THE FUTURE OF THE SDR AS AN INTERNATIONAL UNIT OF ACCOUNT

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This article comments on the role which the special drawing right (SDR) plays as a unit of account from the perspective of international financial relations. This is not the usual perspective from which to look at the SDR. As a rule, the SDR is seen as a monetary asset which is held in the international reserves of central banks and governments and which is used by them much like foreign exchange holdings for the financing of balance of payments (BOP) deficits and surpluses.

Origin of the SDR

At the time SDRs were first allocated by the Fund in 1970, the new asset did not have an identity of its own. It possessed only two of the three fundamental attributes generally ascribed to money: it served as a means of payment among participants and between them and the Fund and could be held by them as a reserve asset; it was not used as a unit of account. The value of the SDR at that time was equal to a fixed quantity of gold, which was the same as the gold content of the U.S. dollar.

The SDR was originally invented to forestall a shortage of reserves of the traditional kind – gold and foreign exchange such as the U.S. dollar and other currencies – and to permit a deliberate, rational, and internationally controlled creation of reserves. Gold reserves had not been rising for many years and the expansion of U.S. dollar holdings depended essentially on the BOP deficits of the United States. Initially, SDR allocations were intended to defend the Bretton Woods par value system. Not long after the creation of the SDR, however, the par value system of Bretton Woods was effectively ended. In 1971 the link between gold and the U.S. dollar was broken. For a period, the value of the SDR remained fixed in terms of U.S. dollars. But in 1974, when it had become clear that a floating U.S. dollar had come to stay for an indefinite period, members of the Fund decided that the value of the SDR was no longer to be determined by the U.S. dollar but would, instead, be calculated each day on the basis of a basket of the 16 most important currencies of the member countries of the Fund. At the same time, the rapidly growing BOP financing conducted through the credit department of the Fund was also denominated in the new SDR. Finally, in April 1978, a legal seal was put on this evolution: when the amendment to the Fund's charter was ratified, the official price of gold was abolished, the members pledged to make the SDR the principal reserve asset and the Fund's own unit of account became the SDR. The remainder of this article focuses attention on this function of the SDR.

An International Unit of Account

For the time being, a number of units of account (old and new) and national currencies are likely to coexist and at times to compete with each other. This is not due to the technical faults of these units but to the divergencies and imbalances that exist in the world economy. Some of the major payments imbalances have been greatly reduced and are expected to decline further, but floating exchange rates can be expected to continue for some time, notwithstanding the efforts to achieve a zone of monetary stability in Europe. Traders and bankers engaged in international business spanning several floating currencies no doubt will have a need for an international standard of value to reduce the impact of these fluctuations on their own operations.

The need for these new units of account was perceived as created by two main factors: (1) the reduction of the role of gold as the standard of reference for the value of currencies; and (2) the large, and often violent, fluctuations in currency values which have taken place under floating exchange rates.

There is little dispute today on the basic economic reasons for the breakdown of the "stable but adjustable" link between gold and currencies; first, the disruptive forces of inflation; second, huge BOP deficits and surpluses, including the oversupply of U.S. dollars to the rest of the world; third, *hot* money flows generated by the distrust in the stable exchange value of major currencies; and fourth, and one of the worst factors, the prolonged defense of exchange rates that had become unrealistic during the last years of the par value system.

One important conclusion of the Second Amendment of the Articles of Agreement of the Fund is that the monetary role of gold should be gradually reduced. The removal of gold from a central position in the Fund has far reaching consequences going beyond the confines of the Fund. Indeed, many international conventions that are based on gold are being interpreted, revised, or reformulated; as a rule, the conclusion is that the SDR should take the place of gold.

The second major factor which has enhanced the need for some composite currency unit is the fact that large and often violent fluctuations occur under floating exchange rates.

While upward floating rates allow countries to protect themselves better against inflation coming from abroad, downward floating rates can aggravate inflation at home. The changes in rates under a floating system can and have been occurring at a speed and to an extent that is sometimes in stubborn disregard of the relative prices and costs and interest rate differentials. In addition, they have sometimes induced damaging feedbacks on the domestic economy. For strong currencies, these variations can slow down investment and lead to recession; for weak currencies, they act to speed up inflation, tend to drive up the exchange rates of strong currencies, and further push down the rates of weak currencies.

Major currencies – in particular, the U.S. dollar – seem to be susceptible to such disequilibrating movements. It must be recognized that the gyrations of the U.S. dollar in the exchange markets during much of 1978 were in no small part due to the widespread use of the dollar as a unit of account for international trade, to its large share in the Eurocurrency and other off-shore money markets. Once confidence is shaken, there can be large-scale shifts from the reserve currency which can lead to much greater exchange rate depreciation and volatility of exchange rates than would be the case if the U.S. dollar were not performing these international functions. Whatever the reason, this instability has rendered the U.S. dollar less efficient as an international unit of account and as a store of value.

Alternative to the Dollar

It does not automatically follow, however, that other currencies will be able to fill the gap caused by the instability of the U.S. dollar and play a commensurately greater role as the monetary unit for invoicing foreign trade and for denominating international credit. In the first place, it is possible that the appreciating currencies simply reflect the condition of an unstable dollar. It cannot be assumed that other currencies can or wish to shoulder the responsibilities involved, in part because their money and capital markets are not large enough to undertake the substantial task of financing world trade and international capital movements on the scale that the U.S. dollar has been used.

Of course, changes in yields will gradually produce some shifts in financing. For example, Japanese traders have been shifting to yen financing and German banks have expanded their deutsche mark loans but, in such cases, the debtors can be concerned about such arrangements in that they carry the risk of further appreciation of the currencies of the surplus countries.

At the same time it is doubtful that the authorities of the surplus countries are eager to have their currencies used more and more as international units of account. Often such a shift goes hand in hand with a greater use of these currencies as vehicle and reserve currencies. A larger external use of a currency in this way not only has advantages, but can have substantial drawbacks: both the exchange rate and domestic monetary policy can become more difficult to manage.

From an international point of view, the shifts from one currency unit to another are not very desirable either. A reserve currency system tends to be highly unstable when the reserve center, wherever it is, cannot reconcile reasonably stable internal conditions with its external economic and financial commitments and functions. It is, however, too much to expect that a country will, in all circumstances, subordinate its domestic economic aims to its external role as a reserve center; herein lies the inherent long-run instability of a monetary system based on reserve currencies.

IMF Goals for the SDR

It is a major objective of the Fund to put the SDR into the center of the international monetary system. Its members have pledged on the occasion of the last amendment to collaborate with each other and with the Fund to make the SDR the principal reserve asset. Practical steps have been and are being taken to strengthen this evolutionary process.

First, the allocation of SDRs will be resumed by the distribution of SDR 12 billion over the next three years. SDRs are being allocated to lessen the increase in foreign exchange reserves that would otherwise occur through the process of official borrowing on the international markets. If successful, this process should reduce the proportion of reserve currencies in future additions to reserves.

Other steps to improve the SDR are in hand. SDRs can now be exchanged freely among the participants against currency, and such voluntary transfers have already taken place on a large scale. In addition, the interest rate on the SDR will be increased and it will be possible to use SDRs to settle obligations without changing them first into currencies, to lend SDRs, and to pledge them as security for a loan by another central bank or government. Further improvements are high on the agenda. They include forward operations in SDRs and swaps of SDRs and enlarging the number of official institutions that may deal in SDRs. This last point is potentially of great significance for enlarging the volume of SDR-denominated financing in the private market, since many of the institutions – unlike the Fund – have direct links with the private market. Once such institutions hold SDRs in their books, they are likely to seek to increase their SDR-denominated liabilities by developing transactions in private markets.

Second, the credit mechanism of the Fund, which is denominated in SDRs and guaranteed by Fund members in SDRs, has been substantially expanded over the last few years to cope with large-scale BOP deficits. For much of this expansion, the Fund has issued liquid reserve claims denominated in SDRs. As a result, international reserve assets held in the form of SDR-denominated reserve positions in the Fund have tripled in the last five years from SDR 6 billion to SDR 18 billion.

The low interest loans of the IMF Trust Fund to poor countries are also denominated in SDRs. These loans are financed by a portion of the profits realized in the gold auctions. In the first two years of the gold auctions, the Trust Fund disbursed loans of over SDR 800 million.

Use of SDRs by INTERNATIONAL AGENCIES

In sum, the official market in SDR-denominated credit is no doubt of major and growing importance. While such credit is largely connected with the activities of the Fund, this is no longer exclusively the case. A number of international official agencies – for example, the African Development Bank, the Arab Monetary Fund, and the Nordic Investment Bank – have adopted the SDR as their unit of account and some of these institutions have begun to place SDR-denominated deposits with private commercial banks.

A few of the smaller Fund members are pegging their currencies to the SDR; many others manage their currencies by pegging them to custom-made baskets of currencies usually composed to reflect the geographical distribution of their foreign trade. In a number of instances, these baskets do not differ much in practice from the SDR basket. Thus, a small "SDR area" exists not by special design, but because pegging to the SDR has helped these Fund members in the developing world to stabilize their external and internal positions and to better protect their economies from the effects of instability elsewhere.

SDRs Enter the Private Market

SDRs are distributed and used only in the official field. But the Fund has no copyright on the use of the SDR as a unit of account. In fact, developments on the international scene will help to give the SDR a firmer and more permanent footing in the private market.

Usually, the private interest in the SDR is strongest when the U.S. dollar is weak. A few transactions are then arranged, but as soon as the U.S. dollar improves the volume tends to ebb.

For the time being, the private market for SDRs is still small but more than a dozen commercial banks are presently actively accepting short-term currency deposits indexed in SDRs and many more are interested in developing this business. The banks accepting SDR deposits usually will try to cover themselves, for example, in the forward markets or make loans in the individual currencies which comprise the SDR. Less frequently, they extend SDR-denominated loans. Interest rates on SDR-denominated deposits have been readily quoted to the Fund and can, of course, be checked against the calculated forward exchange value of the SDR. Except for public bond issues (which consist of less than SDR 150 million), complete information about the volume of SDR operations is not available.

The private financial market in SDR-denominated paper is a somewhat specialized market – this is reflected in the relatively low volume of notes traded, in the predominance of short maturities, and in the fact that little if any redepositing seems to take place. There are, however, three potential sources of future growth: (1) the rising number of official institutions based on the SDR and engaged in the private markets; (2) the trend toward diversification of central bank reserves, including a possible desire of central banks to cover open SDR-denominated positions resulting from their indebtedness to the Fund; and (3) the deficit countries, which are familiar with the SDR and may be willing to take up medium-term banking credit indexed in SDRs to spread their currency risk.

As regards the Fund, no plans exist at the moment to issue SDR-denominated notes to the market, although the legal possibility exists for the Fund to do so with the consent of the members whose currencies it would use as a vehicle. As a trustee of the Trust Fund, the Fund could also, if it so wishes, place SDR deposits with commercial banks. So far, however, all deposits have been placed with the BIS.

For the moment, the Fund acts as a center of information for the private SDR markets. It calculates and publishes daily the official spot exchange value of the SDR for more than 40 currencies. In the near future, forward SDR rates against a number of important currencies might be published on a regular basis; the Fund is also collecting information on the private SDR markets, especially on the SDR interest rates, on the volume of SDR deposits and SDR credits, and on bonds denominated in SDRs.

Since the Fund is commited to make the SDR the principal reserve asset, these conclusions on the role of the SDR as a unit of account in the private market may look rather modest. In my view, however, it would be wrong to conclude that the use of the SDR as a unit of account in the markets is an idea whose time has still not come.

This theme was further developed in expanded form in the author's article entitled "The SDR as an International Unit of Account" published in the March 1979 issue of Finance and Development.

BOOK REVIEWS

JEFFREY B. GAYNER
Namibia: The Road To Self-Government
Council on American Affairs, Washington, D.C. (1979), 108 pp., $6.00

For more than thirty years the Territory of Namibia has been the subject of an acrimonious dispute between the International Community and South Africa. However, by the early 'seventies, it had become apparent that all the parties to the dispute were in agreement on at least one important issue – that the Territory was ready for independence. The question which continued to divide the parties concerned was exactly how and under what circumstances independence should be granted.

At that point the five Western powers then on the Security Council (United States, United Kingdom, France, West Germany and Canada), launched an imaginative initiative to attempt to resolve the outstanding differences on the independence issue, in a manner which would secure the basic acceptance of all the parties involved. The complexity of the challenge which confronted them may be gauged when one considers the widely divergent natures and ideologies of the parties which had to be accommodated. These included, not only South Africa and SWAPO, but also the internal Namibian political parties, the Front Line States, Nigeria, the United Nations and, of course, the western Five themselves.

Behind these divergent elements the perceptive western diplomats were, however, able to discern a solid underlying base of common interest on which they believed they might be able to erect a workable settlement proposal: South Africa, they reasoned, had no desire to become embroiled in an escalating guerrilla war on a hostile and unfavourable border; nor would she relish the prospect of the international economic sanctions which continued intransigence might bring. The Front Line States, for their part, badly needed a speedy settlement to the dispute to stabilize their own borders with the territory and to speed up the removal of at least some guerrilla forces from their troubled countries. The United Nations for its part, sorely needed an exercise which would enable it to restore waning