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The Expanded Role of SDRs and the Possibilities of an SDR Standard

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The SDR—Special Drawing Rights, issued by the International Monetary Fund to participating member countries—has really come up in the financial world. It has been nominated for functions which a couple of years ago no one had thought it could or should be capable of performing. The SDR has been proposed as a successor to the present reserve currencies, particularly to all the dollars now held by national monetary authorities ; as a successor to gold as the ultimate official reserve asset into which currencies should be convertible ; and as the common denominator by which all currencies should be defined or in which their official par values should be stated. This ambitious career was not foreseen by even the most friendly of the good fairies that came to present their gifts and wishes when the SDR was born, let alone by the unfriendly fairies who predicted a rather dim future for the bastard child. All these fairy wishes can be found recorded in the minutes of the Annual Meeting of the International Monetary Fund held in Rio de Janeiro in September 1967, and similarly in those of the Meeting held in Washington in September 1969.

My task today is to examine the qualifications of the SDR for the jobs for which it has been recommended. My own qualifications as an examiner of the qualifications of SDR are perhaps attested to by my monographic study published in 1968 under the title *Remaking the International Monetary System.*[1] I neither expect nor assume that every one has read my booklet and, hence, I shall have to repeat a few things—a very few only—which I wrote there.

THE CHARACTERISTICS OF SDRs

The original intention was that SDRs would be a supplementary reserve asset, replacing, not existing currency reserves or existing gold

[1] Fritz Machlup, *Remaking the International Monetary System,* Baltimore, The Johns Hopkins Press, with the Committee for Economic Development, 1968.

reserves, but increases of currency or gold reserves. It was expected that there would be no further net increases in monetary gold and that the net additions of dollars in monetary reserves would decline and soon come to an end. With these assumptions, only two types of reserves would be subject to augmentation : one, the countries' reserve positions with the Fund through increased drawings made on the basis of quinquennial increases of quotas and, two, the annual allocations of SDRs.

The essential characteristics of the allocation of SDRs are the following :

— they are gratis reserves in the sense that the countries to which they are allocated have neither to earn them through surpluses in their balance of payments nor surrender any assets in exchange for them nor consider them as debts to be repaid (except in the case of liquidation) ;

— they are not debts, either of the IMF or of anybody else : they are, therefore, assets of the holder without being liabilities of anybody (thus resembling in this respect the stocks of monetary gold) ;

— they are, although defined as equivalents of a certain weight of gold, not convertible into gold or any other assets ;

— they are not "backed" or "covered" by any other asset ;

— they are simply drafts that can be exchanged for convertible currencies held by countries designated by the Fund, because of their generally strong reserve position, as possible drawees (recipients of the drafts).

SIGNIFICANCE OF THE PRINCIPLES OF SDR CREATION

My list of particulars or characteristics was offered here not as an enumeration of defects, though some old-fashioned monetary experts may think so. To be sure, the non-debt character of the SDR, its non-convertibility, and the lack of cover have all been cited as serious shortcomings, fatal weaknesses, or mortal sins. In contradistinction, I praised these characteristics as perfectly sensible and most desirable, and I commended the innovating officials for accepting the long overdue breakthrough in monetary institutional practice. Let me quote three sentences from my book : "Money needs takers, not backers ; the takers accept it, not because of any backing, but only because they count on others accepting it from them. The myth of backing is dead. It was buried in Rio de Janeiro on 29 September 1967." I must now add some apprehension that the ghost of the dead myth is still making its midnight rounds and frightens some of the grown-up children. (It seems especially terrifying to gnomes.)

Most academic economists are amused, not frightened, by the antics of the ghost. But a good many political economists still dislike the first of the characteristics on my list : the gratis allocation of the SDRs. There are some who regard free gifts to wealthy nations as immoral (even if they impose no costs on anybody) and would favor such gifts only to poor countries ; there are others who would prefer the issuance of official reserves as loans rather than as gifts. I cannot here take the time to repeat my defense of the principle of gratis allocation to all participating countries ; but I should not fail to point to the most important advantage of gifts over loans. If money, international or national, is created by granting loans, it can also be destroyed by repayments of loans ; when repayments exceed new borrowings, the stock of money is reduced. (Irving Fisher saw in such periodic "debt deflations" the main cause of the "credit cycle" with its crises and depressions.) If destruction of monetary reserves is to be avoided, reserves should not be created by extensions of repayable loans but, instead, by free allocations.

The reasons for providing for annual increases in total monetary reserves are as strong as ever. To be sure, countries want reserves in order to be able to finance deficits in their balance of payments ; but the creation of new reserves prevents some deficits from occurring and reduces those that it cannot prevent. Most countries—except those that have experienced excessive increases in reserves in preceding months and years—do not want their reserves to decline and they prefer to see them grow year after year. If total reserves are not growing, the surpluses of some countries impose deficits on other countries ; attempts to avoid these deficits take the form of credit restraints, trade restrictions, capital embargos, and exchange controls. The total of surpluses (calculated on the basis of official reserve transactions) can exceed the total of deficits to the extent that new reserves are created. Reserve creation, by keeping deficits smaller than they would be without it, serves to reduce the countries' propensity to restrict international flows of goods, services, and capital. And this is of eminent importance.

The arguments for annual creation and free allocation of monetary reserves remain valid even after the dollar flood of 1971 ; and SDRs are a most suitable instrument for this purpose.

SDRs AS MAJOR RESERVE ASSET

From the acceptance of the Rio Agreement in September 1967, to the activation of the SDR facility in January 1970, and indeed even later, not a few commentators expressed serious doubts that SDRs would ever become a reserve asset acceptable to national monetary authorities. It would be tempting to compile a list of the doubting Thomases and the reasons for their skepticism.

In contrast with these pessimistic views, I foresaw the possibility of a bright future for SDRs. Although I expected that SDRs in 1970 would be no more than 3 per cent of total reserves, I held that ten years later SDRs would have attained first place among the official monetary reserve assets of the world. This now appears to be even more likely, especially if a large part of existing reserve currencies is to be exchanged into SDRs, newly issued for this purpose, as proposed by several governors of the Fund. I am in favor of funding proposals but would prefer to have existing currency reserves exchanged into IMF deposits. I would, accordingly, anticipate first place among monetary reserves to be attained by the whole group of IMF issues, including deposits, but not by SDRs alone.

My present view is that SDRs will (or should) share top ranking with IMF deposits, that reserve currencies will not completely disappear from official holdings, and that gold will have come from first place to last place among the reserve assets in a not too distant future. I must now explain why I want Fund deposits rather than SDRs to be the asset for which currency reserves should be exchanged.

EXCHANGING EXCESS DOLLAR RESERVES INTO SDRs OR IMF DEPOSITS

For a good many years proposals have been made to remove currencies from official monetary reserves. We may recall the plans of Keynes, Triffin, Maudling, Bernstein and many others, all proposing an exchange of currencies into other assets, preferably deposit claims against the Fund. At the annual meeting of the IMF in 1971 several governors proposed the exchange of official holdings of dollars and sterlings into SDRs.

I fully share the conviction of these proponents that the excess holding of dollars and pounds in official reserves should be mopped up through a large funding operation. We may conceive of several workable techniques by which such funding may be achieved. We might, if time permitted, compare a few of these techniques in greater detail. At this moment I shall concentrate on arguing against an exchange of excess currency reserves into SDRs, and in favor of their exchange into deposit claims against the Fund.

My reasons for this preference are as follows :

— the essential characteristics of SDRs as non-debt assets not covered by anything should be preserved ;

— the creation of SDRs against surrender of dollars or sterling would create a claim of the depositor and a debt of the depository ;

— the currencies received by the latter, or the assets into which the currencies were to be funded, would constitute backing or cover for the SDRs issued ;

— thus the principle of SDR creation would be adulterated and we would have two kinds of SDRs, some uncovered non-debts, others covered liabilities of the Fund.

Such an adulteration of the principle of SDRs may put in jeopardy the important function of the SDR facility as the source of annual increases of reserves through free allocations to monetary authorities.

The alternative proposal of exchanging dollars into IMF deposits would have none of these disadvantages. IMF deposits would be a new type of reserve asset in addition to those now in existence. We need not fear the operation of Gresham's Law with respect to the three different assets issued by the IMF. Still less need we fear that Gresham's Law would operate with respect to the increasingly insignificant stocks of monetary gold. As a matter of fact, it may be desirable to assure the usefulness of monetary gold by providing for its (voluntary) exchange into IMF deposits. (If the price of gold in the free market should appreciably increase, it might be decided that the Fund eventually begin selling its gold—in small instalments—at a profit, which can be used for additional financing of development aid.)

MAKING SDRs THE COMMON DENOMINATOR FOR PAR VALUES OF CURRENCIES

Several governors of the Fund have discussed the possibility of using the unit of SDR as a common denominator for stating the par values of currencies. In view of the fact that SDRs are now defined in weights of gold, the proposal seems to make little practical difference. None the less, monetary authorities may wish to continue the "phasing out" of gold by replacing it also in the function of common denominator in fixing par values of their currencies.

Difficulties of definition may tax the imagination of lawyers. For the economist no such difficulty exists : in the mode of Gertrude Stein, "a unit is a unit is a unit"—and the unit may be a pure abstraction. Thus there would be no problem in expressing all par values in terms of a Fund unit. It would be awkward to call it SDR, since also the general account of the IMF and the deposit claims against the IMF should all be denominated in the same units. "Fondor" strikes me as a good name for the unit.

The hope has been expressed that the replacement of gold by SDRs as common denominator for par values would provide more symmetry in the positions of different currencies and do away with the special position of the dollar. The dollar could then be devalued or upvalued in terms of SDR or Fund units like any other currency. Alas, this is a fallacy. The lack of symmetry is not a question of the choice of denominator but is due to several facts of our financial life. The most pertinent of these are, one, that the dollar is the most convenient international transactions currency and, two, that the dollar is generally used as official intervention currency. As long as monetary authorities intervene in the foreign-exchange markets by selling and buying dollars, the dollar remains in an asymmetrical position.

This position is essentially the logical corollary of the fact that there can be only n-1 exchange rates for n currencies. If n-1 countries intervene in dollars at rates which they themselves determine, the United States can neither raise nor lower the external exchange value of the dollar. The United States can devalue or revalue the dollar only with the cooperation of the other countries. A set of rules with sanctions will have to be developed to enforce the necessary cooperation.

One may argue that all other countries would respect any change in par value (in terms of SDR, gold, or anything else) announced for the dollar by the United States, and would always adjust their intervention rates to conform with that announcement. If they did, they would be obeying a "rule" in a system of perfect cooperation. But would they? Would Japan or France have accepted a devaluation of the dollar if the United States had "announced" it on 15 August 1971? Surely not.

Alternatively, one may reject the view that the United States must passively accept the pattern of exchange rates which other countries determine by their interventions in the foreign-exchange markets. If the United States finds any of these rates seriously undervalued in relation to the dollar, it could start intervening, buying the currency in question at a higher price. Since such an exchange-rate war would lead to unlimited profits for arbitrageurs and perpetual inflationary money creation in the warring countries, an economically weaker country would have to capitulate sooner or later and accept the devaluation of the dollar. Thus, the denial of the need for international cooperation turns out to be in fact a confirmation of the thesis that cooperation may have to be imposed on those who want to go on imposing an overvaluation of the dollar on a "benign" United States.

An interesting suggestion in this connection has recently been made by Professor John Williamson.[2] If the United States wanted to reduce or remove an enduring payments deficit by devaluing its overvalued dollar, but other countries insisted on perpetuating the overvaluation of the dollar by declaring parallel devaluations of their currencies (in terms of gold or SDRs) and thus continued to purchase dollars at unchanged exchange

[2] John Williamson, *The Choice of a Pivot for Parities*, Essays in International Finance, No. 90, Princeton, International Finance Section, November 1971.

rates—too high for restoring balance—the Fund should issue sufficient amounts of SDRs to enable the United States to buy back the dollars being accumulated by surplus countries. These issues of SDRs would make it possible for other countries to go on having their surpluses and for the United States to remove its deficit. (The deficit would be "removed" if the allocation of SDRs is entered above the line in the balance of payments ; it would be "financed" if the receipt of the SDRs is entered below the line.) When other countries eventually get tired of exchanging their goods, services, and securities for ever increasing piles of SDRs, they may decide to accept a devaluation of the dollar.

An interesting aspect of Williamson's suggestion is that *more* SDRs are to be issued when more dollars flow into foreign reserves. This is in sharp contrast to the recommendations of other experts, who would issue *less* SDRs when more dollars swell the reserves of other countries.

MAKING SDRs THE OBJECT OF CONVERTIBILITY OF OTHER RESERVE ASSETS

At present the dollar is inconvertible. No matter how much some of the monetary authorities press for resumption of convertibility, the dollar must remain inconvertible as long as the vast mass of dollars is held by other monetary authorities. There cannot even be an approach to convertibility until the existing dollar holdings have been funded, mopped up or locked in ; perhaps provisional arrangements can be made for conditional convertibility or exchange-value guarantees limited to dollars acquired after 18 December 1971 (or an even later date). The only reason for such interim arrangements would be to encourage the monetary authorities of the financially most important countries to declare that they would defend the new floor price of the dollar no matter how many dollars were offered to them. Such a declaration would inspire private holders of dollars with sufficient confidence to hold on to their dollar balances and not to be panicked into a renewed flight from the dollar. (Incidentally, if the countries had agreed to a system of limited adjustments of central rates or par values—"crawling pegs"—the new pattern would have been more credible than the presumably fixed parities with a fixed floor only 2 ¼ per cent below these parities.)

Long-term arrangements for convertibility can become effective only after the great mopping-up and locking-in of the excess holdings of dollars (acquired before 15 August or 18 December 1971) have been completed. Mopping-up would be preferable to locking-in, at least from the point of view of the dollar-holding national authorities. Blocked or locked-in currency reserves can hardly be considered liquid monetary assets, unless special arrangements secure their transferability to other countries when their present holders are in deficit positions. In any case, the exchange of official excess holdings of dollars into Fund deposits denominated in Fund units would be more appropriate from the point of view of international liquidity.

When the official excess holdings of dollars are out of the way, dollars newly acquired by national monetary authorities can be made convertible into SDRs (or also into reserve positions with the Fund and deposits with the Fund). The new convertibility may still raise problems with regard to the large dollar balances held by private foreigners. These are now estimated to run to about $18 billion, with their "normal" size estimated to be about $25 billion at the present volume of international transactions. Can the United States reasonably undertake an obligation to convert official holdings of dollars into SDRs (or into claims against the Fund), if large amounts of privately held dollars may come onto the market at the slightest provocation—crises of confidence—and may have to be absorbed by monetary authorities, which in turn will present them for conversion? I would answer this question affirmatively only if the new international monetary system provides for greater flexibility of both interest rates and exchange rates.

A large speculative outflow of funds from the United States and excess supply of dollars in the foreign-exchange markets can be stemmed if interest rates for dollars rise sufficiently above those for other currencies and if the exchange rate for the dollar can fall sufficiently to make people anticipate a strong recovery of the dollar in subsequent months. A band of only 4 1/2 per cent, that is, 2 1/4 per cent up or down from the center, is probably not enough for this purpose. I stick to my recommendation of a band of 5 or 6 per cent, that is, 2 1/2 or 3 per cent around a center (parity) that can glide up or down with maximum changes of 1 per cent at a time and 2 or 3 per cent cumulatively over any twelve-month period. These speed limits for changes in parities and exchange rates can reduce the threat of speculative movements of liquid funds and can facilitate the adjustments to divergent trends in structural and monetary developments in different countries.

THE COEXISTENCE OF CONVERTIBILITY AND FLEXIBILITY

If limited flexibility of exchange rates is necessary for the promise of convertibility to be honest and credible, why, one may ask, is convertibility needed at all? If the exchange rate of the dollar is flexible, will monetary authorities be willing to acquire dollars in any large amounts? How can one expect a central bank to acquire large amounts of dollars at or near an agreed par of exchange if the rate at which the dollars can be converted into SDRs may be reduced before the dollars can be presented to the United States ?

The answers to these questions presuppose comprehension of the fact that "limited flexibility" may mean greater stability of exchange rates than that which exists under "fixed parities". Fixed parities are adjusted from one day to another by as much as 8, 12, or 16 per cent, and even more. In contrast to these jumping parities, gliding parities (or "crawling pegs") under a system of limited flexibility can be changed by only one per cent at a time, and by only 2 or 3 per cent over a year. Hence, if the rule is obeyed, the risk of acquiring and holding dollars is smaller under a system of greater flexibility than under one of rigidity of par values ; and convertibility is more easily maintained than with allegedly fixed parities.

I realize, of course, that convertibility (into SDRs or any other kind of reserve asset) would make no sense under a system of freely flexible exchange rates. Such a system would have no par values, no interventions in the foreign-exchange markets, no official acquisitions of dollars or any other foreign currencies and, hence, no conversions of currencies acquired. But we are not talking now about a system of freely flexible rates, because we all realize that such a system will not exist in the foreseeable future. We are talking about managed, limited flexibility. Such a system will include official interventions, official acquisitions of dollars, and hence, arrangements for converting dollars so acquired into other reserve assets (such as SDRs). The only alternatives to convertibility of this kind would be guarantees for the maintenance of the exchange value or purchasing power of the dollars acquired and held by the authorities of foreign countries.

THE "SDR STANDARD"

In the title of my paper appear the words "possibilities of an SDR standard". I have not used this expression up to now. I have avoided it because it has no clear meaning. I now want to expose the ambiguity of the phrase.

Adoption of the "SDR standard" may mean any of the following things :

(1) The SDR, or a unit of SDR, is the standard of value in which the people—businessmen, government officials, and perhaps also households—in the countries that have adopted that system calculate and compare the exchange values of goods and services.

(2) The SDR is the unit of account in which, in international transactions, prices, claims, debts, and payments are expressed.

(3) The SDR is the common denominator for stating, fixing, and refixing the par values of different currencies.

(4) SDRs are the most important asset held in the monetary reserves of the financially most important countries.

(5) SDRs are the reserve asset into which currencies are convertible under rules adopted by the major countries.

(6) The amounts of SDRs held as reserve by the monetary authority of a country determine the supply of its national money, or the increase in its SDR reserve determines the increase in its money supply.

Meaning (1) may be rejected out of hand (because it is inconceivable that the SDR will become the general standard of value). Meaning (6) may be excluded as too unlikely ever to become relevant. This leaves four possible meanings : the SDR may serve as the international unit of account, as the common denominator for setting par values, as the most important reserve asset, and as the asset into which currencies are made convertible. These four functions are independent of one another ; any one can possibly be performed without any of the others. Hence, the expression "SDR standard" would always require specification of the meaning in which it is used, and this would take more time than to state the function or functions which the SDR is really supposed to serve.