Special Drawing Rights and the Reform of the Global Reserve System

Jose Antonio Ocampo[1]

Initiative for Policy Dialogue

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Fundamental flaws in the current global reserve system have led to a massive build up of hard currency reserves that, in turn, have helped generate the global imbalances which cause deep systemic vulnerabilities. At the center of the unstable and unequal system is the capricious provision of the *global* reserve asset by a *national* entity coupled with the absence of an adequate *collective insurance* mechanism for states. The solution to the infirmities of the system, therefore, involves the collective provision of the global reserve asset by a global institution and the strengthening of collective insurance mechanisms. Reforming the IMF's Special Drawing Rights (SDR) facility embodies both these features.

[1] José Antonio Ocampo is Professor, Director of the SIPA Economic and Political Development Concentration and co-President of the Initiative for Policy Dialogue at Columbia University. He was formerly Under-Secretary General of the United Nations for Economic and Social Affairs, Executive Secretary of the Economic Commission for Latin America and the Caribbean, and Minister of Finance of Colombia.

The financial globalization of the post-1970s period meant that developing nations were integrated into a market segmented by risk categories, with high-risk borrowers being subject to strong pro-cyclical swings. The financialization of commodities markets meant that the inherently pro-cyclical nature of the commodity trade essential to developing nations was exaggerated. The combined effects of these pro-cyclical features, in the context of the absence of a global lender of last resort, led to a defensive or precautionary demand for foreign exchange reserves by developing nations as a form of "self-insurance" or "self-protection".

Not only did the system lack a collective insurance mechanism but, in common with the preceding system, it lacked an adjustment mechanism to mutually offset the balance of payments surpluses and deficits of different countries without adversely affecting world economic activity. The capriciousness of the system means that it could have either an inflationary or deflationary leaning depending on the phase of the business cycle. The three main flaws of the present system are:

1. A deflationary bias that is derived from the fact that the burden of adjustment falls on deficit nations. This might be called an anti-Keynesian bias as it was emphasized by Keynes during the debates that established the Bretton Woods institutions.

2. The Triffin dilemma, wherein the contradiction between the *national* provision of the key *international* currency generates fundamental instabilities.

3. An inequality bias, wherein the fragilities of the system and the absence of a global lender of last resort results in a foreign exchange reserve build-up by developing nations that constitutes a net transfer of resources to major economies.

While these reserve built-ups might be rational from the point of view of individual nations, there is a "fallacy of composition" at the systemic level as, in the aggregate, this reserve build-up leads to global imbalances that render the system seriously unstable. The present system displays a critical *inequality-instability link*, wherein its instabilities viz. the lack of adjustment mechanisms are derived from its inequalities viz. the privileges enjoyed by

reserve granting nations and the absence of a credible collective insurance. The flaws of the system can be examined in turn.

The Anti-Keynesian Bias

The fundamental asymmetry that Keynes tried to undo through institutional design was the fact that, once the system was imbalanced, surplus nations faced less pressure to adjust their net asset positions. The burden of adjustment thus fell to deficit nations who, with net liabilities to the rest of the world, faced the threat of capital flight and/or increasingly unstable indebtedness. The operative adjustment mechanism was therefore the deflation of the deficit countries, leading to a deflationary bias for the system as a whole. Keynes' International Clearing Union was a mean to make the system symmetric, but the failure to establish it meant that this flaw was embedded into the new Bretton Woods institutions.

Triffin Dilemma

In the 1960s, Robert Triffin noted that the national provision of the global reserve asset can lead to unstable swings in the global economy. The greater acceptance of the reserve currency can lead to an over-expansion of the provider's current account deficit as borrowing becomes easier, leading to the threat of mass conversion of the asset into gold once imbalances built up. On the other hand, the proper maintenance of external balances by the providing country would starve the world of liquidity. Such a system would either result in a bloated and unstable center or a liquidity-starved periphery, or an "erratic" oscillation between the two. The initial fear was of liquidity shortage from a surplus American economy; this was the context in which more orderly creation of SDRs was first discussed.

In the absence of the link to gold, and therefore contrary to Keynes' expectations, the fiduciary dollar standard had an inflationary bias from the lack of constraints on the US balance of payments deficit. This freedom saw the US accumulate a huge net liability position by the mid-1980s. The long-term trend in the US capital account sees deterioration in cycles

of ever-greater amplitude, with major corrections associated with US and global slowdowns. The resulting *inflationary* bias—the obverse expression of the Triffin dilemma under the dollar-gold exchange standard—led to a flood of global liquidity and a capriciousness in the dollar that militated against the stability required of a global reserve asset.

The global role that the US economy plays as the consumer/deficit of last resort interacted with these features of the global reserve system, leading to a long and unprecedented expansion of the current account deficit at the center of the system. As indebtedness grew and reserves accumulated in the periphery, serious systemic vulnerabilities began to emerge, notwithstanding the recent crisis-driven demand for dollar assets.

Systemic Inequalities and the Inequality-Instability Link

That the unprecedented accumulation of foreign reserves followed major financial crises, both the Latin American debt crisis of the 1980s and the Asian Crisis of 1997, ought to indicate that systemic inequalities and instuabilities are deeply interconnected. It was the latter crisis that exposed the lack of a collective insurance mechanism at the heart of the system as highly conditional IMF lending was abjured. This lead directly to a huge additional demand for reserves from developing nations.

Experience indicates that an appreciation of the currency—a reaction to pro-cyclical capital flows—and a consequent deterioration in the current account frequently leads to both balance of payment and currency crises. Self-protection in the form of currency management and reserve accumulation can therefore be interpreted as a form of *countercyclical* macro management. Indeed, since capital account fluctuations occur over the medium term, it appears prudent to go beyond the Guidotti-Greenspan rule of holding reserves to cover short-term external liabilities and provision for *total* external liabilities.

And yet at the aggregate level, there is a fallacy of composition as far as the risk management efforts of developing nations are concerned. The demand for "safe assets" that this risk management entails at the global level will lead to a deflationary bias in the system unless a

countervailing deficit is opened up somewhere else in the system. Of course, in the boom of 2003-7, it was the US that provided both the safe assets and the consumption engine that drove the world economy. The more the inequalities of the system generated the demand for safe assets and concomitant deficits, the more unstable the system became as the US over-expanded. This is the essence of the *inequality-instability link*.

Simply asking developing nations to appreciate their currencies will not solve this deep systemic problem; witness the experience of several Central and Eastern European economies after the recent crisis. The driver of self-protection must be addressed, namely pro-cyclical capital and trade flows and the absence of collective insurance for balance of payments crises. The only way out is to reform the system itself.

SDR-based Global Reserve System

There would be two parts to a fully SDR-based IMF with a clear countercyclical purpose. One would involved the "unconditional" *allocation* of SDRs to generate countercyclical liquidity, while the other would would entail SDR *financing* as a mode of "conditional" countercyclical liquidity provision to countries facing balance of payments crises. Jacques Polak suggested a mechanism for SDR financing three decades ago, one that mimics the operations of central banks during crises: the IMF would, like a central bank, create SDRs (domestic money in the case of central banks) to meet crisis needs, SDRs that would be automatically destroyed when loans were paid for. Limits on overall and country borrowing would of course have to be in place, but both these mechanisms would entail a substantial augmentation of the IMF's balance sheet, which has seriously lagged behind global growth since the 1970s, giving rise to the need for individualized insurance in the first place.

The SDR allocation part of the proposal can be facilitated by treating unused SDR allocations as deposits in the Fund, or loans to the Fund that can then be on lent to countries in need. This would obviate the excessive power that lending nations have during crises as fresh resources will not have to be raised by the IMF. Backing up these fresh allocations of

SDRs would, in boom time, be the bonds of member countries that have a high degree of liquidity and thus safety. This stock of bonds could then be disgorged during crises.

While the entire global monetary system could be reformed if the SDR is used more broadly, in the short-term it is wise to concentrate on reforming the *reserve* system first. The dollar would thus diminish as a reserve asset while maintaining its function as the major international *means of payment*, creating associated demands for the concerned functions of the US financial system. A substitution account at the IMF would facilitate the smooth transformation of dollar reserves into SDR-based assets, and the issuance of SDR-denominated bonds could be a step in this direction.

Complementary Role of Regional Monetary Arrangements

The IMF of the future ought to be modeled on the European Central Bank or the Federal Reserve Bank in one salient feature: it should be the apex of a network of regional funds. Not only would these funds generate complementary forms of collective insurance, but they would provide fora for macroeconomic policy coordination as well as giving voice and ownership to smaller countries. Existing regional arrangements take different forms—payments agreement, swap lines, reserve pools, common central banks—and exhibit different degrees of multilateralization. The ASEAN Chang Mai initiative is committed to full multilateralization and is augmenting its resources; evolution into a structured reserve fund could see this institution issue its own currency, which would be useful even as merely an international unit. Regional monetary arrangements might run against the principle of diversification given the possibilities of contagion within a region, but to the extent that members of a regional fund are heterogeneous in their demand of crisis liquidity, stemming for the lack of correlation between certain macroeconomic variables even as others are correlated, (as the experience of the Latin American Reserve Fund indicates), these funds would have important stabilizing properties.

Conclusion: Complementary Reforms

While the focus here has been on reforming the monetary system rather than the broader financial system, two more general points can be made in conclusion. First, by being inclusive and structuring macroeconomic coordination and surveillance, the IMF displays clear advantages over ad hoc arrangements. The crisis is an opportune moment for the Fund to fulfill its original design and take its place at the center of global macroeconomic policy making. Second, by acting to reduce risks that developing countries face in a world in which finance is strongly pro-cyclical, expanding the reach of domestic policy options, and by reducing the cost of self-protection, capital controls could serve a critical system-stabilizing function.