Why the SDR is DOA

The recent discussions of the IMF's Special Drawing Rights needs to be placed within the context of the current profound crisis and calls for a new financial architecture. At least four months ago George Soros (and others) proposed an increase in SDRs to help provide sufficient liquidity to arrest the deflationary forces that were growing. Ironically, China and Russia, apparently inspired the by famous speculator, have gone even further. A combination of nationalism and traditional realist balance-of-power politics, lies behind their arguments to grow the SDRs into a super-reserve currency that goes beyond supplementing the dollar and seeks to supersede it as the world's reserve asset.

While a new allotment of SDRs is possible, even likely, the push for a new international monetary regime based on the SDR as China, Russia and some other countries seem to be encouraging is a non-starter. It is a mistake to expect the G20 meeting on April 4th to become a new Bretton Woods. It is unreasonable to expect the G20 itself to even discuss the SDR issue and the foreign exchange market is not likely to be the center of discussions.

SDRs not a Currency but a Basket

Special Drawing Rights have captured the market's imagination in recent days. Behind the scenes, Chinese and Russian officials have reportedly been keeping a steady drum beat on it, and the head of China's central bank posted a report suggesting that SDRs should have an expanded role in global finance, including as a super-reserve asset. In a presentation to the Council on Foreign Relations, beleaguered US Treasury Secretary Geithner appeared to some to initially be open to such proposals.

Part of the problem is that many people are unfamiliar with SDRs. Special Drawing Rights were first issued by the IMF in 1969, as Bretton Woods was straining and fears there was not enough gold and dollars, the main reserve assets, were growing. SDRs are a basket of existing currencies. The basket gets reset every 5-years.

The last reset was in November 2005. The US dollar accounts for 44% of the SDR basket. The euro's share is 34%, while the yen and sterling's shares are 11% each. The SDR is a basket of existing currencies not a single currency like the euro, but rather more like the old European Currency Unit. The value of the SDR is calculated and posted by the IMF daily. It is currently worth about $1.51.

There have been two allocations of SDRs. The first was in 1970-1972 for 9.3 billion SDRs and the second one was in 1979-1981 for another 12.1 billion SDRs. In 1997, there was a proposal to double the SDR issuance to 42.8 billion (roughly $64 billion). One hundred and thirty one members endorsed the proposal and they had a weighted vote of 77.7%.

Approval requires 85%. The US has a 16.75% vote share, and has not approved the proposal. If there was a signal in Geithner's remarks is was that the Obama Administration may reconsider the US stance. Here is why it is necessary: Roughly the fifth of the IMF members which have joined since 1981 have never received an SDR allocation. Of course that inhibits their ability to participate in the SDR system. Moreover, given the depth and magnitude of the financial crisis and economic downturn—anticipated to be the first time in more than half a century that the world economy will likely contract—an new allotment of SDRs may be compelling.

Dollar's Role is Secure

A new issuance of SDRs is not the same thing as diluting the role of the dollar. The sums are a pittance, especially given the magnitudes of world trade, cross border movement of capital or the holdings of currency reserves. While it is true that few countries peg their currency to the dollar any more, the role of the dollar as a reserve asset appears fairly steady.

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Although all countries do not report their reserve composition (notably China), generally speaking the dollar's share of global reserves are about two-thirds. Most of the fluctuations are largely a function of valuation swings. The euro's share, like its key predecessors (the ECU, German deutschemark and French franc) hovers between a fifth and a quarter of reported reserves. Sterling and the yen account for the bulk of the remaining share of reserves.

The steadiness of the dollar's share of reserves appears lost on many observers. Consider what the usually astute FT Alphaville blog wrote last November, endorsing a new issuance of SDRs: "Many dollar holders, including central banks and sovereign wealth funds as well as private investors, clearly want to diversify into other currencies [than than the dollar]". Alphaville does not cite a single piece of evidence for such a claim.

The incontrovertible fact of the matter is that in the five months to December 1, 2008, the euro fell 20% against the dollar and sterling lost more than a quarter of its value against the greenback. Judging from the price action of the dollar, the swap lines the Federal Reserve established with a number of central banks, and the TIC data, the world could not get enough dollars in that period. Indeed during what appears to have been the worst of the crisis, far from an overhang of dollars that the so many observers have chronically warned about, there was a dearth of dollars.

Money

SDRs have been around for 40 years, but they are not really money. Money, as economists understand it, is a means of exchange, a store of value, and a unit of account. SDRs are not a means of exchange. As a basket of already existing currencies, it might appear more stable and hence a better store of value, but what is the metric? The purchasing power of fiat currencies individually and collectively has generally been eroded by inflation. The SDR is not a fiat currency, but a basket of fiat currencies. For the most part SDRs are relegated to a unit of account for (no surprise) the IMF and a few other international organizations.

Some observers suggest that SDRs are the IMF's money (sometimes they are referred oxymoronically as paper gold), but that reflects a misunderstanding. Issuing SDRs is not the same as the IMF printing money. The IMF doesn't do that. An increase in SDRs simply boosts each member's claims on the composite currencies. The IMF is not a central bank.

There are two ways holders of SDRs can obtain the underlying currencies in exchange. First, members can arrange a bilateral voluntary agreement. Second, according to the IMF, it can designate members with strong external positions (current account surpluses) to purchase the SDRs from members with weak external positions. This second method of obtaining SDRs is more suggestive, and does not appear to have ever been used.

Countries consider their SDR holdings as part of their reserves, but it does not really get beyond the Triffin Dilemma. Named after the Yale economist Robert Triffin, the Triffin Dilemma points to the problem inherent in a national currency also serving as a reserve asset. As the world's trade and capital flows increase, there is a greater demand for reserves. Yet as reserve currency is provided, its credibility is undermined. Dollars, the present reserve asset, are provided through the US current account deficit. The chronic US current account deficit worries many economists and policy makers.

The Best Laid Plans of Mice and Men

There is an Aesop fable about a bunch of mice who are being terrorized by a cat. They hold a town hall meeting. They debate about what they could do. One bright mouse suggests tying a bell around the cat's neck so the mice could hear when the cat was nearby. What a wonderful idea. The mice applauded and shouted and after being brought back to order, the chair asked for volunteers. There was a deafening silence.

The fact of the matter is that countries now can chose which currencies and combinations thereof they want to hold in reserves. If they wanted they could duplicate the SDR's composition. Yet they do not. Central banks vote with their pocketbooks, and the dollar's role remains largely unchanged.

The governor of the People's Bank of China, Zhou Xiaochuan suggested an increase in the use of SDRs, and in effect turning SDRs into money. It was not a concrete proposal but some provocative theoretical musings. Many pundits and reporters mistook the castles in the sky for the real thing. One of the few things the BRICs have in

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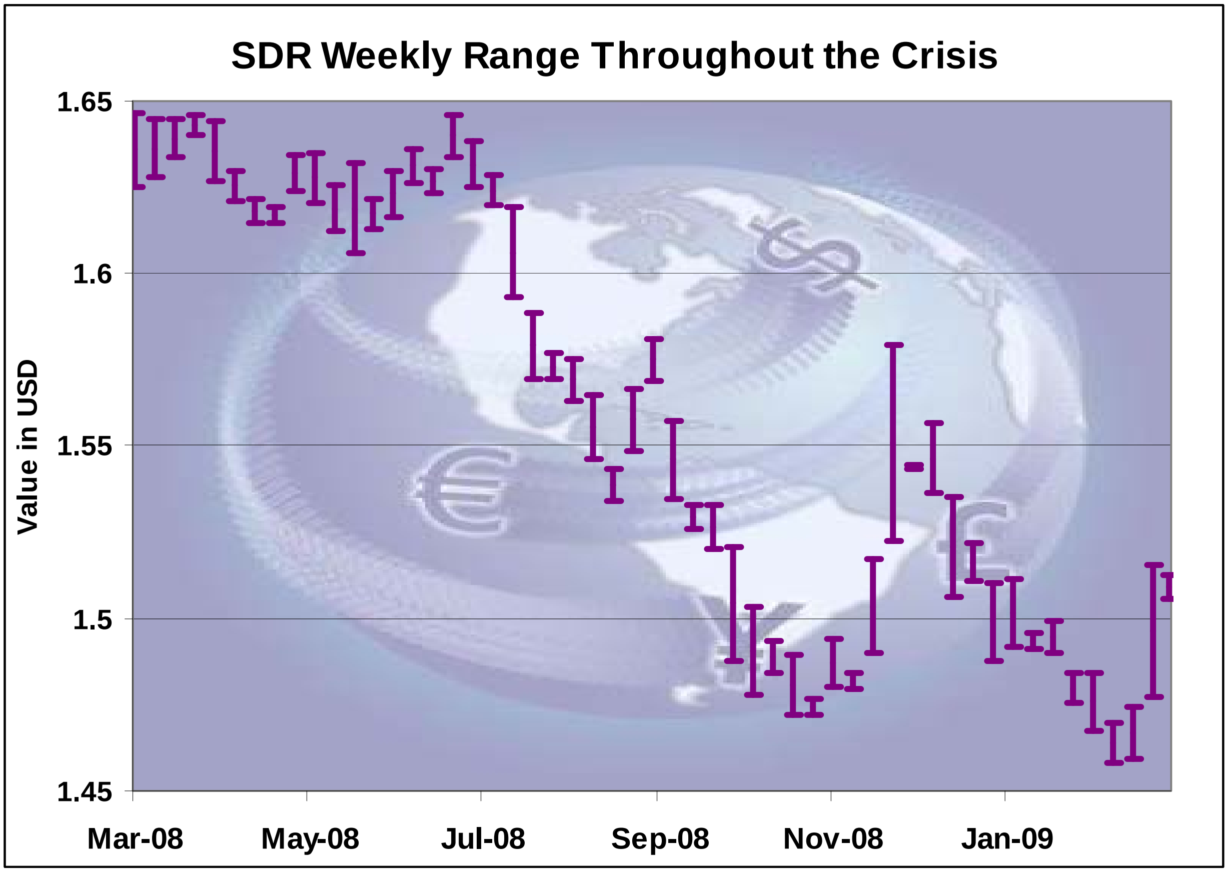
common is their tendency to look for means to curb, check, and in other ways re-direct US influence. It would only be the proverbial shot across the bow, that some claimed it was, if this was in some fashion a change in their behavior or tactics. It is neither.

It is intriguing that Mr. Zhou's musings gave such a prominent role to the IMF. After the IMF's insistence on the so-called Washington Consensus during the 1997-1998 Asian financial crisis, it lost a great deal of credibility there. In fact the Financial Times recently quoted an anonymous finance minister from a middle sized Asian country saying he would rather be dead than go the IMF for assistance. Yet, China appears to be proposing an increase in that very institution's power. The idea of a super-reserve currency is a non-starter. Once past the G20 meeting, the talk will die down, only to erupt at some future point.

Yes, perhaps in some one's ideal world, a new reserve asset—a global common currency—would facilitate trade, cross border movement of capital and greater economic efficiency. But if one were to entertain such fanciful notions, why not go for the whole package—a world government and when it rains it could rain lager.



Source: Bloomberg

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