Triffin International Foundation

USING THE SDR AS A LEVER TO REFORM THE INTERNATIONAL MONETARY SYSTEM

REPORT OF AN SDR WORKING PARTY

May 2014

Foreword

In 2009 the *Triffin International Foundation* (www.uclouvain.be/fondation-triffin.html) launched, under the chairmanship of Alexandre Lamfalussy and with the support of the *Compagnia di San Paolo di Torino,* the "Triffin 21 Initiative": this was aimed at addressing "the fundamental role" in the recent crisis "played by a flaw in the present monetary arrangements" which Robert Triffin had clearly identified and denounced in his time. The Triffin International Foundation argued "as long as this flaw is not addressed, one cannot expect to achieve lasting financial stability and sustainable economic growth".

This initiative first gave rise to the inaugural lecture "The Ghost of Bancor: the Economic Crisis and Global Monetary Disorder" given in Louvain-la-Neuve on 25 February 2010 by the late Tommaso Padoa-Schioppa[1], and to the symposium "Towards a World Reserve Currency" organized in Turin in May 2010 by the Compagnia di San Paolo and Triffin International Foundation[2].

Moreover, in October 2010, Michel Camdessus, Alexandre Lamfalussy, and Tommaso Padoa-Schioppa, convened, with the moral support of the Triffin International Foundation, a group of 18 former Ministers, Governors, Heads of International Institutions and Senior officials, which took the name of *Palais Royal Initiative* (PRI), to evaluate the international monetary system (IMS) and to propose changes that might be needed to stabilize it and reduce the likelihood of future failures. On February 2011, the PRI delivered to the Chairman of the G-20 the report "Reform of the International Monetary System: a Cooperative Approach for the Twenty First Century", which was communicated to the governments of the member countries, in preparation of the G-20 Summit that was held in Cannes in November 2011[3].

The Palais-Royal report made 18 concrete suggestions in the domains of Economic and Financial policies, Exchange rates, Global Liquidity, SDRs, and Governance. Taking on board a number of these suggestions, the G-20 Presidency proposed to the Cannes Summit five areas for reform: surveillance of the global economy and financial system, global financial safety nets, management of global capital flows, reserve assets and reserve currencies, and IMS governance. However, at the Summit, these proposals were crowded out by the onset of the sovereign debt crisis, and relatively little ground was covered on the reform of the IMS. The bulk of the PRI suggestions and of the G-20 proposals largely inspired by them are still available for consideration by public authorities.

Nevertheless, the PRI report, in its section V, remained relatively succinct regarding the role of the SDR and indicated in a footnote: "Suggestions 13 to 15 (devoted to SDRs) have not been fully developed but there was a near consensus amongst the group on proposing that the subject merits serious discussions". This is the research area of this working party[4], which was initiated by the Triffin International Foundation, in the aftermath of the conference organized in Brussels on 3-4 October 2011 on "The International Monetary System: Sustainability and Reform Proposals", to celebrate the 100th anniversary of Robert Triffin.[5]

[1] http://www.uclouvain.be/cps/ucl/doc/triffin/documents/TPS_EN_finale_clean.pdf.

[2] http://www.federalist-debate.org/index.php/component/k2/item/40-an-international-colloquium-on-the-initiative-triffin-21.

[3] The report, along with introductory documents and working papers, can be found in *Reform of the International Monetary System. The Palais Royal Initiative,* Jack T. Boorman and André Icard (eds.), New Delhi, Sage Publications, 2011.

[4] The composition of the Working Party is detailed in annex 1. Financial support was kindly provided by the *Centre for Studies on Federalism* and *CNH Industrial*.

[5] The proceedings of this conference were edited by Jean-Claude Koeune & Alexandre Lamfalussy under the title « A la recherche d'un nouvel ordre monétaire mondial- In Search of a New World Monetary Order". P.I.E. Peter Lang, Brussels, 2012.

The SDR Working Party's Report

The present report starts (section I) by reaffirming the existence of a "built-in-destabilizer" in the present IMS, which is based on the use of national currencies -mainly the US dollar- as reserve currencies, and by presenting the theoretical first-best solution, which unfortunately is likely to remain out of reach for long. Nevertheless, the need to break free from the status quo leads to re-explore the potential role of the SDR (section II) for strengthening monetary and financial stability, in the present globalized and multi-polar world. Then, based on analytic elements, the report makes nine suggestions (A to I) aimed at overcoming the present deficiencies in the functioning of the IMS through an enhancement of official SDRs (section III) and the development of a private SDR market (section IV)

I. The systemic flaw in the present IMS and the basic principles for a first best solution

1. Understanding the "built-in destabilizer" in the present IMS.

The goal and functions of an efficient IMS are essentially to provide for two intertwined global public goods: supplying adequate global liquidity to ensure global economic growth in balanced monetary conditions; and minimizing the costs to activity and employment when global external disequilibria need to adjust.

The systemic defect of the present arrangements on which we focus is due to the failure to resolve the Triffin dilemma. This consists in the difficult choice, for the country or the monetary area issuing the reserve currency, between going ever deeper into debt in order to satisfy the growing world demand for liquidity, with the danger that this will undermine its creditworthiness on the one hand, or failing to satisfy this demand by giving priority to preserving its creditworthiness on the other hand. This basic fact is independent of the exchange-rate regime, whether a general peg like the past Bretton Woods system or all kinds of "clean" or "dirty" floating regimes, since by definition, with such an arrangement, the reserve currency is a liability of the issuer toward the other reserve-holding users, who invest it into liquid financial papers issued by the key-currency country (Treasury bills and bank CDs). Indeed, by virtue of the inner nature of a key-currency, its foreign official holders do not simply deposit its amounts on their accounts with the issuing Central Bank but re-inject them into financial assets issued by the reserve currency economy (automatic capital inflows). Therefore, whatever the exchange-rate regime, the liquidity effect created abroad by the variation in the holdings of external reserves in this key-currency is not offset by a contrary variation in the monetary base of the issuer. Thus any national currency used as foreign reserve by other countries provokes a significant spillover on global liquidity conditions.

Actually, since the creation of the Bretton Woods system and even after its breakdown, this kind of spillover has prevailed, most often in an expansionary fashion, and has given rise to global monetary waves. In the last decade, this phenomenon has been amplified by an unprecedented accumulation of reserves based on large and often persisting current and capital account imbalances, in a world of rapidly growing global trade and fast development of international financial markets prone to frequent episodes of instability.

As the international use of a national currency automatically relaxes the external constraint on the issuer country and allows it to follow, too easily, macroeconomic policies that prioritize domestic full employment, even if there are negative spillovers on the rest of the world, one cannot exclude the possibility that such growing global imbalances lead to massive reserve accumulation and increasing financial instability as explained by the Triffin dilemma.

Indeed, Triffin foresaw, in the last published version[6] of his analysis of the asymmetries generated by the dollar-system, the development of a vicious circle of disequilibria he named a "built-in destabilizer", which affects both the reserve currency country and the other economies, and relies upon two intertwined mechanical channels: first the weakening of the external constraint on the issuer of the reserve currency, which tends to exacerbate its macroeconomic imbalances by pushing down its saving rate and, second, the transmission to the rest of the world of the monetary conditions prevailing in the reserve currency country. Other creditor central banks, concerned by a growing instability risk and sometimes also motivated by mercantilist objectives, are inclined to pile up additional reserves, resist appreciation of their currencies, and re-inject in reserve currency assets their excess holdings, lowering these assets' yields, especially at the long end of the curve.

As a result, global liquidity conditions cannot be adequately regulated, reinforcing the cyclicality of global economic trends, and braking the macroeconomic and structural adjustments in both deficit and surplus countries. Whatever the initial causes of the macroeconomic imbalances, the present international monetary system allows them to persist unduly.

This mechanism, theorized by Triffin in 1991, well illustrates the process that developed twenty years later in an environment of rapidly growing global trade and international capital flows, which ended up in the 2007-2008 crises and their aftermath. Indeed, one can observe the parallel trend between accommodative monetary policies in the United States with ever growing over-consumption and indebtedness, and their mirror image in the form of growing current account surpluses for the rest of the world. This fact, possibly compounded by domestic policy distortions such as mercantilist behavior which may encourage excess savings outside the USA, helps explain why an excess demand for new external reserves is fed primarily by concerns over financial instability.

In turn this excess demand for reserves automatically tends to nourish the US deficit, worsening the global disequilibrium and the financial exposure of the banking system and calling for further monetary and fiscal stimuli in the US economy. Therefore, Triffin's "built-in destabilizer" hypothesis, confirmed to a large extent by the events of the last decade, could explain why an IMS based on reserve currencies is largely responsible for a "global vicious circle" which generates global monetary waves and systemic instability with boom-and-bust episodes, and results in a loss of welfare for all countries, including those issuing reserve currencies.

Irrespective of the position economists have taken on this explanatory hypothesis, global disequilibria registered in the last decade have shown a rising trend. Since the use of the dollar as the main reserve currency produces significant policy spillovers and external liquidity effects, there is a clear case for examining the way to internalize them in either a systemic/centralized fashion, or at the least in a cooperative one. At the national level, economists long ago agreed on the need to control the spillovers generated by the banking system's money creation through a "Central Bank"

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[6] Triffin, Robert, "The IMS (International Monetary System…or Scandal?) and the EMS (European Monetary System…or Success?)", Jean Monnet lecture, European University Institute, Florence. *Banca Nazionale del Lavoro Quarterly Review*, n°179, December 1991

charged with regulating bank liquidity by issuing or destroying its own liabilities used as the national currency. At the global level, this very same need should logically lead to the creation of a single global reserve currency issued by a single multilateral central bank, which could regulate the global liquidity needed for a globalized economy in a rational way. Nation-based monetary policies, by showing their inability to regulate properly global liquidity and financial markets, have revealed the need for collective action.

2. The long-term need for a systemic reform eliminating the Triffin dilemma.

The best solution would be to create a multilateral reserve currency, issued by an IMF transformed into a global central bank, in other words a liquid liability that is not the debt of any individual country. The purpose is to make feasible a symmetric regulation of global liquidities able to contribute to offset deflationary or inflationary tendencies in effective world demand. External constraint is inherently asymmetric and deflationary as it tends to depress world demand because the constraint upon deficit countries to balance their account is stronger than the disposition of surplus economies to adjust by saving less. Indeed, as initially proposed by Keynes at Bretton Woods in 1944 and taken up repeatedly by Triffin since the 1950s, only a globally created reserve currency - i.e. a liquid liability of the IMF (or another IFI with near-universal membership) – can make up for the contractionary bias of external adjustment while satisfying world demand for reserves without creating any national debt, because by definition there is no net foreign liability for the world as a whole, as an increase in the IMF's liabilities does not increase the deficit of any country.

We take it that the world has decided to stay with a floating exchange-rate system. We also believe it to be desirable that the international reserve currency becomes multilateral, with its issuer (the IMF) getting the means to actively regulate issues of reserve assets in both directions. This requires not only making the IMF a genuine lender-of-last-resort (LOLR), but also transforming it into a global monetary authority capable of preventing the creation of global excess reserves as much as the occurrence of a global shortage of reserves. Of course, each national monetary authority would remain free to set different objectives for its own economy and to diverge from the global stability policy; that is inherent in floating.

However, one must admit that the first-best solution of global liquidity conditions being determined by a world central bank is out of reach in today's world because political forces, voting, decision-making processes and regulations remain mostly national while economic and financial developments are global. This divergence allows national and vested interests to neglect global public good considerations and to override world welfare concerns. One must therefore search for a second-best solution that is compatible with existing constraints and which could ultimately evolve toward the first-best solution.

II. <u>Making the best out of the current system: the SDR as a key element for an improved IMS</u>

3. The medium-term need for a pragmatic step towards a systemic solution.

The Working Party is aware that in the current circumstances getting agreement on necessary adjustments would be the most valuable reform, but in the absence of significant progress in this field, it focused on a specific solution involving the use of the SDR.

Searching for a second best solution raises the question: is there a pragmatic way to make the best out of the current system and to correct the main deficiencies in the current management of the IMS, using existing instruments? By good fortune such an instrument already exists in the form of the Special Drawing Rights (SDR), which "was originally conceived in the 1960s as an official reserve asset that would be both supplement to and substitute for the US dollar"[7]. Indeed, the Committee of Twenty that met from 1972 to 1974 visualized this asset becoming the basic asset of the international monetary system. However this vision has not been realized because nations pursued their individual short-run self-interest, which resulted in a continuation of the reserve currency system. Even though it has so far fallen short of expectations, clearly the SDR should be a good candidate for playing a catalytic role in a pragmatic and progressive approach.

The present excessive accumulation of reserves has its main proximate cause in global macroeconomic instability along with mercantilist behavior and the induced central banks' desire to be able to conduct autonomous intervention policies free from the constraints of IMF conditionality. It is permitted by large and persisting current account surpluses or, in some cases, large borrowings on unstable international financial markets. Its consequence is a significant worsening of the Triffin dilemma to the extent that net additions to reserves are invested mainly in US debt instruments, even though this trend has slowed down.

Addressing this complex problem requires a comprehensive set of measures. Indeed, a mere diversification of reserves could reduce the Triffin dilemma but would not eliminate the other negative aspects, while the enlarging of IMF financial facilities, even up to the level required by the LOLR function, could decrease somewhat the desire for reserve accumulation but probably not the preference for autonomous intervention policies. In such conditions, market reserves are likely to remain abundant and kept mostly in USD, with a still significant Triffin dilemma, unless a liquid private SDR market is developed, where public and private SDRs are linked. Thus, the solutions to be envisaged should be comprehensive and cover all aspects related to SDRs, both public and private.

4. The need for a stable reserve currency.

According to recent statistics, the dollar's share in foreign reserves amounts to 62%, while the euro's is 24%. Other currencies play a marginal role. The SDR represents about 4% of total reserves.

If one considers the three functions to be taken into account when assessing the quality of a reserve currency, the USD has no equivalent in two of them: unit of account and medium of

[7] George M. von Furstenberg, article "SDR" in *The New Palgrave Dictionary of Money and Finance*, Macmillan, 1992.

exchange. It is used in a large majority of international contracts for invoicing, trading and settling, and the liquidity, depth and size of its main financial markets are unique. In current circumstances, as long as the renminbi (RMB) does not play a significant international role, only the euro (EUR) could be considered a possible substitute in these functions, but the comparison cannot go very far as EUR capital markets are much smaller and also still segmented by national boundaries. BIS statistics show that the USD is one side of 87 % of all the trades in foreign exchange, while for the EUR it is only 33%.

By contrast, if one considers the third function, namely store of value, the USD's performance appears much less satisfactory. The dollar has depreciated almost continuously in terms of goods (the CPI has more than quadrupled in the last 40 years). It has also depreciated against currencies in general, in particular against the German currency (DEM and then EUR). The decline is impressive, as the purchasing power of a USD against this reference has been divided by 2.5 since 1970. Actually, the USD has followed a long declining trend over the last four decades and, in addition, has been subject to intense short term cyclical pressures, up and down, according to changes in international investors' expectations. Although supposed to be an anchor, the USD was, at least no less than other currencies, subject to the vagaries of the floating exchange rate regime.

In this respect, the SDR would have been a much better standard in terms of long- term value and short-term stability. True, it too has depreciated against the price of goods. But while, by construction, it depreciated against strong currencies, like the DEM (later the EUR) and the Yen, it appreciated against the dollar (from 1.00 at its creation to about 1.50 now). Also, by virtue of its valuation as a basket of currencies, it has been more stable than any of its components. Although it cannot be used as an intervention currency unless and until it develops an active private market, it would be perfectly satisfactory as a precautionary reserve.

5. The need for an effective management of global liquidity.

Global liquidity comprises both private international financing and central bank reserves. Today, except in very rare circumstances such as during the 2009 crisis, these matters are not subject to any collective decision-making and are influenced mainly by monetary conditions in leading countries and by international financial market conditions. In particular since the FED's, as any other national Central Bank's, monetary policy is legitimately and unavoidably oriented towards the internal needs of the U.S. economy, this generates significant external effects on global liquidity, which are incompatible with the preservation of world economic stability.

Indeed, national monetary policies in the big countries influence strongly private international financing, generating huge flows through international financial institutions and the shadow banking system. This means that one has to take into consideration how liquidity creation and credit extension in major economies - especially those with large financial systems - are driven by their central banks and transmitted to other economies through global integrated markets and exchange rate movements. Today, there is no international instrument to regulate these elements. This is particularly damaging as monetary policies, considered individually, can be perfectly designed for national purposes, and yet have strong negative effects on the rest of the world, through an international financial system left largely out of control.[8] The PRI report made several suggestions in this respect in its 4th section.

[8] Private international financing can be extremely volatile: from 2007 to 2009, gross capital inflows worldwide fell from nearly 20% of global GDP to less than 2%, leading to a massive SDR issue in 2009. Such extreme

Central bank reserves include both reserve currencies, mainly USD, held in the form of market instruments, and IMF reserve positions and SDRs.

As total reserves can derive from current account surpluses or capital flows and as quotas cannot be adjusted easily, the only element of global liquidity that, in practice, can be subject to collective decision-making is SDR holdings. The development of permanent financing mechanisms, akin to a global LOLR, is necessary. SDRs constitute the natural IMF instrument for this purpose and should play a much larger financial role than today. Such an approach would have the additional advantage of providing, at least to some degree, an effective alternative to further precautionary reserve accumulation.

6. The SDR as the best instrument for a gradual reform of the IMS.

The SDR offers several well-known advantages as a multilateral standard.

As a reserve asset, it is the only existing instrument which can be issued without being a direct liability of any single economy; it is therefore the easiest and most rational channel for providing alternative reserves to central banks that plan to build them up for facing any future crisis, without implying larger deficits for issuers of national reserve currencies. Furthermore, it is the only existing monetary reserve, which can be issued on the basis of available international official procedures. Finally, it is the only one that is accepted by "conventional officials and central bankers" since it already has an agreed institutional existence firmly locked in the IMF system.

As a store of value, the SDR is by construction an international standard: as it is defined by definite quantities of the different constitutive currencies, a weakening currency loses weight in the basket, while a strengthening one gains weight.[9] The SDR also offers a clear advantage from the standpoint of short-run stability, to the extent that its composition is aligned with the relative economic weights of different countries. In this respect the addition of the RMB at the first possible opportunity and later on of other emerging countries' currencies is to be strongly recommended. If the RMB is still not ready to enter the basket at the next five-year review (due to take place in 2015), the IMF should confirm that it would do so as soon as certain objective conditions are satisfied.

As a unit of account, the SDR has the advantage of being by definition immune to the impact of floating exchange rates; as such it would contribute to reduce the volatility of valuation, in comparison with the use of any single currency. Less volatility of valuation means less necessity to hedge, less impact from financial expectations and, finally, greater market stability. Even though its use would probably increase transaction costs, at least at the start, it could be useful as the invoicing currency in international contracts, especially those related to commodities.

However, its negligible share in official reserves and the absence of any private market are handicaps. Indeed, the use of the SDR is currently limited to rare movements inside the official sector, for amounts that remain insignificant, though this does not preclude the accumulation of substantial precautionary balances in SDRs. This cannot be sufficient for a comprehensive reform of the IMS, which should also include the possibility to use the SDR directly in interventions. This would imply extensive private holdings of SDRs and a significant SDR private market. The following two

fluctuations have critical effects on the functioning of the global economic and financial system and on macro-financial stability at country level.

[9] This loss/gain of weight is however reversed when the basket is revised conformingly.

sections make concrete suggestions aiming, firstly, at enhancing the role of official SDRs in the IMS, and, secondly, at developing private SDR transactions on a significant market.

III. Enhancing the role of official SDRs

7. Use the SDR more actively in the official sector life.

While the IMF's Articles of Agreement[10] envisage that the SDR would become the principal reserve asset in the international monetary system, very little has been done to give the SDR a greater role in the life of international institutions.

In particular, it remains regrettable that the IMF still conducts its General Account in terms of member currencies. There would be significant benefits to the IMF in converting all its operations to an SDR basis: this would enable the IMF to present a comprehensible balance sheet to the world, simplify its own accounting, and make it clear that a quota enlargement does not have a real resource cost (which is an important consideration in terms of US Congressional politics).

Similarly, the SDR should be given more visibility in IMF documents, surveys and statements, and more broadly in the life of the official sector. Initiatives should also be taken to develop the use of the SDR as a reference by international institutions in their accounts (following the BIS' example), their publications, and as far as possible their operations.

8. International Lender of Last Resort.

The ability of the IMF to act as an international LOLR is urgently needed in crisis situations, in order to provide, for countries that fear a repeat of 1997, an alternative to self-insurance. In order to activate this, the international community, presumably represented by the IMF Council (or until then, by the International Monetary and Financial Committee), should be required to declare that a crisis situation exists. Such a vote should empower the IMF to issue unlimited quantities of SDRs (liabilities against itself) to be used in financing programs for helping member countries in need.

9. General SDR allocations.

There is a major need to resume the practice of making general SDR allocations. The third general allocation, which was made on August 28 2009, in the amount of SDR 161.2 bn[11], to cushion the effects of the financial crisis on global liquidity, was an example of what can be done, in case of need, at the global level. However, regular allocations should not follow a pre-defined program, as

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[10] Article XXII of the Articles of Agreement stipulates that „each participant undertakes to collaborate with the Fund and with other participants in order to facilitate the effective functioning of the Special Drawing Rights Department and the proper use of special drawing rights in accordance with this Agreement and with the objective of making the special drawing right the principal reserve asset in the international monetary system."

[11] Separately, the Fourth Amendment to the Articles of agreement became effective August 10, 2009 and provided for a special one-time allocation of SDR 21.5 bn to members who had not benefited from previous allocations.

laid out in the IMF Articles. Instead, the amount should be determined on an *ad hoc* basis[12], after a survey of liquidity conditions jointly conducted by the IMF and the BIS which, since October 2013, publishes updates on indicators for global liquidity conditions, together with the underlying BIS data.

10. Targeted allocations.

Restricting the creation of additional SDR liquidities to general allocations according to existing rules, that is in proportion to the quotas, would certainly miss the target since the main part of these new reserve would be allocated to countries which do not need them (the main quotas holders), while the majority of small and fragile countries would only obtain a marginal part of the allocation.

A possible solution proposed by the working party would be to allocate 20% (say) to advanced countries and 80% (say) to emerging markets and developing countries, with allocations within each group in proportion to IMF quotas. This solution would avoid the danger of losing the discipline imposed by limited reserve holding and maintain the principle that allocations should remain independent of national perception of need, while greatly mitigating the problem of misdistribution.

Some members propose, in addition, a more flexible approach, which would not retain quotas as the unique allocation criterion but rely also upon IMF expertise and adequate surveillance to allow the opening of SDR denominated financing mechanisms to individual countries in need of preventive reserves. They see this facility as an effective alternative to precautionary reserve accumulation. Establishing such new individual allocations would imply a specific attention by the Fund to necessary safeguards and to the liquidity of its SDR position.

In both cases, a revision of the Fund's Articles would be needed.

11. Diversification of reserves.

One could consider stand-by procedures, rule-based, through which central banks could acquire SDRs against currencies, upon request. The idea of a "substitution account" open permanently or on a periodic basis (for instance twice a year for predetermined amounts) should be revived. Another possibility is to give the IMF the faculty to buy against SDRs currency reserves, for instance those coming in addition to the ones already built up by countries at a determined date. Selling the proportion of the acquired currency (say USD), necessary for the purchase by the IMF of the other part of the SDR basket (currently EUR, GBP and JPY), would influence markets, but less than if the full amount (of USD) were sold by the central bank in search of reserve diversification. This operation would generate no exchange risk for the IMF.

12. SDRs and the Triffin dilemma.

General SDR allocations made according to existing rules, in proportion of quotas, would be freed from any Triffin dilemma if quotas truly reflected the relative importance of member's economies; as this is not the case, the problem would not be entirely eliminated though considerably

[12] This means that, in the current circumstances, the SDR Working Party does not presuppose that new SDR issues would be needed.

reduced. In other cases (targeted allocations, private SDRs), SDR issues would not solve the Triffin dilemma, but they would contribute to reduce its intensity and smooth its negative effects. In the case of reserve diversification, the Triffin dilemma would be at least mitigated through the fact that the "exorbitant privilege" would be spread across countries whose currencies make up the SDR basket, reducing the asymmetry of the dollar and introducing some external constraint on the US economy. For the non-dollar part of the SDR, the so-called "privilege" would be transferred from the dollar to other basket currencies, but the IMS would be improved by the fact that the system would no longer be based on the debt of a single country but of several countries, representing a much larger part of the world economy and trade. The better the basket would represent the composition of world GDP, the more the dilemma would be reduced.

13. Making the SDR more attractive and user-friendly.

Ways to make the SDR more appealing should be considered. Smoothing the administrative rules applicable when a country decides to use its SDRs would certainly be welcome. For example, the IMF could be put in the position to convert immediately, upon request, SDRs into usable currencies, either out of its own resources, by negotiating with the issuing national central bank, or by relying on private currency markets. Also, the way interest rates are calculated should also be revised, replacing the present short-term rates basis by medium- and longer-term references. If, as is envisaged, a private SDR market were to develop, the use of a market rate or a range of market rates would anyhow substitute the present administrative procedures for the remuneration of official SDR assets and liabilities.

→ Suggestion A: Give the SDR a greater international public role.

First of all, the IMF's accounts should be placed on an all-SDR basis, requiring an amalgamation of the General Resources Account with the SDR and that future lending would all be in SDRs. International organizations that are not using the SDR as their unit of account should also be invited to do so, following the example of the BIS. In addition, the IMF and other international institutions should use the SDR more systematically as a reference in their work, in particular in the domains of international statistics, balance of payments, international reserves, article IV exercises, surveillance of exchange rates, capital flows analyses, etc. Also, international public contracts should, whenever possible, employ the SDR as an unit of account, and the use of the SDR in government borrowing should be encouraged; this would incite the private sector to do the same, for example in commodities contracts.

→ Suggestion B: The IMF should be enabled to issue SDRs at last resort in a crisis situation.

When the IMF Council (or, pending that, the International Monetary and Financial Committee) declares a crisis situation, the IMF should gain the power to issue SDRs to itself through an institutionalized mechanism, and to lend them to member countries affected by the crisis.

→ Suggestion C: The IMF should resume SDR allocations.

General allocations should be decided year by year on the basis of an assessment of global conditions, undertaken jointly by the IMF and the BIS.

However, restricting the creation of additional SDR liquidities to general allocations according to existing rules, that is, in proportion to the quotas, would result in allocating the main part of new reserves to the main quotas holders which generally do not need them, while the majority of small and fragile countries would only obtain a small part of the allocation. Two solutions could be envisaged:

One would be to mitigate the problem of misdistribution by allowing only a marginal part of the allocation to advanced countries and the main part of it to emerging markets and developing countries, with allocation within each group in proportion to IMF quotas. This solution would avoid the danger of losing the discipline imposed by limited reserve holding and would maintain the principle that allocations should remain independent of national perception of need.

Another solution, aiming at a more flexible approach and considered by only some members of the working party, would not retain quotas as the unique allocation criterion but rely also upon IMF expertise, adequate surveillance and specific attention to the liquidity of the Fund's SDR position, to allow the opening of SDR-denominated financing mechanisms to individual countries in need of preventive reserves.

Both solutions would necessitate a revision of the Fund's Articles.

→ Suggestion D: An orderly diversification of reserves

Reserve diversification should be facilitated through a mechanism allowing their conversion into SDR-denominated claims. In particular, periodical substitution account facilities should be offered to member countries, and currency exchange operations against SDRs should be organized between the IMF and its members.

→ Suggestion E: SDRs should be made more attractive.

SDR interest rates should be based on medium or long term yields rather than short term, and rules applicable to the conversion of SDRs into marketable currencies should be simplified if possible, with the IMF acting as a financial intermediary temporarily until such operations can be carried out by private intermediaries in the market.

→ Suggestion F: The composition of the basket should reflect more closely the relative importance of economies in international trade and financial transactions.

In particular, the introduction of the RMB into the basket should be envisaged as soon as the internationalization of this currency will allow it.

IV. Promoting a private SDR market

14. The need for an SDR market.

The role of the SDR in central bank reserves would be greatly enhanced if these institutions could use the SDR as a market asset. To this end, the development of a private SDR market should be strongly encouraged to the point where its liquidity becomes significant. It is clear that, from a technical point of view, the development of an SDR market is much more the business of financial institutions than of the official sector. However, it is the responsibility of the latter to take the lead at the start. Indeed, for the time being, the financial sector appears to have little appetite for SDR instruments, even though it would probably react positively if significant demand was expressed by clients. In spite of this, there are financial instruments in the market that are akin to SDRs such as Currency-Basket Exchange-Traded Funds (ETFs), which are attractive for institutional investors.[13] There might also be a potential interest on the part of non-financial corporations (e.g. for those engaged in commodity markets), but it is also unlikely that they are prepared to move spontaneously. Hence, the initiative should come from the public sector.

This initiative should be resolute as the aim should be to reach a critical mass sufficient to make SDR markets competitive with those for other internationally used currencies in terms of transaction costs, depth, liquidity and range of available financial products. Tradability of SDRs appears to be a first step in rendering them acceptable to private markets and thus giving them a greater role in private finance. Reaching this critical mass could require a significant degree of public policy action, which might be justified by "infant market" considerations. Re-creating a private SDR market more than thirty years after the few operations, which existed in the past, vanished would thus necessitate big efforts on the part of public authorities and their close cooperation with market participants. Indeed, whatever steps are taken by the public sector to create a good environment favorable to the emergence of a significant SDR financial market, there would be little chance of success if market operators were not convinced of the robustness of this initiative, in terms of costs/advantages for their clients and for themselves. Hence, appropriate structures should be put in place to ensure the adequate coordination between market specialists of the official and the private sectors.

15. The need for SDR Clearing arrangements.

As soon as a number of banks start offering SDR bank deposits, some form of interbank SDR market will need to come into existence. The more efficient way to clear bilateral interbank transactions would be to create a multilateral clearing, at least among a number of high quality participants, on the model of the former ECU clearing operated in the past by the BIS. Setting up such clearing arrangements either through an existing international institution or through a specific

[13] However the market tends to create various ETFs whose composition is tailored to the needs of financial investors, which does not necessarily match the composition of an official SDR basket. However a passive ETF (basket of currencies) with pass-through or neutral currency board arrangements could also be of interest to investors, in particular State Pension Funds and Sovereign Wealth Funds.

private body to be created is a necessary condition to the development of a private SDR market, and it would be needed from the start. [14]

16. Providing legal certainty and practicable administrative rules.

The development of markets in SDR financial instruments requires legal certainty and continuity regarding the content of this unit. The periodical basket revisions could be a source of uncertainty regarding the future properties of the basket, which depend on both present and future weights. One way to solve this potential problem would be to make the introduction of the RMB in the basket as soon as it is possible (see suggestion F), to pre-announce the times of future basket revisions, and to implement transparent rules regarding the variables and the data to be used in re-calculating the weights, so that market participants could form reasonable forecasts of each revision's outcome.

17. Developing private SDR operations by the public sector.

Several initiatives could be envisaged:

- In order to provide a critical mass to the development of an SDR debt market, major international institutions active in bond markets as regular issuers should start issuing SDR-denominated bonds. This could well be a triggering point as central banks might be interested in holding these financial assets, even before the development of mature SDR financial markets.

Using the possibilities offered by the Articles of Agreement, the IMF itself could also, as far as needed, issue long term SDR bonds that would be floated on a regular basis and which central banks could subscribe to in parallel to private investors. The flotation of these SDR denominated bonds would be a good diversification instrument for central banks, and the possibility to trade them with private financial institutions would contribute to the development of the market.

Owing to the occurrence of basket revisions, short-term instruments are expected to have a better chance to succeed at first. However, if SDR markets are to develop, there will quickly be a need to offer an SDR yield curve with a sufficient array of maturities.

- While governments are well-advised to issue debt in their own currencies, there would be room for them to issue some in SDRs. National public entities could also use the SDR for invoicing and possibly settling their contracts with foreign entities and could encourage doing the same in private international contracts, in particular for commodities

- If the SDR became a significant component of central bank foreign reserves and if an active "private" SDR market were to take shape, swap operations could be needed in order to strengthen the liquidity of this developing market and to facilitate SDR use.

[14] Initially this could be facilitated by allowing a small number of selected banks, say the 10 most active in currency markets, to trade a marketable SDR not on the exchanges, but through official Real-Time-Gross-Settlement Systems (RTGS) of central banks as executed by the private CLS bank currently.

18. Linking private and official SDRs.

In order to enable central banks to use their official SDR holdings directly on private markets, it is necessary to create a link between private and official SDRs. This could be achieved either by allowing private banks to hold SDRs or by allowing the official SDRs to be converted into claims that central banks and private banks could hold.

Allowing private banks and institutions to hold SDRs on the Fund's book would be a major positive step, even though it would necessitate a change in the Fund's Articles.

Alternatively, the link between official and private SDRs could be built upon the interbank clearing arrangements described in §15. Central banks could get private SDRs by establishing deposits with the clearinghouse and transferring to its name official SDRs. If the clearinghouse is already a "prescribed holder" of SDRs, this procedure would be easy to put in place; if it is a private sector institution, a procedure of agreement would be needed.

However beyond this institutional aspect the clearing house would be confronted with specific risks linked to the fact that it would have to load on one side of its balance sheet official SDRs underpinned by the financial activities of the IMF and, on the other side, private SDRs bearing different credit-related characteristics attached to the issuer's credit (a government, a financial institution, or even a corporate…). This risk mismatch, inherent to bank activities but less compatible with a clearing function, could become a major impediment when the market develops unless the clearinghouse gets from its members appropriate guaranties. These matters merit discussions with market specialists.

→ Suggestion G: The official sector should take the lead in providing appropriate structures suited to the functioning of an active SDR market.

It should first ensure a proper degree of legal certainty, especially in the domain of basket revisions, and reassess the conditions in which the forex rate fixing is organized. It should also facilitate the establishment of appropriate clearing arrangements.

→ Suggestion H: Subject to necessary adjustment to existing statutory rules, international institutions and national authorities should start operating in private SDRs.

In order to provide a critical mass to the development of an SDR debt market, SDR-denominated debt instruments should be floated by international institutions, first and foremost the World Bank and other supranational IFIs, and on a limited scale by national authorities. The latter should also consider invoicing international public contracts in SDR, and encourage the use of the SDR in private international contracts, in particular for commodities.

→ Suggestion I: The IMF should name a limited number of leading private banks as holders of SDRs.

This would have the effect of linking the circuits of official and private SDRs but would necessitate an amendment to the Fund's articles.

In conclusion, the Working Party is convinced that the first best solution to solve the weaknesses inherent to the present International Monetary System would be to create a multilateral currency, with the IMF acting as a central bank and national central banks holding all their reserves as claims on the IMF. However it admits that such a fundamental change is not likely in the current geopolitical environment and, in making the best of the existing system, it sees the SDR as the best available option to improve the IMS. With a minimum of political will, a lot could already be done in the domains of official and private SDRs, without having to adjust the IMF's Articles of Agreement. However, for the reform to be significant, a private SDR market should be strongly encouraged and for this it is necessary that a link be institutionalized between official and private SDRs with a view to allowing central banks to use their official SDRs directly in intervention. For these purposes, a limited number of amendments to the IMF's Articles of Agreement are necessary.

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Appendix

Composition of the SDR Working Party (*)

Hervé Carré	Former Director General, European Commission
Elena Flor	Corporate Social Responsibility Manager, Intesa Sanpaolo Group
Christian Ghymers	Former Adviser, European Commission; Deputy Secretary General, Triffin International Foundation
André Icard	Former Deputy General Manager of the Bank for International Settlements; Chairman of the Working Party
Alfonso Iozzo	Former Managing Director, San Paolo IMI; Vice President, Triffin International Foundation
Jean-Claude Koeune	Emeritus Professor, *Université Catholique de Louvain* ; Secretary General, Triffin International Foundation
Antonio Mosconi	President, *Centro Einstein di Studi Internazionali*
Andrew Sheng	President, Fung Global Institute, Hong Kong
Paul Bernd Spahn	Emeritus Professor of Economics, Goethe-Universität, Frankfurt-am-Main
John Williamson	Senior Fellow (retired), Peterson Institute for International Economics

Experts consulted at the Paris meeting on 18 December 2013

Denis Beau	Director General of Operations at *Banque de France*
Dominique Hoenn	Senior Advisor and former Co-Chief Operating Officer at BNP Paribas
Günter Pleines	Former Head of the Banking Department at BIS
Xin Wang	Chief Representative, Repr. Office in Frankfurt, The People’s Bank of China.

(*) The Working Party held three meetings: in Brussels on 10 October 2013, in Paris on 18-19 December 2013, and in Brussels on 8 May 2014.