensus was to give governments the power to issue money at will.

This continues to be the case today. Given rising public demands on governments, and what governments themselves feel inclined to do, they have decided—across the globe—that inflation is a price worth paying for the flexibility that the printing press provides. The same voters who approve of government activism and spending also complain about inflation. But, on the whole, voters appear to prefer electing relatively activist governments plus inflation over more limited governments focusing on stable prices.

The abandonment of the gold standard after World War I may have given governments flexibility, but certainly did not guarantee economic stability or success. The Roaring Twenties were followed by the Great Depression in 1929, which created a decade of misery until it was ended by the demands of war economies in World War II. During the Great Depression, competitive devaluations by different countries constituted a form of protectionism that invited retaliation by trading partners. The net result was a huge shrinkage of world trade, a fall in world GDP, and widespread unemployment and distress.

In 1944, major market economies gathered at Bretton Woods, New Hampshire, to devise a

post-war monetary system. The British economist John Maynard Keynes had written about the possible advantages of creating a new international currency—Bancor—which would be anchored in 30 commodities. But there was no political will to give up national currencies or the printing press. The U.S. economy was by far the strongest in the world at the time, and the U.S. dollar was the strongest currency. So instead, the Bretton Woods meeting agreed on creating the International Monetary Fund to oversee a new international system that would be anchored to the dollar—the only currency convertible to gold by central banks. The exchange rates of other currencies were fixed in relation to the dollar, and any changes in exchange rates were to be negotiated with the IMF in order to prevent the competitive devaluations that had wrecked the world economy in the 1930s.

Immediately after World War II, much world trade was still done by barter or by special arrangements (for instance, countries with sterling balances could use them to buy British goods, but not goods from other countries). The Marshall Plan (1948–1951) sought to aid the revival of war-hit economies and aimed for the restoration of currency convertibility on current account. But it was only in 1958 that European economies were able to achieve this aim, and Japan followed in 1964. Convertibility on capital account was not part of the Bretton Woods framework, and came decades later.

The Bretton Woods system appeared to give the United States an advantage: it had the only convertible currency, and so could issue domestic currency to pay its import bills. The convertibility was not absolute; individuals could not demand gold for dollars, but foreign central banks could. As world trade grew in the 1950s and 1960s, and countries accumulated rising stocks of dollars in their foreign exchange reserves, it became apparent that the United States would run out of gold if every foreign central bank demanded gold for dollars. President Charles de Gaulle of France aggressively converted his dollars into gold, partly out of resentment of dollar dominance,

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and partly out of fear that the United States would ultimately not be able or willing to honor its gold convertibility. The U.S. government found this potential attack on its gold reserves uncomfortable, and also found that the Bretton Woods system denied it the flexibility to devalue to improve its trade balance. Eventually President Richard Nixon devalued the dollar and ended convertibility to gold in 1971.² An attempt was made to refix exchange rates of the biggest economies (the so-called Smithsonian Agreement) within a small trading band. But this arrangement soon broke down and currencies began floating.

Many economists feared that global trade would be hit by the uncertainty of floating currencies. There were indeed major ups and downs. The dollar was weak in the 1970s, but appreciated very sharply in the early 1980s. That rise was finally checked by the Plaza accord of 1985, when major countries used coordinated currency intervention to reverse the dollar's rise. One of the aims of doing so was to reduce the U.S. trade deficit, which had soared to 3.5 percent of GDP because the strong dollar sucked in imports and made exports less profitable. The U.S. trade deficit with Europe did indeed fall, though not its deficit with Japan. The 1987 Louvre accord ended the decline of the dollar. World trade continued to boom in the next two decades, notwithstanding recessions in 1991 and 2001. The experience ended earlier fears that floating currencies would damage trade.

The emergence of floating currencies greatly eroded the importance of foreign exchange reserves. Earlier, under the old Bretton Woods system of fixed exchange rates, a country needed foreign exchange reserves to plug current account deficits. Then, in the early days of floating, countries also used foreign exchange reserves to intervene in currency markets and try to defend implicit or explicit exchange rates. But as time went by, countries became increasingly comfortable with currency fluctuations and greatly reduced their interventions in currency markets. Even in floating regimes, central banks sometimes intervened to prevent extreme movements—this was called a

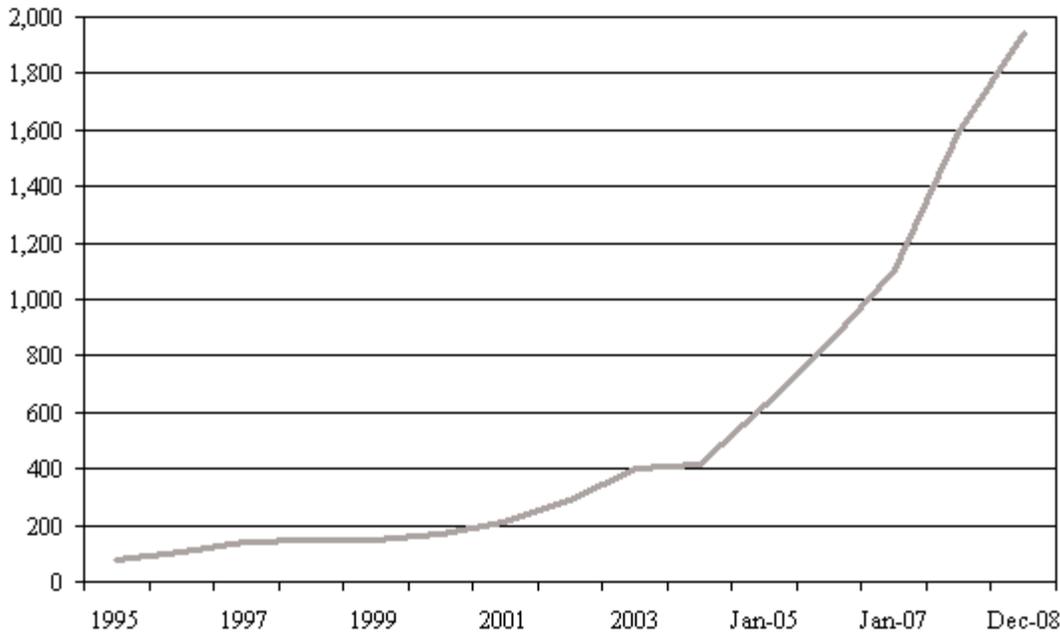
managed float. The European Monetary Union aimed at harmonizing currencies within the EU, and eventually produced the euro. The dollar value in the last ten years fluctuated between \$0.80 and \$1.60 to the euro, yet this huge currency fluctuation did not damage the world financial or trading system.

However, many developing countries wanted to have implicitly or explicitly pegged exchange rates. A few countries like Hong Kong or Saudi Arabia pegged their currencies to the dollar: they felt too dependent on trade to try to manage an independent currency regime. But some other countries aimed for undervalued exchange rates to facilitate export-oriented growth. The central banks of such countries would, if faced with a major dollar inflow, buy up much of the inflow rather than let their currency appreciate, and then park those dollar surpluses in their foreign exchange reserves.

China was the main such country, and its approach was widely criticized by economists who correctly viewed it as mercantilist. It sought to pile up foreign exchange reserves rather than let its currency appreciate, lowering the price of imports for its citizens. However, the Chinese government felt that the advantages of mercantilism more than offset the costs. After all, China's overall policies—including trade liberalization and deregulation—made it the fastest-growing country in the world. In the process, it also accumulated the largest foreign exchange reserves in the world.

During the Asian financial crisis of 1997–2000, the United States began running large trade deficits. This was very useful in enabling the stricken Asian economies to recover as they relied on the United States to play the role of importer of last resort. But that crisis left an impression in Asia that their economies were highly vulnerable to capital outflows. As long as Asian countries chose to deviate from a market-based exchange rate mechanism that was either fully fixed, as in the case of Hong Kong, or fully floating, they would need to rely on a discretionary policy of reserve accumulation to defend their pegged rates. So they resolved to build high foreign

Figure 1
Chinese Foreign Exchange Reserves (minus gold) (\$US billions)



Source: State Administration of Foreign Exchange, People's Republic of China.

exchange reserves to ensure future safety. This meant running high current account surpluses, which in turn meant aiming at undervalued exchange rates plus high domestic savings. China was the champion in both respects.

Asian countries could not run huge current account surpluses unless some others were willing to run corresponding deficits. The deficit role was taken on mainly by the United States and the United Kingdom. The trade deficits of these countries were financed by a huge transfer of hard currency to Asian countries (mainly China) and OPEC members. These countries put the hard currency in foreign exchange reserves—meaning they purchased bonds designated in dollars, euros, yen, and sterling—the four major hard currencies. Chinese foreign exchange reserves skyrocketed (see Figure 1), as did Chinese holdings of United States bonds, which are now valued at about \$768 billion.³

This huge demand for U.S. bonds depressed long-term U.S. interest rates and induced a U.S. borrowing spree, both for spending and for

buying assets. The U.S. buying spree created the current account deficit required to match the Asian surpluses. The asset-buying spree led to bubbles in the housing market, the stock market, and ultimately the commodity market, as financiers pounced on commodities as one more asset class.

This is the interpretation of events favored by many U.S. analysts, notably Ben Bernanke, chairman of the U.S. Federal Reserve Board. This interpretation views the root cause of macroeconomic imbalances as China's "savings glut." In fact, the macroeconomic imbalances flowed not just from China's savings glut to the United States, but from the U.S. profligacy towards China. The Federal Reserve Board kept interest rates in the United States too low, especially from 2003 onward, and U.S. lawmakers and regulators encouraged huge borrowing by financial institutions, corporations, and homeowners.⁴ Loose money plus fiscal deficits stemming from the Iraq war sucked in huge imports, creating trade deficits. Thus

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With the breakdown of the Bretton Woods system in the early 1970s, reserves were no longer needed on a global scale to maintain fixed exchange rates.

Chinese mercantilism and U.S. overspending fed on one another in a vicious cycle.

Not even the strongest economy in the world, the United States, could keep on running current account deficits in excess of 5 percent of GDP. It was equally unfeasible for China to keep household consumption at less than half its GDP and use huge excess savings to build up foreign exchange reserves. These global imbalances were unsustainable and helped create bubbles that were bound to burst at some point. In 2008, global credit collapsed and financial markets froze in fear. Production and employment plummeted as the whole world slipped into what some now call the Great Recession.⁵

Governments around the world came out with stimulus packages, involving fiscal and monetary expansion. They all decided to run huge budget deficits to pump purchasing power into their economies. And they expanded money supply to rush liquidity into frozen markets. Interest rates were slashed—down to the range 0–0.25% in the case of the United States. Quantitative easing—the printing of currency by central banks—began on a massive scale. The U.S. Federal Reserve injected a whopping \$2 trillion into U.S. markets, an unprecedented avalanche of money. Other countries across the globe followed suit.

In pursuit of the same economic logic, the G-20 proposed a fresh IMF allocation of \$250 billion worth of SDRs. The aim was not to move toward a new world currency, but to provide hard currency access to countries suffering a sudden disappearance of global liquidity. Since 1981, the major shareholders of the IMF had failed to agree on the creation of fresh SDRs, mainly because of fears that that this would be inflationary. But in the context of the Great Recession, these fears were set aside.

Evolution of the SDR

How did SDRs come about? In the 1950s and 1960s, world trade was rising fast. The dollar and gold were the only two reserve curren-

cies at the time. Fears arose that the supply of reserves might not be enough to grease the wheels of world trade. If the United States ran large trade deficits, it would of course flood the world with more than enough reserve money. But if the United States ran a zero deficit or a current account surplus, this could lead to a shortage of reserve currency and a slowdown of trade. Hence, a demand arose for creating additional reserve money, possibly through the IMF. This was the genesis of the SDR.

Many economists saw in the SDR a possible resurrection of Keynes's idea of Bancor as a new international currency. But no country wanted to give the IMF the right to print money on its account. So, the SDR was devised as neither a currency nor a claim on the IMF. In official jargon, it was described as a potential claim by all IMF members on the hard currency issued by a handful of strong countries.⁶ In simple language, SDRs were lines of credit extended by IMF members to one another. In theory, the United States could use its SDR allocation to purchase the currency of Liberia or Togo, but of course there was no interest at all in such transactions. The key feature of the SDR arrangement was that Liberia or Togo could exchange their SDR allocations for dollars, or other hard currency. The hard-currency countries were obliged to accept SDRs from weak members. Naturally, the hard-currency members were conservative about giving such unconditional lines of credit. That explains why SDR allocations were few and far between.

The value of the SDR was initially defined as equivalent to 0.888671 grams of fine gold—which, at the time, was also equivalent to one U.S. dollar. After the collapse of the Bretton Woods system in 1973, however, the SDR was redefined as a basket of currencies. The basket today consists of the U.S. dollar, euro, Japanese yen, and British pound sterling, in the ratio of 44:34:11:11. The basket composition is reviewed every five years to ensure that it reflects the relative importance of currencies in the world's trading and financial systems. The SDR interest rate is determined weekly as a weighted average of interest rates on three-month bonds of the currencies in the SDR basket.

The amendment of the articles of the IMF which provided for the issue of SDRs made it clear that the IMF could not allocate SDRs to itself. If it could, it might indeed have become a creator of new money, but it has been prohibited from doing so. Its role is simply to manage the mutual lines of credit that constitute SDR allocations.

There are two kinds of SDR allocations. General allocations of SDRs are based on a perceived long-term global need to supplement existing reserve assets. The first such allocation was for SDR 9.3 billion, distributed in 1970–72. The second allocation of 12.1 billion SDRs was distributed in 1979–81 and brought the cumulative total of SDR allocations to SDR 21.4 billion.

After that, no SDR allocations were made until the latest G-20 decision. Why were no SDRs created for decades? First, with the breakdown of the Bretton Woods system in the early 1970s and the floating of currencies, reserves were no longer needed on a global scale to enable countries to maintain fixed exchange rates. That initial justification for fresh SDR allocations therefore faded away. Secondly, fears arose that additional SDR issues would stoke inflation. From the 1980s onwards, many central banks adopted a policy of targeting low rates of inflation, and of not printing money to monetize government deficits. This inflation focus did not sit well with the idea of issuing new SDRs that would expand global purchasing power and tend to create inflation.

In 1997, the IMF considered a proposal for a special one-time allocation of SDRs through the Fourth Amendment of the Articles of Agreement. This allocation would have doubled outstanding SDR allocations to SDR 42.8 billion. Its intent was to enable all members of the IMF to participate in the SDR system on a basis more accurately reflecting the relative size of members' economies, and correct for the fact that many countries that joined the IMF after 1981—more than one-fifth of its membership—had never received an SDR allocation. The Fourth Amendment was to become effective when three-fifths of the IMF membership

(111 members), with 85 percent of the total voting power, accepted it. Currently, 131 members, with 77.68 percent of total voting power, have accepted the proposed amendment. But the United States, with 16.75 percent of the total votes, refused to accept the amendment, which therefore did not cross the approval threshold.

The Great Recession finally persuaded the United States to relent and agree to a fresh issue of SDR 250 billion. When fear gripped credit markets after the collapse of Lehman Brothers in September 2008, normal trade credit to many developing countries suddenly dried up. Countries found it difficult to open the usual letters of credit that had for decades routinely provided short-term credit for their imports. The meltdown's impact on their capital account was in some cases even greater. Emerging markets had earlier benefited from capital inflows of around \$600 billion in 2007, but after the meltdown, they could face an outflow of up to \$180 billion in 2009.⁷

Developing countries could and did inject domestic currencies into their own markets to stimulate domestic economic activity. But only an external injection could provide some international liquidity to compensate for the fear-induced disappearance of capital flows and trade credit. Fresh liquidity could help not only developing countries but developed ones too: the additional liquidity would enable developing countries to import more from developed ones. A consensus among world leaders emerged that additional liquidity was needed to grease international trade. This facilitated the G-20 decision on a fresh allocation of \$250 billion worth of SDRs, as part of a total stimulus package of \$1 trillion. Of this \$250 billion, barely \$100 billion will accrue to developing countries, and some big allottees among developing countries (such as China and Saudi Arabia) have no shortage of foreign exchange. Maybe \$50–80 billion of the additional allocation will be used by countries in need. That is a significant sum for distressed economies, but very modest in terms of adding to globally usable reserves.

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China can diversify its reserves gradually, without causing huge currency gyrations.

The new SDR issue represents quantitative easing at the international level to supplement quantitative easing within countries like the United States. This has potentially inflationary risks. In the middle of a recession, quantitative easing will tend to stoke sales rather than prices. Yet when normalcy returns, the huge overhang of money will become inflationary, and the U.S. Fed will have to find some way of sucking the money out of the system without causing another recession. This will be politically and financially tricky. When inflationary fears return—as they surely will once the Great Recession ends—key IMF members will once again become very reluctant to agree to further SDR allocations. As happened after 1981, anti-inflation sentiment might thwart further SDR allocations for decades.

However, for reasons totally unrelated to liquidity, some other developing countries seek a much-expanded role for the SDR. China and some other countries want to explore ways to upgrade the SDR into a super-sovereign reserve asset. These countries hold trillions of dollars in their foreign exchange reserves. With the United States printing trillions of dollars to stimulate the U.S. economy, China fears that the dollar—and China’s own reserves—will crash, a fear shared by many U.S. economists, too. Hence, China wants SDRs as a rival reserve currency. Other countries, as well as some eminent economists, have backed this proposal.

Replacing the Dollar with the SDR as a Reserve Asset

In the 1970s, as is the case today, there were fears that inflation would erode the future value of the dollar, and hence of foreign exchange reserves held in dollars. Not surprisingly, the proposed solutions at that time resemble the ones being proposed by China today. In the 1970s, IMF staff worked out details of a scheme called the IMF substitution account.⁸ Countries would be able to deposit dollar securities into this account, and in return the IMF would give them secu-

rities designated in SDRs. Since the SDR was a basket of currencies, SDR-designated securities would be more stable in value than dollar securities, and countries with SDR-designated reserves would have less currency risk than those holding dollar securities alone. The obvious objection to the substitution account was that it would, in effect, transfer the currency risk from surplus-dollar countries to other members of the IMF. Mainly for this reason, the scheme never got off the ground.

However, this approach has been resurrected by the governor of the People’s Bank of China, Zhou Xiaochuan, in recent speeches and writings. Consider the following passages from Zhou’s widely noted speech on March 23, 2009:

The outbreak of the current crisis and its spillover in the world have confronted us with a long-existing but still unanswered question: what kind of international reserve currency do we need to secure global financial stability and facilitate world economic growth, which was one of the purposes for establishing the IMF? . . . Issuing countries of reserve currencies are constantly confronted with the dilemma between achieving their domestic monetary policy goals and meeting other countries’ demand for reserve currencies. On the one hand, the monetary authorities cannot simply focus on domestic goals without carrying out their international responsibilities. On the other hand, they cannot pursue different domestic and international objectives at the same time. They may either fail to adequately meet the demand of a growing global economy for liquidity as they try to ease inflation pressures at home, or create excess liquidity in the global markets by overly stimulating domestic demand. . . .

The desirable goal of reforming the international monetary system, therefore, is to create an international reserve currency that is disconnected from individual nations and is able to remain stable in

The SDR is best viewed as a currency exchange traded fund.

the long run, thus removing the inherent deficiencies caused by using credit-based national currencies. . . . Compared with separate management of reserves by individual countries, the centralized management of part of the global reserve by a trustworthy international institution with a reasonable return to encourage participation will be more effective in deterring speculation and stabilizing financial markets. The participating countries can also save some reserve for domestic development and economic growth. With its universal membership, its unique mandate of maintaining monetary and financial stability, and as an international “supervisor” on the macroeconomic policies of its member countries, the IMF, equipped with its expertise, is endowed with a natural advantage to act as the manager of its member countries’ reserves. . . . The centralized management of its member countries’ reserves by the Fund will be an effective measure to promote a greater role of the SDR as a reserve currency. *To achieve this, the IMF can set up an open-ended SDR-denominated fund based on the market practice, allowing subscription and redemption in the existing reserve currencies by various investors as desired* [emphasis added]. This arrangement will not only promote the development of SDR-denominated assets, but will also partially allow management of the liquidity in the form of the existing reserve currencies. It can even lay a foundation for increasing SDR allocation to gradually replace existing reserve currencies with the SDR.⁹

Zhou’s proposed solution—an open-ended SDR denominated fund—looks similar to the substitution account first proposed in the 1970s. It has been supported strongly by some economists, notably Fred Bergsten of the Peterson Institute of International Economics. According to Bergsten, “The risk is that China and perhaps other monetary authorities, together holding more than 5 trillion in dollar reserves, will lose confidence in the dollar

owing to the prospects for huge and sustained budget deficits in the U.S.” If China dumps dollars to buy euros, this would send the dollar into free fall and send the euro skyrocketing. Far better, argues Bergsten, would be a substitution account that he claims would be a win-win proposition for all concerned. “The dollar holders would obtain instant diversification. The U.S. would avoid the risk of a free fall of the dollar. Europe would prevent a sharp rise in the euro. The global system would eliminate a potential source of great instability.”¹⁰

However, there are two obvious objections to the scheme. First, China has accumulated its dollar hoard through mercantilist policies that have been criticized widely. China appears to have gained tremendously in GDP through such mercantilism, but it has come at a high cost, including the cost of piling up currency risk in its foreign exchange reserves.¹¹ If China suffers because of a fall in the dollar, it surely deserves to suffer the consequences of its own mercantilism. Why rescue a mercantilist?¹² Let China diversify into euros or yen at its own pace. In any case, there is no reason to think it will dump dollars on such a huge scale as to send the dollar plummeting—that would be shooting itself in the foot. China can diversify its reserves gradually, without causing huge currency gyrations, and with the same outcome as a substitution account. Suppose, for instance, that China wants to use the substitution account to exchange \$100 billion into SDR securities. If so, the break-up value of those SDR securities will be \$44 billion worth of dollars, \$34 billion worth of euros, and \$11 billion worth each of yen and sterling. But China could just as well convert \$100 billion of its existing reserves into the same mix of four currencies through market transactions. No IMF help or subsidy is needed.

Indeed, China can rearrange its entire reserves with weights of 44 percent for the dollar, 34 percent for the euro, and 11 percent each for the yen and pound sterling. This will have exactly the same effect as converting its entire foreign exchange reserves into SDRs! This drives home the point that the SDR is

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SDR securities
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Collateralized
Debt Obligations
of the IMF.**

best viewed as a currency exchange traded fund. ETFs are bundles of assets tracking a well-known index, such as the 30 companies in the Dow Jones Industrial Index. The SDR is a currency ETF that tracks four currencies. ETFs represent no more than a convenient bundle of existing assets, and do not constitute a new asset. Any portfolio can contain the components of an ETF rather than the ETF itself, and the outcome will be the same.

Bergsten has argued that if Chinese-held dollars are not switched into SDRs, then China may dump huge quantities of dollars on the market if it feels severely threatened by U.S. protectionism, or if there is a flare-up over Taiwan or the Dalai Lama.¹³ However, the substitution account will not change this risk. If China wants to penalize the United States, it can simply dump SDRs for euros, and this will hit the dollar, which constitutes 44 percent of the SDR basket. The political power to penalize does not depend on the composition of one's reserves.

The second objection to a substitution account is that it will transfer a big currency risk from China to the IMF. Bergsten believes that the risk is limited, and that if necessary the gold holdings of the IMF can be used to give extra comfort to holders of the SDR securities. But members of the IMF want the gold to be used for other purposes, notably for increasing lines of credit or providing cheaper loans to poor countries. Why use the gold to subsidize the portfolio diversification of dollar-surplus countries like China and Saudi Arabia? This cannot be a priority for the overwhelming majority of countries, rich or poor.

In fact the risks of the substitution account are not small; they are very substantial. An open-ended substitution account of the sort Zhou mentions could end up receiving trillions of dollar securities, and issuing trillions of SDR securities in exchange. If the dollar falls, the assets of the IMF (the dollar securities it has acquired) will be worth much less than its liabilities (the SDR securities it has issued). The resulting hole in its accounts could be hundreds of billions of dollars. Who will plug the resulting hole? The United States and oth-

er major shareholders have no interest in doing so, but they will be called to do so. A large hole will reduce and possibly destroy altogether the IMF's ability to lend to its poorest members, many of whom ironically see the substitution account as a quasi-political way of reducing the dollar's dominance.

The risks of the substitution account can be understood by looking at the parallels with the housing meltdown in the United States. One cause of the meltdown was the emergence of Collateralized Debt Obligations. Clever financial engineers combined bits of subprime mortgages with prime mortgages, and argued persuasively that the package would be virtually risk-free. Rating agencies like Moody's gave the CDOs a rating of AAA. We now know this was a huge boondoggle. After the meltdown, we are on guard against schemes to launder BBB mortgages into AAA securities.

The substitution account is, in essence, a comparable laundering scheme. Dollar securities are proposed to be laundered into SDR securities, accompanied by assurances from financial experts that the risk is really quite manageable. The proposed SDR securities will be CDOs of the IMF: that is, these securities will be debt obligations of the IMF, backed by dollar securities as collateral. The major shareholders of the IMF are aware of the risk, and for that reason, the substitution account right now is not under active discussion in the IMF.

However, many economists feel that the current reserve system is so flawed that major reforms are indeed required.¹⁴ The macroeconomic imbalances leading to the Great Recession arose, in part, from the determination of Asian countries to build huge foreign exchange reserves, and to avoid any future repetition of the Asian financial crisis. The current meltdown appears to have vindicated this approach, and will strengthen the Asian resolve to keep high reserves. This approach can be called reserve anxiety. Economist Martin Wolf writes:

While the international monetary system is indeed defective, this is hardly the sole

reason for the world's vast accumulation of foreign reserves. Another is overreliance on export-led growth. Nevertheless, Governor Zhou is correct that part of the long-term solution of the crisis is a system of reserve creation that allows emerging economies to run current account deficits safely.¹⁵

High foreign exchange reserves imply that a country is saving more than it needs for investment, and stashing the excess into foreign securities. An excess of savings in China and other surplus countries contributed to today's meltdown. To rectify global imbalances, the United States and the United Kingdom need to save much more, and Asia needs to save much less. The U.S. household savings rate, which had fallen to zero, is now up to 5 percent or so. This needs to be matched by smaller savings in Asia. But if Asians seek to keep their reserves high, they will in effect be saving too much. And if both the United States and Asia aim for high savings, and neither encourage spending, then the Great Recession could become another Great Depression.

Hence, some economists seek a reform of the foreign exchange reserve system to assuage reserve anxiety and prevent another build-up of macroeconomic imbalances. Asian and other developing countries want assurances that they will survive future shocks without very large reserves. These other proposals have included the tripling of IMF quotas (though most IMF loans carry politically tricky conditionalities) and access to the newly created IMF flexible credit line that enables pre-qualified countries to get unconditional access to IMF funds. Mexico, Poland, and others have signed up for this credit line, which they hope they will never have to use. They believe that the mere existence of the credit line will thwart concern on the part of other creditors.

The United States Federal Reserve has unilaterally provided swap facilities of \$30 billion to Brazil, Mexico, Singapore, and South Korea, to reduce reserve anxiety and ensure liquidity to its trading partners. China has offered swap lines to select developing countries. Large, fresh

SDR allocations would amount to a multilateral swap facility between members. All these measures might relieve reserve anxiety.

Independent of their merit or lack of merit, however, all these are technocratic solutions to the reserve problem. In the public debate, the more important issue is political.

The Politics of a New Currency

Technocrats know well that the SDR is not a currency and cannot become one. Yet the media and public debates remain full of speculation about a new international currency, drawing on concerns around the world of U.S. dominance and the possibility that it can be trimmed by ushering in a new currency that will diminish the stature of the dollar.

Now, the IMF does not have too many admirers across the world. It has been attacked by many developing countries—among other reasons, for serving the interests of the United States and Europe, which dominate the shareholding and decisionmaking of the IMF. Yet the shareholding of China and other developing countries in the IMF is likely to rise, and that of the United States and Europe to fall, in coming years. So, despite their reservations about the IMF, many developing countries would nevertheless like power to shift from the United States and Europe to the IMF, thus reducing U.S. political and financial clout. Developing countries believe they would have some say over an IMF-managed currency, which they view as better than having no say at all over U.S. currency. However, for its own economic and political reasons, the United States has no interest in trying to engineer a shift of power from itself to the IMF, or from the U.S. dollar to the SDR.

Indeed, U.S. resistance to more frequent SDR allocations stems not just from worries about inflation, but from the political consequences, too. The main effect of SDR allocations is to provide additional purchasing power for poorer countries. To this extent, the allocations resemble aid. But this aid goes not

Lending money is not an exercise in democracy.

The really big change on the horizon is the arrival of the Chinese yuan as a fully convertible currency.

just to governments the United States would like to help, but to others whom it believes might not merit it, and still others it might want to sanction rather than help—for example, Venezuela, Iran, Zimbabwe, Myanmar, Syria, and Sudan. Washington would rather give bilateral aid to its friends than SDR allocations to all countries—which includes its foes.

Bennett McCallum of Carnegie Mellon University made the following remarks in Washington about China's desire to replace dollars with SDR credits in the IMF:

It is not foolish for China to have such a desire. But it would be foolish for the U.S. to support a reorganization of the international monetary system that turns over control to the IMF, especially as the political structure of that organization will likely be changing over time in ways that will reduce the influence of the U.S. over its decisions and actions. Such support would also, arguably, be foolish from the standpoint of the world as a whole. In this regard, one needs to imagine how the world's international monetary system would function if it were managed by an agency of the United Nations.¹⁶

Although it is self-evident to McCallum that the UN was a politicized bumbler, in developing countries speeches are routinely made exhorting IMF reforms that will make the organization more democratic, like the UN. At the spring meeting of the IMF in April 2009, Brazilian Finance Minister Guido Mantega complained of a “democratic deficit” in the IMF.¹⁷ Borrowers might like a greater say in the IMF, but lenders understandably will (and should) resist a system in which borrowers have as much say as lenders. Lending money is not an exercise in democracy.

Rather, voting at the IMF reflects the shareholding of its members. The shareholding of countries in the IMF is modified every five years, taking into account changes in the economic profile and trading importance of dif-

ferent countries. At present the U.S. vote share in the IMF is 16.77 percent, followed by Japan with 6.02 percent. China comes well down the list (3.66 percent), and further down are Saudi Arabia (3.16 percent), Russia (2.69 percent), India (1.89 percent), Brazil (1.38 percent), and South Korea (1.33 percent). Third World countries have a voting share that is far less than their share in world GDP. They look forward to the day when they will have a majority of shares, believing that will change the balance of power in decisionmaking. The IMF requires a majority of 85 percent for key decisions like amending Articles of Agreement or approving gold sales. The United States, with its 16.77 percent share, has an effective veto today over such decisions. If the United States share falls below the 15-percent threshold in the future, that will end the U.S. veto.

The next quota review of the IMF is due in 2013, but may be brought forward to 2011. China hopes that its voting share will increase to 6.3 percent, making its share second only to that of the United States.¹⁸ That will give China a greater say in the world economy. Third World countries see in this the hope of reduced U.S. dominance. Yet that hope may miss altogether the great new partnership that some see as arising between the United States and China. Historian Niall Ferguson has spoken of a new United States-China condominium, which he calls Chimerica. He believes this new combination will dominate the 21st century, replacing older 20th-century power structures. Martin Wolf has written about the United States and China as representing a new G-2 (Group of Two) that will replace larger groups like the G-8 or G-20 in decisionmaking. If this happens, China will clearly have abandoned the Third World for a new partnership with the United States. The consequences for other developing countries are not clear.

But one thing seems clear. The really big change on the horizon as regards international reserves is the arrival of the Chinese yuan as a fully convertible currency that floats and is not actively managed by the People's Bank of China. This may take more than a decade to occur. But when it happens, the Chinese yuan

itself will become an important and sought-after reserve currency. As a floater, China itself will no longer require large reserves, and so its interest in the substitution account and other technocratic remedies will diminish greatly. The problem of the dollar overhang in reserves will largely disappear. As an issuer of reserve currency, China will finally get the political stature and clout that it has long sought.

The dollar and euro are strong currencies today not because of some political manipulation within international organizations, but because the United States and Europe are economic powerhouses. Their currencies have earned their strength and credibility through performance—the market believes that they will always be freely convertible. 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 commitments. 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.

However, China has a large and fast-growing GDP and tax capacity. The size of China's economy will grow larger than that of the United States one day. Well before then, the Chinese yuan will probably become an important reserve asset. The future rival to the dollar is thus the yuan, not the SDR.

China itself seems not to have grasped this. Historically, countries move from having soft currencies to hard currencies only after running current account surpluses for a significant period, and hence emerging as creditor countries. The United Kingdom achieved creditor status in the 1800s and the United States in the early 1900s, and the markets rewarded them with hard-currency status. Once a country establishes credibility in the markets, it continues to have hard-currency status even if it runs deficits.

China has now achieved creditor status. So it can, and surely will, aim for hard-currency status in a decade or so. Ironically, it may have proved that the emergence of a large new hard-

currency superpower causes macroeconomic imbalances. Once it becomes a hard currency country, China will find no advantages—and see clear disadvantages—in an IMF substitution account, just as the United States does today. But as of now, China retains the mindset of a soft-currency country. One day, it will surely wake up to its true long-term interest.

Notes

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15. Wolf.

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