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FRUITS OF THE CRISIS

*Leveraging the Financial & Economic Crisis of 2008-2009
to Secure New Resources for Development and
Reform the Global Reserve System*

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EXECUTIVE SUMMARY

The recent global financial and economic crisis has opened up new opportunities to mobilize resources for development finance and reform the structures of the global monetary system in a way that would eliminate distortions and benefit all countries.

The recourse of the G20 in April 2009 to a call for a general allocation of Special Drawing Rights (SDRs) by the IMF - the first in a generation - persuaded many government officials in developing countries, as well as advocates for development, that SDRs can be an effective tool not only for building reserves, but also for financing development and meeting urgent liquidity needs. The work of the UN Stiglitz Commission and the discussions around the UN Conference on the Global Financial & Economic Crisis articulated significant support for expanding the scope of SDRs. While prudence would be required in utilizing SDRs, there is potential for using this resource, which costs nothing to create, in creative ways. Greater amounts of SDRs should be provided to developing countries, and the costs of converting them should be reduced or eliminated, particularly for low-income countries. The use of SDRs for a range of purposes, including for medium- or long-term public investments, should be asserted and defended on an international level.

To guard against a risk of inflation, a new category of SDRs - temporary or reversible - should be created. These SDRs could be issued to middle-income countries during times of crisis, and would expire on a date certain once the worst of the crisis passes. Such regular allocations of SDRs in times of financial crisis would act as a 'counter-cyclical' way to meet urgent liquidity needs, and could help to prevent excessive currency depreciations in times of crisis. This is especially important for developing countries that experience sharp currency devaluations which tend to encourage capital flight that can destabilize a national economy.

SDR allocations should be made on the basis of need rather than on the basis of IMF quotas. Criteria could be based on development indicators, relative poverty levels, or more specific macroeconomic factors such as shortfalls in a country's foreign exchange reserve levels, out of which import payments and foreign debt servicing are made.

Because rich countries are accorded the majority of SDRs in any general allocation, there have been proposals for facilitating their transfer to the developing countries that need them more. Unfortunately, recent moves by donor countries seem to confirm that any such transfers will be made to the IMF rather than on a bilateral basis between countries. This means that SDRs, which provide unconditioned, cheap resources, will be turned into debt-creating loans with standard IMF conditions.

The UN Commission and Conference also generated a great deal of interest in the prospects for a more comprehensive reform of the global reserve system, as did interventions by the People's Bank of China, the largest holder of dollar reserves. The distortions imposed by the reliance on the US dollar as a global reserve currency are now widely acknowledged. Most obviously, developing countries seeking to "self-insure" against future crises find themselves lending the U.S. (and to some extent Europe and Japan) funds at very cheap rates, and in the process reinforcing the monetary system that prevents them from asserting greater independence. Enormous sums of money are frozen in reserves instead of being put to use for development and productive investments. And, as economists have pointed out, the latitude of the US in economic policy-making is also circumscribed, as it is encouraged to run large deficits while also maintaining confidence in the dollar, the world's de facto reserve unit.

Most theorists of a new global reserve currency identify the SDR as the most likely candidate. The IMF could end up serving as a de facto global central bank, or a new institution could be created to serve that function. Allocations of SDRs would have to be greatly increased, and countries encouraged to convert their reserves to SDRs. Allocations could be governed in such a way as to discourage consistent or excessive surpluses or deficits. The calculations involved in those allocations could end up leading to substantial changes in the way the IMF itself is governed - especially if proposals for making it an entirely SDR-based institution, with no need for member subscriptions, are adopted.

There are many views on how the transition from the dollar to SDR or other reserve unit could be handled, but the potential benefits are enormous, and self-evident. The international community has a key opportunity from the fallout of the current financial and economic crisis to build momentum for the expanded scope and use of SDRs, and importantly, for greater acceptance and support for their use in sovereign states as well as with the UN. This unique moment in recent economic history must be exploited to make this reform possible.

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Introduction

The global financial and economic crisis that struck in 2008 forced governments and international institutions to adopt measures that seemed unthinkable in 2007. Leading industrialized country governments have spent an estimated \$17 trillion in bailing out their largest banks, and many prestigious financial institutions have gone out of business or come under partial government ownership. Developed countries have the means to borrow or create money to fuel the fiscal stimulus packages necessary to start recovering from the global recession, but most developing countries do not have those options without external financial assistance.

Even if developed countries are now beginning to recover - and that is by no means certain - it is clear that the impacts of the crisis will linger for some time in developing countries. The recent financial crisis has caused a severe reduction of liquidity in the global economy as multiple sources of revenue -- exports, migrants' remittances, foreign direct investment (FDI), and tariff income -- have declined precipitously. Banks reduced lending in order to build their capital reserves, and access to private capital and development aid has become a challenge. According to the World Bank, world trade is on track to register its largest decline in 80 years. Global industrial production has declined by over 20 percent and as a result, unemployment across both developed and developing countries is at an all-time high [World Bank, 2009].

Developing countries are confronting a massive shortfall in external financing. According to UNCTAD, this shortfall could reach up to \$3 trillion in 2009 alone [UNCTAD, 2009]. Many developing countries are experiencing sharp reductions in their foreign exchange reserves, and the IMF [March 2009] predicts that many low-income countries (LICs) could run out of foreign exchange to pay for imports or service their foreign debts. The need for immediate liquidity to developing countries is clear. In particular, LICs that are dependent on concessional loans and development aid are especially vulnerable, as they need external funds to protect core public expenditures, including for social protection programs.

According to UNCTAD, developing countries confront a \$3 trillion shortfall in external financing in 2009.

The crisis has spurred discussions of the flaws, and possible fixes, of the global reserve system.

Although the political challenges involved in changing the status of the US dollar and the introduction of a global reserve unit are daunting, the present moment is the first in which a broad range of players have acknowledged their desirability. If done effectively, such reform could free up significant financial resources for developing countries. Many of the consistent distortions of today's global economy, such as the inherent asymmetry of responsibilities between deficit countries and surplus countries and the trend where developing countries lend to rich countries, particularly the U.S., in order to self-insure against financial volatility and boom-and-bust crises, could be transformed into a fairer system for all countries.

A new allocation of Special Drawing Rights (SDRs)

For the first time in 28 years, the IMF has completed a general allocation of Special Drawing Rights (SDRs), its "international reserve asset" or "reserve currency." The G20 group of major world economies had called for the \$250 billion allocation at its London Summit in April 2009 in a bid to inject liquidity into the troubled global economy. After formal approval by the IMF board, the SDRs were allocated on August 28. In another move

urged by the G20 in April, an additional \$33 billion in SDRs was allocated on September 9 and distributed to countries which joined the IMF since the last allocation, in 1981. (Although this special allocation had the effect of giving a boost to many crisis-ridden Eastern European countries, it was not purely a response to the crisis. It represented the culmination of a proposal for a special allocation approved by the IMF in 1997 but delayed by the U.S. Congress until this year.) These allocations have put the SDR firmly back in play as a monetary vehicle, and could open the door to further allocations.

SDRs are created by the Executive Board of the IMF. They are backed essentially by the consensus of the world's governments; there is no material cost to their creation. The allocation of SDRs is free, and they can be held as assets in reserves at no net cost. They can also be converted into hard currency to be used as governments determine: in sharp contrast to IMF loan financing, there are no conditions on SDRs. The cost of converting and using SDRs is usually small. Indeed, for LICs, SDRs are probably the most convenient, least expensive source of liquidity short of outright grants. Unlike most resources from donors and lenders, the unconditioned funds derived from SDR conversions can be used for counter-cyclical public spending that can help counter domestic recessions.

There is no material cost to the creation or allocation of SDRs. And in sharp contrast to IMF loan financing, there are no conditions on SDRs. For low-income countries, SDRs are probably the most convenient, least expensive source of liquidity short of outright grants.

SDRs are a valuable boost for developing countries, but their potential impact has been compromised by the fact that general allocations are done according to the "quotas" which determine voting power at the IMF and are based on the economic size of member countries. Most of the SDRs, then, go to the wealthy countries which have the biggest quotas and largely control the IMF. For example, of the \$250 billion in SDRs being allocated, less than five percent - about \$11 billion - will go to the most vulnerable countries in sub-Saharan Africa. It is a particularly blatant example of the rich being *required* to get richer before others can get some lesser benefits.

How do SDRs work?

SDRs have existed for 40 years, but have long been absent from development debates. They were created in 1969, when the "Bretton Woods" system of currency values -- under which most currencies were valued in U.S. dollars, and the dollar in turn held a steady value to an ounce of gold -- still prevailed. Their creation by the IMF board was sparked by a shortage of both dollars and gold. But by 1973, the creaking Bretton Woods system collapsed when the U.S. abandoned its commitment to dollar-gold convertibility, and currencies began to float freely. No longer a crucial supplement to the Bretton Woods system, SDRs faded into obscurity, though they continued to make up a small portion of countries' reserve holdings. Only two distributions, in 1970-72 and 1979-81, took place before this year's allocation; the total value of SDRs before 2009 was about \$47 billion (at today's rates). The two recent allocations, then, increased the amount of SDRs by more than a factor of six.

Once SDRs are allocated to a country, they are listed as reserves, and are under the management of the country's Central Bank. While maintained in that state, they cost nothing, and bolster a country's savings, thereby increasing its creditworthiness and

perceived economic stability. With greater reserves, a country can generally borrow more and on better terms, or free up existing hard currency reserves. SDRs, whose value is based on a basket of four major currencies (a carefully proportioned mix of the U.S. dollar, the euro, the Japanese yen, and the U.K. pound sterling), can also be converted into cash through a system of swaps managed by the IMF. Countries pay fluctuating interest charges on converted SDRs until they are replenished. The countries providing the hard currency in the conversions get additional SDRs, on which they earn interest.

Governments are otherwise free to use the cash realized from SDR conversions however they like: to stimulate a stagnant economy, boost spending for social programs, or substitute for investments that may have dried up. Even though SDRs are issued by the IMF, which is notorious for the pro-cyclical “structural adjustment” conditions it has imposed on borrowers since the early 1980s, they are not subject to its conditions. The IMF manages the system, but has no say in *how* SDRs are used.

In June, at the United Nations Conference on the World Financial & Economic Crisis and Its Impact on Development, the G77-plus-China group of developing countries united behind a call for a significant expansion of SDR allocations. However, the conference’s final statement, approved by unanimous consent, did not reflect their position. The outcome document did, however, call for a “review [of] the allocation of special drawing rights for development purposes.” [UN, 2009] Although the U.S. and Canadian governments formally went along, they immediately issued “explanations,” saying that SDRs should only be seen as a source of added liquidity. Depending on how countries deploy them in the months to come, there may be some debate about the appropriate use of SDRs, even in the absence of any formal mechanisms for outsiders to influence their use.

New special allocations of SDRs

Civil society organizations have called for additional SDR allocations—either at regular intervals, or automatically in times of crisis—which would be apportioned on the basis of need rather than quota. Such need could be gauged, in part, by the gap in resources available to countries to meet their goals for healthcare, housing, education, and food security. It could also be determined by more specific macroeconomic factors such as shortfalls in a country’s foreign exchange reserve levels, out of which import payments and foreign debt servicing are made. As already noted, creating SDRs costs nothing. The only material basis for objections is the risk of inflation. This risk has been generally discounted for the allocation during the recent crisis because there is consensus on the need for more global liquidity.

Jacques Polak, the long-time research director at the IMF, has, with P.B. Clark, argued that the only appropriate gauge for determining how SDRs are allocated is “the benefit of permitting low-income countries to acquire and hold reserves at a much lower interest rate than they would have to pay in the market, and a reduced dependence of the system on borrowed reserves that are liable to be recalled when they are most needed.” [Polak & Clark 2006]

Targeted allocations - to just the LICs, for example - would probably require an amendment to the IMF’s Articles of Agreement, which can be a lengthy process, as the U.S. Congress’s 12-year delay on the recent special allocation illustrates. By contrast, the process that started with the G20 calling for the \$250 billion SDR allocation in April took only four and a half months to result in an allocation. With this precedent and the heightened political will demonstrated by the G20, a special allocation could happen in a timely fashion.

Reversible, or Temporary, SDRs

The different circumstances and needs of LICs and emerging economies as well as concerns about the potential inflationary impact of additional, more frequent, or larger SDR issues could be taken into account with different kinds of allocations. As Yilmaz Akyüz, former director of UNCTAD's Division on Globalization and Development Strategies, argues, additional standard SDRs could be distributed to low-income countries while middle-income countries get larger amounts of "reversible," or temporary, SDRs. If converted, these SDRs would be replenished once the crisis ends. Whether converted to cash or maintained as reserves, the temporary SDRs would expire at an established time after the impacts of the crisis subside. Indeed, the proposal made by the G77-plus-China at the recent UN Conference called for \$100 billion worth of SDRs be allocated by the IMF to low-income countries at no cost to them, while another \$800 billion in temporary SDRs would be issued to middle-income countries. This could enable countries to pursue a quick, counter-cyclical "quantitative easing" - stimulating the economy by lowering interest rates to near zero -- at the global level at low cost, which is exactly what many individual rich countries have done.

Temporary SDRs for better-off developing countries would respond to concerns about any potential inflationary impact that might be associated with broad and regular issues of SDRs. Countries which are able to use SDRs for their external financing needs would be more likely to be able to avoid conventional, condition-laden IMF loans, and would reduce the IMF's possible need for new funds from their wealthier shareholders. Finally, as Akyüz points out, large SDR allocations could allow emerging economies with surpluses, such as China, to diversify their reserve holdings and reduce both their dependence on the U.S. dollar and their vulnerability to its fluctuations in value.

Proposals for SDR transfers

To address the imbalance in the recent general allocation, there have been calls for creating a system that allows for, and encourages, the transfer of SDRs from wealthy countries to those which need them. One problem is that the interest charges for the SDRs would remain with the donor country to which they were originally allocated – a serious disincentive to altruism. There were hopes that the IMF would address this issue in the guidelines for the new allocation, but when the SDRs were issued in July they stated only that "no proposal for the voluntary redistribution of SDRs has ever been put into effect" because it "has a real cost to the provider" [IMF, June 2009]. The exploration of other options by which the interest costs to the provider could be financed has not been addressed by the IMF.

In practice, the recipient countries could agree to reimburse the contributing countries for transferred SDRs. The charge would be the same fee they pay for converting SDRs from their own allocations, and would be offset by the interest they would earn for holding SDRs above their own allocation (or, if they previously converted some SDRs, by the reduction in the charges corresponding to the increased levels of SDRs). Added costs would emerge when the recipient country converts its transferred SDRs into cash: at that point it would cease receiving credit for additional SDRs in its account, meaning it would have to pay more to the IMF even as it continued to pay the contributing country's fees. But this would still be equivalent to the costs a country would incur for converting SDRs from within its own allocation. There is thus little cause to object to transfers or to recipient countries making use of those transfers as they see fit

The interest charge countries pay on converted SDRs is based on the interest rates on short-term debt for its chosen currency. At the moment, with the driving down of interest rates in response to the financial crisis, the rate is very low - less than 0.5 percent. However, as the interest rates of the four currencies that comprise SDRs begin to increase with perceived recovery in industrialized countries, the composite interest rate of the SDR will also increase. In fact, the SDR interest rate can vary a great deal, and has been as high as 9 percent. The interest charges continue until the country replenishes its SDR account by re-converting hard currency.

There are reports of African countries accumulating unmanageable debts in the early 1980s after converting SDRs in advance of the sudden rise in interest rates spurred by the U.S. Federal Reserve. At least for LICs, then, the costs for converting SDRs, including transferred SDRs, should be eliminated or subsidized through the use of other IMF resources (such as the sale of some of the IMF's massive gold stocks). Not only would this make SDRs more attractive for poorer countries, but it would also reduce richer countries' reluctance to transfer their SDRs. If it should prove impossible to mitigate these costs, some mechanism for making the costs predictable, or smoothing them over time, should be introduced.

Another factor discouraging transfers is that some potential donor countries, including the U.S. and the U.K., have accounting rules which count SDRs as assets – even though they are acquired at no cost. Thus their transfer would have to be accepted as a loss or balanced by other assets. But it should be a relatively simple matter for governments to change the budgetary status of SDRs.

When SDR proceeds are transferred to the IMF instead of directly to low-income countries, they are converted from unconditioned, cheap resources to conditioned, debt-creating loans.

In August 2009, the IMF floated a proposal that wealthy countries transfer their idle SDR allocation, not to countries in need, but rather to the IMF itself, which would then loan the resources to low-income countries. At the IMF/World Bank annual meetings in October, the British and French governments that they would do so (though because the IMF cannot itself hold SDRs, the governments converted them to hard currency first). This was an unfortunate move, as it will almost certainly discourage any other wealthy country from instead offering direct transfers. The loans to LICs that will result will be concessional, but they will also be attached to the IMF's characteristic fiscal and monetary conditions, which are, even at this time of global crisis, pro-cyclical and contractionary as they require public spending cuts and tight monetary policy. When the SDR proceeds are transferred to the IMF instead of directly to LICs, they are converted from unconditioned, cheap resources (or free, if maintained as reserves) to conditioned, debt-creating loans. This method allows donor governments to be seen as generous even as they increase the power of the IMF over low-income country economies.

But as the European Climate Foundation points out, there is a positive effect of the move by the U.K. and France: it sets a timely precedent for transfers of wealthy countries' SDRs, and for "de facto using SDR-generated resources for development funding."

At the Copenhagen climate conference in December 2009, philanthropist George Soros built on this precedent by proposing the transfer of the remaining SDRs issued to developed countries in the most recent allocation. He suggested that the proceeds could

create a \$100 billion “fast-start green fund” for climate finance that could be a partial answer to demands by developing countries. The costs of conversion of the SDRs to hard currency could be guaranteed by the IMF’s enormous gold stocks, says Soros, with the expectation that loans made by the fund would most likely be repaid with sufficient interest to cover those costs. This proposal would require U.S. Congressional approval for the use of the gold stocks - hardly an easy hurdle. Otherwise, while its proposed funding of loans, rather than grants, is unlikely to satisfy developing countries’ demands for climate restitution, it is a method for mobilizing the wasted resources held by wealthy countries in the form of SDRs for a vital purpose.



Toward Reform of the Global Reserve System

Just as SDRs were originally created to address a shortcoming of the Bretton Woods system, so they are attractive again because they can help patch some of the manifest failures of the reigning financial system. But that system has been failing developing countries for a long time, and allocations of SDRs cannot substitute for the fundamental reforms required to create a financial system that is just and sound for the entire world. But SDRs can be a *part* of those reforms, specifically the repair of the distorted and inefficient global reserve system.

A number of proposals have been made for how the global reserve system can be refashioned so as to avoid the seemingly inevitable distortions resulting from reliance on one dominant world currency (the U.S. dollar). These distortions include the essential freezing of massive amounts of dollars - potential development resources -- as countries like China “self-insure” against future crises by building up their reserves. This self-protection has resulted in a massive accumulation of U.S. dollar reserves, amounting to \$3.7 trillion across all developing countries in 2007 [Commission 2009]. These reserves are in essence a transfer of resources, at very low interest rates, from developing countries to the industrial countries, especially the U.S., which issue the reserve currencies. While the chief source of emergency finance available to developing countries during times of crises is the IMF, many prefer low-return investments to the imposed, and often harmful, conditions of IMF loans.

Most of the proposals for reform of the global reserve system focus on the creation of a new dedicated international currency for reserves, to avert the distortions created by reliance on national currencies. The June UN conference took a potentially important step by “acknowledging” the calls for such reform. The outcome document includes the following:

The crisis has intensified calls by some States for reform of the current global reserve system to overcome its insufficiencies. We acknowledge the calls by many States for further study of the feasibility and advisability of a more efficient reserve system, including the possible function of SDRs in any such system and the complementary roles that could be played by various regional arrangements. (¶36)

This is a concrete indication of momentum towards addressing the shortcomings of the current reserve system. It could be used as a starting point for pushing relevant discussions in international fora.

Indeed, the idea is now being discussed more broadly. Bloomberg reported in June that John Lipsky, the number-two official at the IMF, told a conference in St. Petersburg, Russia that “there are many, many attractions in the long run” to the introduction of a new global reserve currency. He emphasized that “this is not a quick, short or easy decision,” and indeed that it would be “quite revolutionary” [Nicholson 2009].

In November 2009, the IMF published a “staff position note” - not an official IMF position - on the prospects for reform of the global monetary system. The paper lays out the various options, and acknowledges the sound rationale for exploring them. But while it does not come to a firm conclusion, it suggests that significant change would require so much political will that it may never happen, and so energy should be focused on improving the current arrangement [Mateos y Lago 2009].

The People’s Bank of China, which holds the world’s largest quantity of U.S. dollar reserves at \$2.1 trillion (as of June 2009), has been perhaps the most visible proponent of serious reform, saying that “to avoid the shortcomings of sovereign credit currencies acting as reserve currencies, we need to create an ... international reserve currency that can maintain the long-term stability of its value” [Dow Jones/WSJ 2009]. The density of China’s dollar-denominated reserves makes it vulnerable to the foreign exchange risks of the U.S. dollar; at the same time China is a key contributor to the reduced level of demand, because its static reserves keep global demand lower than it would be if those funds were in play in the global economy.

Like most others making the proposals, the Central Bank Governor, Zhou Xiaochuan, has identified the SDR as the most likely vehicle for a global reserve currency [Kyoungwha 2009; BBC 2009; Dow Jones/WSJ 2009]. The idea of a global reserve currency also attracted support at the recent summit meeting of the “BRIC” countries (Brazil, Russia, India, China), where the idea was broached and pushed by the Russian government, though no joint position was announced [Xu 2009; *Russia Today* 2009].

Why a new system? The risks of relying on the U.S. dollar

As economist Robert Triffin pointed out nearly 50 years ago, an international reserve system based on a national currency suffers from inescapable contradictions. Triffin’s point applies as much to today’s system as to the system in place when he wrote in 1960 - the “dollar-gold” or “Bretton Woods” arrangement, in which currencies were linked to the U.S. dollar, and the dollar in turn held a steady value to gold. With the world relying on the dollar, the U.S. must maintain a current account deficit in order to maintain the level of liquidity required for global trade and growth. But when it runs such deficits, feeding the global appetite for dollar-liquidity, it accumulates liabilities to the extent that confidence in, and the value of, the dollar can be negatively affected.

If that happens, restoration of confidence and resisting inflationary pressure would require rising interest rates in the U.S. But that would mean falling deficits and a reduction in global economic activity. Thus, while it seems that the U.S., as the issuer of the global reserve currency, has the flexibility to finance its deficits, it actually takes on unique restrictions to its monetary policy autonomy, since to preserve the global growth it relies on it must balance the requirement of running deficits with the risk of declining confidence in its currency.

The difficulties of maintaining that balance doomed the Bretton Woods arrangement; the world went from struggling with a dollar shortage after World War II - for which the creation of the SDR was one of the solutions - to a glut when the U.S. started printing

money to finance the combination of its expansive social programs and the Vietnam War in the 1960s. That glut finally forced the U.S. to break the dollar-gold convertibility in the early 1970s, leading to the collapse of the Bretton Woods system and the introduction of the system of floating exchange rates and currency trading we have today.

According to José Antonio Ocampo, this transfer of resources from developing countries to the U.S. that the global reserve system requires can be called an “inequity bias,” which was built into the post-war design of the reserve system. As developing countries accumulate reserves, global imbalances between surplus and deficit countries are worsened and a deflationary bias is created, in that dormant reserve holdings have a contractionary effect on the world economy. This creates the “instability link,” which together with the inequity bias results in a dangerous combination of inequity and instability in the world reserve system [Ocampo 2009].

The growth of reserves in developing countries - and the cost

As Akyüz points out, it was initially assumed that in the post-Bretton Woods era, countries would need lower reserve levels as more of them gained greater access to international financial markets, but in fact the opposite has been the result. Growing international flows of capital have allowed countries to run larger current account deficits, “but this has also resulted in an accumulation of large stocks of external liabilities and growing presence of foreigners in domestic securities markets,” making debtor countries vulnerable to “reversals in capital flows, with grave consequences for stability, growth and development.” With the onset of the East Asian financial crisis, IMF lending was the only meaningful insurance available, and the delays and conditions imposed on it made it both unreliable and often counter-productive.

Akyüz sums up: “the combination of increased capital account liberalization in DEEs [developing and emerging economies], accumulation of external liabilities, pro-cyclical behaviour of international financial markets, and the absence of effective multilateral arrangements for the provision of international liquidity and orderly debt workout procedures has forced DEEs to look for self-insurance by accumulating large stocks of international reserves, mostly held in dollars.” While the IMF’s standard gauge of reserves for LICs - sufficient funds to cover three months of imports - was used for most developing countries, the new gauge for emerging economies was reserves that would meet or exceed a country’s total short-term external liabilities. Reserves held by these countries soared to about \$5.5 trillion, roughly the equivalent of seven months of imports. For most countries other than oil producers and China, these reserves are essentially borrowed, since they represent claims on the domestic economy by non-residents, e.g. in the form of equity investments.

The “carry cost” of holding reserves in dollars exceeds \$130 billion per year for developing countries, a figure which is larger than total official development assistance to developing countries.

These reserves are typically invested in low-yielding assets such as U.S. treasury bills and bonds with the “carry cost” - the difference between the cost of acquiring the reserves and the income earned on them - estimated by Akyüz to reach \$130 billion per year for developing countries, a figure which is larger than total official development assistance to developing countries. Those funds are essentially subsidies offered by developed countries to industrialized ones, especially the U.S. This figure, says Akyüz, is actually too low, since

it does not include estimates for the growth that could have been achieved if the resources had instead been put into productive domestic investments. In other words, the opportunity cost of not using the reserve assets for economic activities needs to be considered in addition to the “carry cost” to arrive at the *total cost* of reserve accumulation in DEEs. Many, including the Stiglitz Commission (2009), have highlighted that in a world where there is so much demand for development financing and for building national productive capacities through public investments. The assets being held in reserves in developing countries have many alternate uses for economic and social development needs or for investments that would yield much higher returns than the primary mode of investments in U.S. Treasury bills today.

Fixing the Global Reserve System . . . and the IMF too

While analysts of the prospects for a new global reserve system acknowledge a variety of options - including reviving the gold standard, or implementing Keynes’ proposal, at the time of the Bretton Woods agreements, for a global currency issued by a global central bank (the “bancor”), most of the proposals identify the SDR as the most convenient existing vehicle for creating a new system.

Both Akyüz and Ocampo advocate using SDRs in a much more expansive way than they currently are, by making the IMF, which issues them, use SDRs exclusively. That is, all of its funding would be supplied and maintained as SDRs, and all its lending operations would be conducted in SDRs. This would pave the way for the IMF to take on the role of the world’s de facto central bank.

As Ocampo points out, this would complete “the transition launched in the 1960s with the creation of SDRs, fulfilling the objective then included in the IMF Articles of Agreement of ‘making the special drawing right the principle reserve asset in the international monetary system’ (Article VIII, Section 7 and Article XXII)” [Ocampo 2009].

Clearly such a development is not doing to be brought about by the very slow pace of SDR allocations: the ones just completed are only the third and fourth in history, and SDRs still constitute a small percentage of total world reserves. Ocampo estimates they now make up less than five percent of the world’s *non-dollar* reserves.

If the IMF were to become entirely SDR-based, SDRs would replace quotas and the emergency borrowing mechanisms (the General and New Arrangements to Borrow) as the single source of funding for the IMF. Countries with surplus reserves would be allowed - indeed, encouraged - to convert their reserves to SDRs. This would allow countries like China to decrease the percentage of their reserve holdings in dollars, thereby creating a healthier distribution of risks. A “substitution mechanism” based on proposals within the IMF to deal with earlier instances of dollar weakness could be devised. Under it, according to Akyüz,

the IMF would issue interest-bearing certificates denominated in SDRs against dollar reserves handed over by central banks at the market exchange rate, and invest these reserves in interest-bearing United States treasury bills and bonds. The operation would not affect the total volume of international reserves but its composition - thus no “inflation” fears. Countries can use these certificates to settle international payments or to acquire reserve currencies. The substitution would result in a withdrawal of a large stock of dollar reserves from the market and put them into IMF coffers. It would eliminate the risk of monetary turmoil that could result

from a potential widespread unloading of dollar reserves by central banks. [Akyüz 2009]

Ocampo would accept the continuing use of the current quota system to determine SDR allocations and voting power within the institution, but Akyüz holds that with an SDR-based IMF, “the present practice of allocations [of SDRs] to countries according to their quotas would be discontinued.” Allocations could be done on the basis of formulas gauging the relative importance or size of economies, relative proportions of national income devoted to building foreign exchange reserves, and the need for greater reserve backing in some countries. They could also be used as a counter-cyclical tool at times of turmoil or crisis. This, says Akyüz, “would help counter deflationary forces in the world economy and provide an offset to fluctuations in private balance-of-payments financing.” The UN’s Trade and Development Report (2009) also highlights that one of the advantages of using SDRs in such a counter-cyclical manner is that it would, in principle, facilitate the task of preventing excessive currency depreciations for countries in crisis.

The Stiglitz Commission, which advised the UN conference and helped draw attention to the deficiencies of the global reserve system, also suggests that the IMF take charge of the system and that SDRs be used as the global reserve currency. But it suggests that if there are objections to the IMF playing this role, a ‘Global Reserve Bank’ could be created. It foresees the global currency (probably SDRs) being allocated annually to countries based on their weight in the global economy, their needs, or a combination, and also suggests varying the total amounts issued to respond counter-cyclically to global

If the IMF became entirely SDR-based, it would no longer need to borrow from some of its members in order to lend to others. Such an arrangement could thus bring a considerable improvement to the governance of the IMF, allowing it to stay at equal distance to all its members.

economic trends. The Commission maintains that such an arrangement “should be designed to regulate the creation of global liquidity and maintain global macroeconomic stability” and make problems “related to the creation of excess liquidity by the reserve currency country less likely to occur.” It adds that the system should “be designed to put pressure on countries to reduce their surpluses and to thus reduce their contribution to the insufficiency of global aggregate demand” [Commission 2009].

Such pressure could be applied through the allocations: “Countries that maintain excessive surpluses could lose all or part of their quota allocations if they are not utilized in a timely manner to increase global demand.” [Commission 2009]

The Commission also suggests that the system could be phased in gradually, with only countries that immediately see the benefit of converting their reserves to SDRs doing so, thus providing an example that other countries, including the U.S., will want to emulate. Once a critical mass of countries is committed to the system, revised approaches to allocating SDRs could be implemented.

Another method of implementing the reformed reserve system would be to assign regional economic formations (e.g. ASEAN, SADC, Mercosur, etc.) to lead the process. Ocampo takes this idea the furthest, suggesting that the IMF be seen as the “apex of a network of regional reserve funds” and that reliance on the regional formations could be encouraged

by making SDR allocations dependent, in part on countries' reserve holdings devoted to regional funds.

As an SDR-based institution, the IMF would have the necessary leeway to become a more independent monetary institution. It would, in Akyüz's words,

be translated into a technocratic institution of the kind advocated by Keynes during the original Bretton Woods conference. Its funding would no longer be subjected to arduous and politically charged negotiations dominated by major industrial countries. Nor would it need to borrow from some of its members in order to lend to others. Such an arrangement could thus bring a considerable improvement to the governance of the IMF, allowing it to stay at equal distance to all its members and help to perform policy surveillance even-handedly and effectively. More objective IMF governance could mean an end to the ideological rigidity of the institution and an openness to expansionary, development-oriented policies. [Akyüz 2009]

RECOMMENDATIONS

- SDRs should be allocated by the IMF regularly, perhaps annually, in times of financial crisis. To do this, the IMF's Articles of Agreement would need to be amended.
- Special, targeted allocations of SDRs should be made on the basis of need rather than quota, or to categories of IMF members, for example to those eligible to borrow from the Extended Credit Facility.
- Wealthy countries should transfer surplus SDRs directly to those with greater need for the resources, and the IMF should facilitate these transfers without itself taking charge of the funds. Such transactions should be conducted transparently.
- The costs of converting SDRs should be eliminated for the most vulnerable developing countries, or subsidized by other IMF funds, such as the profits realized from the sale of IMF gold.
- A second category of SDRs - temporary or reversible - should be created. It could be issued to middle-income countries for temporary finance or reserve use, but they would have to be replenished by a date certain, after which they would expire.
- The use of SDRs for a range of purposes, including for medium- or long- term development, should be asserted and defended.
- Advocates and governments should build on the support expressed for the expanded scope and use of SDRs at the UN Conference on the World Financial and Economic Crisis to push for greater acceptance of their use with individual countries and with the UN.
- The United Nations and other agencies (e.g. the OECD, the IMF, the Financial Stability Forum) should convene formal discussions on the crisis of the global reserve system and work toward consensus on reforms that would eliminate dependence on the US dollar and develop a new global reserve unit not tied to any single country.

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Annex 1: Language on Global Reserve System and Special Drawing Rights (SDRs) in Key Documents

	G20 Leaders Communiqué, April 2009	G20 Leaders Communiqué, September 2009	Outcome Document of the UN Conference on the World Financial and Economic Crisis, June 2009	Commission of Experts of the President of the General Assembly, United Nations, September 2009
Global Reserve System	We will conduct all our economic policies cooperatively and responsibly with regard to the impact on other countries and will refrain from competitive devaluation of our currencies and promote a stable and well-functioning international monetary system.	<i>[There is no specific language on the global reserve system (or on the global monetary system) in the September communiqué of the G20 Summit in Pittsburgh.]</i>	<p>The crisis has intensified calls by some States for reform of the current global reserve system to overcome its insufficiencies.</p> <p>We acknowledge the calls by many States for further study of the feasibility and advisability of a more efficient reserve system, including the possible function of SDRs in any such system and the complementary roles that could be played by various regional arrangements.</p> <p>We also acknowledge the importance of seeking consensus on the parameters of such a study and its implementation.</p>	The reform of the global reserve system could take place through a global agreement or through more evolutionary approaches, including those that could build on a series of regional initiatives. If a large enough group of countries agreed to pool reserves in a system they agreed to create and to hold a common reserve currency which they would stand ready to exchange for their own currencies, a regional reserve system—or even a system of near-global coverage—could be established without the agreement of all countries. So long as the new currency is convertible into any hard currency that is itself convertible into other currencies, it could serve effectively as a reserve currency. The countries participating might also agree to reduce, over time, their holdings of other reserve currencies.

<p>Special Drawing Rights</p>	<p>We have agreed to support a general SDR allocation which will inject \$250 billion into the world economy and increase global liquidity, and urgent ratification of the Fourth Amendment.</p>	<p>The IMF has made SDR allocations of \$283 billion in total, more than \$100 billion of which will supplement emerging market and developing countries existing reserve assets.</p> <p>Several countries are considering creating, on a voluntary basis, mechanisms that could allow, consistent with their national circumstances, the mobilization of existing SDR resources to support the IMF's lending to the poorest countries.</p>	<p>We recognize that increases in global liquidity play a useful role in overcoming the financial crisis. Therefore, we strongly support and call for early implementation of the new general SDR allocation of \$250 billion.</p> <p>We also call for the urgent ratification of the fourth amendment to the IMF Articles of Agreement for a special one-time allocation of SDRs, as approved by the IMF Board of Governors in September 1997.</p> <p>We recognize the need for keeping under review the allocation of SDRs for development purposes.</p> <p>We also recognize the potential of expanded SDRs to help increase global liquidity in response to the urgent financial shortfalls caused by this crisis and to help prevent future crises. This potential should be further studied.</p>	<p>One possible approach [to reform the global reserve system] would require countries to agree to exchange their own currencies for the new currency—say International Currency Certificates (ICCs), which could be SDRs—and vice-versa, in much the same way as IMF quotas are made up today (except that developing countries would only make their quota contributions in their own national currencies and would thus be exempted from making part of such contributions in SDRs or convertible currencies as is the rule today).</p> <p>This proposal would be equivalent to a system of worldwide “swaps” among central banks. The global currency would thus be fully backed by a basket of the currencies of all members.</p> <p>Indeed, a large counter-cyclical issue of SDRs is the best mechanism to finance world liquidity and official support to developing countries during the current crisis.</p>
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