SM/11/3
Correction 1

February 7, 2011

To: Members of the Executive Board

From: The Secretary

Subject: **Enhancing International Monetary Stability—A Role for the SDR?**

The attached correction to SM/11/3 (1/7/11) has been provided by the staff:

Factual Error Not Affecting the Presentation of Staff's Analysis or Views

Page 7, footnote 6, line 2: for "would cause the U.S.' cumulative allocation …"
read "would cause the U.S.' cumulative allocation during the basic period …"

Questions may be referred to Ms. Mateos y Lago (ext. 37219) and Ms. Maziad (ext. 36619) in SPR.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (1)

Other Distribution:
Department Heads

7. (and only if) Governors representing 85 percent of the voting power of the SDR department[5] agree they are necessary to meet a "long-term global need … to supplement existing reserve assets (…)" while avoiding inflation or deflation." This provision sets a high bar of political consensus among shareholders, particularly considering the need for legislative approval in some cases.[6] The best argument for a long-term global need lies in strong accumulation of reserve assets, which is expected to continue.

8. ***Precautions***. Expanding the volume of SDR allocations would increase the contingent claim on all other participants in the SDR department, who could be required under the designation mechanism to provide freely usable currencies—currently the U.S .dollar, Euro, Sterling, and Yen—in exchange for SDRs up to twice their own allocation of SDRs. This requirement could quickly become burdensome, particularly for members with floating currencies that do not typically hold large official reserves, and could not provide their own currency if not among the freely usable ones. Two complementary solutions could be envisaged. First, expanding the voluntary trading agreements, to avoid recourse to the designation mechanism and concentrate SDR sales on those members most willing to buy. Second, by expanding the current list of freely usable currencies to include a few additional currencies that meet the definition of freely usable currency under the Articles i.e. that are being widely used, in fact, to make payments for international transactions and are widely traded in the principal exchange markets (Article XXX (f)). (Such an expansion in the list of freely usable currency is distinct from and would not necessarily affect the composition of the SDR basket).

B. Limits and Potential Downsides

9. ***Partial solution***. Given its limitations mentioned above, the official SDR may not be perceived as perfect substitute to borrowed or own reserves, reflecting the fact that it cannot be used directly for market intervention or liquidity provision, as well as its low-yield and the relative difficulty to hedge any net positions. In addition, part of the growing demand for reserves is not precautionary, but reflects other objectives such as influencing exchange rate competitiveness. SDR allocations could only influence such intervention if accompanied by policy commitment to reduce reserve accumulation. Indeed in the absence of such commitment, SDR allocations might even encourage further reserve accumulation, by providing a channel for reserve diversification without market impact.

10. ***Misuse***. SDRs are a low cost source of unconditional financing; as their outstanding volume increases, so does the risk of their being used in a way detrimental to macroeconomic stability. Examples include procyclical fiscal financing in inflationary environments, use of

---

[5] Currently, all members of the Fund are participants in the SDR department.

[6] For example, it is staff's understanding that such approval is needed in the U.S. for SDR allocations that would cause the U.S.' cumulative allocation during the basic period to exceed its quota in the Fund.

SDR as a substitute to adjustment, or use of SDRs that contributes over time to an unsustainable debt burden (e.g., as the SDR rate rises). In such cases, not only may macroeconomic stability be compromised, but also potentially the member's ability to pay charges on their allocations or eventually reconstitute their holdings.

11. ***Inflationary impact***. The potential impact on money creation of the large one-off allocation in 2009 was considered likely to be small and easily absorbed, and any expansionary impact on global demand to be beneficial.[7] Large, regular allocations are similarly unlikely to prove inflationary, including at times of limited slack in the global economy, as argued by Richard Cooper in Supplement 1 to this paper. No money is created unless countries sell their SDR holdings to issuers of freely usable currencies (and even then, any money creation could be sterilized if the relevant central banks so wished), and no additional demand for real goods and services is created unless the proceeds are spent and there is no countervailing policy response. Essentially, the global inflationary impact of SDR allocations is expected to be limited even assuming large cumulative allocations, so long as central banks issuing freely usable currencies credibly stick to their inflation targets. An additional safeguard is provided by the discretion to not make allocations—or even cancel existing allocations—at times of strong global demand and inflation concerns.

C. Options for Enhancing the Official SDRs

12. ***Basic improvements***. A number of marginal measures could be taken to improve the SDR in its current form. Providing greater certainty over the basket composition through more objective valuation rules could improve the attractiveness of the SDR. Similarly, daily interest rate setting, rather than weekly, would allow reserve managers fair valuation of SDR assets on a continuous basis and facilitate hedging operations (see Annex 2). However, the lack of appropriate daily instruments in underlying currencies remains a constraint (see SM/10/292). Other small changes identified in earlier discussions include clarifying and expanding the scope of permissible operations by moving from a positive to a negative list, eliminating the mandatory use of the official exchange rate in SDR operations, and simplifying the reporting requirements to the Fund to record transfers among members (for details, see SM/82/92 and SM/83/187).

13. ***Reconstitution and other safeguards***. Reinstating a reconstitution requirement—whereby members would be required to restore their SDR holdings to the same amount as their overall allocation over a given timeframe—would help improve liquidity in the voluntary market by raising transaction volumes and ensuring demand for two-way transactions. It would also reduce the scope for misuse of SDRs as open-ended cash transfers, which can be particularly problematic in cases of fragile debt sustainability. To further reduce the risk of misuse, options could include requiring a discussion of any planned use of

---

[7] SM/09/145 Proposal for a General Allocation of SDRs.