Special Drawing Rights: A Major Step in the Evolution of the World's Monetary System*

A major benchmark in the evolution of the international monetary system was reached last September when the members of the International Monetary Fund (IMF) agreed on a proposal for establishing a new reserve facility to meet the possible need for a supplement to existing international reserve assets. This supplement is designed to assure an adequate supply of international liquidity for a growing world economy if, as is expected, the growth of more traditional reserve assets—gold and foreign exchange—should prove inadequate. The plan provides a means for regularly creating special drawing rights (SDR's) in the Fund, which the participating countries would accept as reserves and could use in international settlements. Although the plan contains certain provisions to ensure the attractiveness of SDR's, their value as a reserve asset rests fundamentally on the obligation of participants to accept them in exchange for a convertible currency. To be sure, the proposal places some restraints on the ability of participating countries to use these assets and limits their obligation to accept them. But, because in general SDR's could be used automatically for the settlement of international payments, they fulfill the essential function of any reserve asset.

This new facility to some extent represents a logical extension of the Fund's current operations, but it departs from the Fund's ordinary procedures in several important respects. First, SDR's will be more readily available than the credit that the IMF now provides through drawings in the credit tranches.[1] Any participating country will be able to use SDR's whenever it has a balance-of-payments or reserve need to do so. Its exercise of this right will not be subject to consultation or prior challenge nor con-

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[1] At present, a member of the Fund may purchase (or "draw") the currencies of other members by depositing with the IMF an equivalent amount of its own currency. The normal quantitative limitations on the use of the Fund's resources depend on the size of the member's quota (which equals the member's subscription in gold and in its own currency to the Fund's resources). Drawings are virtually automatic in the "gold tranche"—i.e., as long as the total amount drawn does not exceed the 25 per cent of the borrowing country's quota normally subscribed in gold. But a country can make additional drawings, in the "credit tranches", only after it has agreed to take measures to correct its balance of payments.

tingent on the adoption of prescribed policies designed to restore balance-of-payments equilibrium. Second, the SDR's are intended to provide a permanent addition to international reserves, whereas most current IMF transactions give rise to only a temporary increase. Third, the SDR's will be distributed to all participants in proportion to their IMF quotas. On the other hand, reserves that arise as a by-product of the Fund's credit operations normally add, in the first instance, to the total reserves of the borrowing country alone and only indirectly to the reserves of other countries. Finally, the use of SDR's does not entail repayment according to a fixed schedule, as does the use of the Fund's ordinary resources, although SDR balances must be partially reconstituted following large and prolonged use. In short, the SDR's are intended to provide systematic and regular additions to international liquidity, and to be readily available to any member of the Fund which elects to participate in the project.

The plan is to be prepared as draft amendments to the Fund's Articles of Agreement not later than March 1968. These draft amendments will then be submitted to all the members of the IMF for ratification—a process that could be completed late in 1968 or early in 1969. However, for reasons discussed more fully below, an affirmative vote for adoption of the amendment does not automatically lead to activation of the mechanism, and just when the plan will be implemented is not known.

THE PLAN IN OUTLINE

ALLOCATION OF SPECIAL DRAWING RIGHTS. The plan does not yet specify the criteria according to which SDR's should be provided, but the general criterion is that there must be a widely recognized need to supplement existing international reserve assets. Indeed, the procedure for the introduction of SDR's is clearly designed to ensure that there is broad support for any decision on reserve creation. Thus, the managing director of the IMF, after having satisfied himself that there is a need to supplement monetary reserves, will undertake whatever consultations may be necessary to determine whether or not there is sufficient support among the participants for the creation of SDR's in the amount he proposes. After the concurrence of the Fund's executive directors, the proposal must then be approved by the board of governors of the Fund by an 85 per cent majority of the voting power of the participants. The Common Market countries, with almost 17 per cent of the voting power in the IMF, could thus veto the creation of SDR's if they vote as a unit, as could the United States with 22 per cent of the voting power.

Since the SDR's are intended to assure the adequate long-term growth of total reserves, the amount created will not ordinarily vary from year to year, nor will it be influenced by the reserve needs of individual countries. Instead, the amount to be issued will be for a "basic" period of several years—during which predetermined allocations are to be made at specified intervals. Initially, the basic period will be five years, but the IMF may decide that any future basic period will be of a different duration. The proposal does not indicate the amount of SDR's to be issued; that will be decided on the basis of a collective judgment of global reserve needs, which will depend in part on the growth of other forms of reserve assets. If it were decided to create $1 billion to $2 billion annually in the initial basic period, for example, total reserves would expand in the first year by 1.4 per cent to 2.8 per cent—considerably less than the 3.6 per cent average annual increase in total reserves from 1960 to 1964 and not significantly greater than the 2.3 per cent growth during 1965 and 1966. All members of the IMF will be able to participate in the "special drawing account" through which all the operations relating to SDR's will be carried out, and allocations will be made to all participants in proportion to their IMF quotas. Thus, the United States would receive roughly 25 per cent, or between $250 million and $500 million a year, if $1 billion to $2 billion of SDR's were issued annually.

If unexpected developments make it desirable to change the rate at which SDR's should be issued, it will be possible, under the same consultation procedure, to increase or decrease this rate for the rest of a basic period or to adopt a new basic period with a different rate of creation. Such changes will ordinarily require an 85 per cent majority vote. However, a decision to reduce the rate of issue for the remainder of a current basic period can be taken by a simple majority of the voting power of the participating countries.

USE OF SPECIAL DRAWING RIGHTS. A participating country will be entitled to use SDR's to acquire an equivalent amount of convertible currencies to finance a balance-of-payments deficit. The user of SDR's will acquire currencies, not out of resources held by the Fund, but directly from other participants or through the intermediation of the Fund. Convertible currencies are expected to be purchased from countries with strong balance-of-payments and reserve positions, thereby following the Fund's existing criteria for the selection of currencies to be used in its lending operations. However, a reserve center may also use SDR's to purchase balances of its own currency held by another country—provided the latter agrees—by transferring SDR's directly to that country. Whether the transfers are arranged directly between participants or

indirectly through the Fund, the countries that use SDR's will have their SDR holdings in the special drawing account reduced and those countries that receive them will correspondingly have their SDR holdings increased by an equal amount.

SDR's may not be used for the sole purpose of changing the composition of a country's reserves. In other words, a country cannot use SDR's simply to build up its foreign currency balances or gold holdings. Although the use of SDR's will not be subject to prior challenge, the IMF may make representations to any country that has failed to observe this principle and may direct transfers of SDR's to that country to restore its SDR holdings. Nevertheless, over time a participant could find the share of its reserves held in SDR's falling if it were to use SDR's when in deficit and receive other reserves when in surplus. Such changes in the composition of reserves, however, will generally be avoided through the guidance of transfers of SDR's by the IMF.

RECONSTITUTION PROVISION. Participating countries that use SDR's may incur an obligation to restore (or "reconstitute") their position to some extent, depending on the amount and duration of their use. The reconstitution provision in the plan specifies that a member's average use of SDR's over a basic period is not to exceed 70 per cent of its average cumulative allocation. Translated in terms of holdings, this obligation means that over any basic period a country's average holdings should be at least 30 per cent of its average allocation over the same period. If at any given time holdings of SDR's fall below this 30 per cent average level, it will be necessary to reconstitute and hold them for a sufficient time to establish the minimum average ratio.

The reconstitution provision is designed to prevent any tendency toward financing large and persistent payments deficits by exclusive reliance on SDR's. In fact, the reconstitution provision includes the principle that "participants will pay due regard to the desirability of pursuing over time a balanced relationship between their holdings of special drawing rights and other reserves". However, the reconstitution provision does not prevent a country from using all its SDR's when its balance-of-payments difficulties are temporary in nature. If the balance-of-payments difficulties that give rise to the use of SDR's are in fact short-lived, then a country which had utilized all its allocation of SDR's in the early part of a basic period could reconstitute its average holdings simply by minimizing the use of its allocation or accumulating SDR's in the latter part of the period. Otherwise, a participating country would have to acquire them either directly from other participants or through the intermediation of the IMF in exchange for some of its other reserve assets. If a country began using SDR's toward the end of the period, holdings of its allocation at the beginning of the period might enable it to satisfy any reconstitution requirement.

The reconstitution provision may, in effect, impose a repayment obligation on part of a country's use of SDR's, but it does not seriously compromise the quality of the SDR's as a reserve asset. That portion of SDR's which is not required to be reconstituted (70 per cent of the cumulative allocations) is as absolutely at the disposal of a participating country to meet balance-of-payments deficits as any asset can be. Moreover, the reconstitution provision is less onerous than the repayment (repurchase) provisions currently applicable to drawings on the IMF. Such drawings must be completely liquidated within three to five years either directly through repayments by the debtor country to the IMF or indirectly by other members' drawings on the IMF of the debtor's currency.[2]

ACCEPTANCE OBLIGATIONS. Every participating country is obligated to provide currency in exchange for SDR's freely and to keep those it receives (so long as it does not have need to use them) until its total holdings are equal to three times the amount of its cumulative allocations. That is, if a country's initial allocation were $100 million and it used none of its SDR's, its acceptance obligation would be $200 million. If the country had transferred all its initial allocation to other countries, its acceptance obligation would be $300 million. A country could, of course, accept and hold SDR's in excess of this amount, and the plan gives surplus countries some incentive to do so. The SDR's will carry a gold-value guarantee. Moreover, holdings of SDR's will earn a moderate rate of interest, although the yield will presumably be less than that on United States Treasury bills.

The limitation on holding countries' obligations to retain SDR's would appear to reduce the facility's usability as a reserve asset, since it is essential that a country have absolute assurance that it will be able to use its SDR's to acquire convertible currencies to meet all or part of its payments deficit. In the long run, however, this limitation seems unlikely to be serious. If, after the plan has been in operation for a number of basic periods, the amount of SDR's outstanding becomes quite large, a country with

[2] Only up to the point where the Fund's holdings of a member's currency fall short of 75 per cent of the quota—as may happen when that currency is used for other countries' drawings—can that member draw from the IMF without incurring a repayment obligation.

a balance-of-payments deficit is almost certain to find some surplus country which holds less than its obligatory limit of SDR's. Moreover, the reconstitution provision, which encourages persistent deficit countries to use other reserves in addition to SDR's, will help to avoid excessive transfers of SDR's. Finally, transfers of SDR's may be made not only to participants with a strong balance of payments but also to countries with a strong reserve position even when they have a moderate payments deficit.

For these reasons, the margin between the amounts of SDR's created and the acceptance obligations will probably be large enough to assure any participant that its holdings are fully usable. If, for example, a proposal were made to create $1 billion of SDR's annually, the United States, with about 25 per cent of IMF quotas, would receive $1,250 million over a five-year period and would not reach its acceptance limit in the fifth year until it held $3,750 million of SDR's, or 75 per cent of the SDR's outstanding. The Common Market countries as a group, with about 17 per cent of IMF quotas, would not reach their acceptance limits until they held about $2,550 million of SDR's—slightly more than half the total issue. If either the United States or the Common Market countries as a group were to have temporary deficits which were settled with the maximum transfer of SDR's, the acceptance limits would be large enough to accommodate a transfer in either direction.

SOME UNRESOLVED ISSUES

The plan appears to provide a workable mechanism for the creation of a supplement to existing reserve assets. But smooth operation of the mechanism depends not only on the provisions, guarantees, and limits contained in the proposal but also on the degree to which various countries, in particular the surplus countries, will support the plan and accept SDR's as a reserve asset.

The question immediately arises as to when the plan will be activated. The adoption of the proposal, which requires an 80 per cent majority of the voting power of IMF members, seems assured, but activation of the plan requires an 85 per cent vote. Thus, an affimative vote for the adoption of the amendment would not necessarily be sufficient to assure activation, and the Common Market countries as a group could veto any proposal to issue SDR's.

Ratification of the plan may be delayed, if creation of SDR's becomes linked to overall reform of the present provisions of the Bretton Woods Agreement. Some Common Market countries seek modification in the voting provisions of the Fund in order to require an 85 per cent vote for approval of quota increases. In effect, this reform would give the Common Market countries the same veto power on regular IMF operations that the United States now enjoys. An alternative and in many ways preferable course by which the Common Market countries could obtain a decisive voice in the IMF would be by increasing their subscription to the Fund to the point where they have just over 20 per cent of the total voting power.

Assuming that the plan is ratified by the IMF members, its activation might nevertheless be delayed until there is substantial reduction in the United States balance-of-payments deficit. The position of the French government, as stated by Michel Debré, Minister of Economy and Finance, is "that the mechanism cannot come into play until the balance-of-payments deficits affecting the countries whose currencies are designated as 'reserve currency' have disappeared". This is an extreme view which has not been taken by other countries. Moreover, as President Johnson indicated in his statement on the new United States balance-of-payments program, movement toward balance will, by curbing the flow of dollars into international reserves, limit the growth of existing reserve assets: "It will therefore be vital to speed up plans for the creation of new reserves".

Even if the plan were promptly implemented, the need to restore balance-of-payments equilibrium in this country would in no way be reduced. The amount of SDR's the United States would obtain each year is small, compared with the size of our recent deficits, and the plan does not prevent countries from converting their existing dollar holdings into gold. Consequently, continued balance-of-payments deficits would still pose a threat to our gold reserves. If the dollar is to continue to function as the principal trading and reserve currency, the United States must substantially strengthen its payments position. Changes in the workings of the world monetary system will not relieve this country of this task.