Office Memorandum

To: Members of the Executive Board January 27, 2011

From: The Acting Secretary

Subject: **Enhancing International Monetary Stability—A Greater Role for the SDR—Statement by the European Central Bank Representative**

Attached for the **information** of Executive Directors is a statement by the European Central Bank representative for the Executive Board discussion on enhancing international monetary stability—a greater role for the SDR, to be held on Friday, January 28, 2011.

Att: (1)

Other Distribution:
Department Heads

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January 27, 2011

Statement by the European Central Bank Representative on Enhancing International Monetary Stability – A Greater Role for the SDR

(Preliminary)

IMF Executive Board Meeting

January 28, 2011

We thank staff for their thought-provoking paper. We agree with staff that enhancing the role of the SDR cannot by itself provide a remedy to all the ills of the international monetary system (IMS). If a certain number of steps were taken, notwithstanding significant practical, political and legal hurdles, the SDR could possibly contribute to improving the functioning of the IMS. Yet it is crucial to consider all elements of the IMS before coming to conclusions. The main problem with the current IMS is the lack of a self-correcting external adjustment mechanism, coupled with international surveillance arrangements that are not effective enough to foster macroeconomic discipline and global stability. As such, the reliance on a small number of currencies that serve as international reserve currencies is much less relevant. Therefore, the strengthening of international policy cooperation and surveillance is of utmost importance.

When considering an enhanced role of the SDR, it should be kept in mind that the SDR is not a full-fledged currency, but a claim to use other members' currencies/foreign exchange reserves. As such, SDR usage depends on the willingness/capacity of members to support SDR transactions. While possibilities exist to alleviate this problem (such as increasing the number of prescribed holders as well as strengthening the voluntary trading arrangements), it remains to be seen whether such options could be developed on a sufficient scale. A further complicating factor is that the balance sheet implications for central banks may become significant as a result of a greater use of the SDR. Since a substantial increase in outstanding SDR amounts in circulation is a precondition for future enhanced relevance of the SDR, both as official and private sector monetary asset, the consequences for global price stability would need to be carefully examined. The option of allowing private holdings and transactions of official SDR would raise additional issues, if such transactions had to be conducted through the existing network of voluntary trading arrangements.

The argument that regular SDR allocations would reduce global reserve accumulation carries weight only to the extent that the build-up of reserves reflects precautionary motives. However, such self-insurance motives account for only part of the current reserve accumulation. Further progress on developing guidelines and metrics on reserve adequacy and guidance on how to deal with capital flows would help to shed further light on the motives underlying reserve accumulation.

Regular unconditional allocations of SDRs could also generate moral hazard as countries would have permanent access to low interest rate liquidity, regardless of their policies and fundamentals. The repercussions for the Fund's lending role and the global financial safety nets should therefore be carefully considered.

SDR allocations represent the creation of unconditional liquidity, which, depending on their size, could have macroeconomic effects and could interfere with monetary policy implementation. In this regard, we would echo those that consider that any allocation should be conditional on a "long-term global need for liquidity…to supplement existing reserve assets", as stipulated in the IMF Articles of Agreement. As for ad hoc allocations at times of severe systemic crisis, it would need to be assessed how such contingent allocations could offer benefits over and above existing Fund instruments. Concerning the proposed safeguards, we see merit in close monitoring of the debt sustainability implications as well as regular assessments of the usage of SDR in Article IV of UFR reports. In this context, we look forward to the review of the 2009 SDR allocation, as it is likely that valuable lessons can be drawn from this decision. We also consider that the reconstitution requirement would help to avoid that SDRs are used as a permanent transfer. Finally, the option of SDR cancellations should also be taken into consideration in view of developments in the global economy and reassessments of global needs for reserves.

The setting-up of a substitution account remains a matter of concern, as this would mainly represent a transfer of exchange rate risk from countries with accumulated exchange reserves to the rest of the world and might even encourage further reserve accumulation.

We welcome staff's proposal to explore in more depth whether a limited number of currencies of systemically important countries should be added to the SDR basket to reflect global economic developments. Such additions should follow transparent criteria and entail adequate preconditions for the currencies concerned. In this regard, it could also create the right incentives for the countries concerned in their endeavours to take a greater part in an open, market-based IMS. Nevertheless, more analysis would be needed on the implications for the stability and usage of the SDR and on what the actual benefits for the stability of the IMS might be.

Further discussions on the potential pros and cons of SDR exchange rate pegs and of issuing SDR denominated debt may be warranted. We also look forward to further work on other ways by which the official sector may contribute to the development of a private market for SDRs.

Finally, we consider that a careful assessment of both intended and possible unintended consequences (including as regards exchange rate developments and volatility) of trying to replace existing international currencies with a synthetic international currency is also warranted.