Office Memorandum

To:	Members of the Executive Board	June 24, 2011
From:	The Secretary	
Subject:	**Criteria for Broadening the Composition of the SDR Basket—Issues Note**	

The attached issues note by the staff on criteria for broadening the composition of the SDR basket is being circulated as background for the **informal session to brief** Executive Directors that is tentatively scheduled for **Thursday, July 14, 2011.**

The staff does not propose the publication of this note.

Questions may be referred to Mr. Kumar, FIN (ext. 37771); Ms. Mateos y Lago, SPR (ext. 37219); and Mr. Rossi, FIN (ext. 35651).

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

FO/DIS/11/129

INTERNATIONAL MONETARY FUND

Criteria for Broadening the Composition of the SDR Basket—Issues Note

Prepared by the Finance and Strategy, Policy, and Review Departments

(In collaboration with the Legal and other Departments)

Approved by Andrew Tweedie and Reza Moghadam

June 24, 2011

At their April 2011 meetings, the IMFC and the G-20 Ministers called for further work on a criteria-based path to broaden the composition of the SDR basket. This followed earlier Executive Board endorsement of a work program on issues relating to SDR valuation and the SDR interest rate basket.[1] *This note focuses on the criteria for selecting new currencies for inclusion in the SDR basket. It identifies a number of key issues as inputs to the upcoming review.*

I. Principles of SDR Valuation

1. **The Executive Board has reviewed SDR valuation on a 5-yearly basis.** These reviews cover the currencies to be included in the SDR basket and determine the weights of those currencies. The reviews have been based on criteria adopted by the Executive Board, which the Board has the authority to modify.[2] Past reviews have been guided by long-standing principles that aim to enhance the attractiveness of the SDR as a reserve asset (Box 1).

[1] *The Acting Chair's Summing Up, Review of the Method of Valuation of the SDR*, BUFF/10/159, 11/17/10.

[2] Article XV, Section 2, provides: "The method of valuation of the special drawing right shall be determined by the Fund by a seventy percent majority of the total voting power, provided, however, that an eighty-five percent majority of the total voting power shall be required for a change in the principle of valuation or a fundamental change in the application of the principle in effect."

Box 1. Broad Principles Guiding SDR Valuation Decisions

While not stated in any decision of the Fund, a number of broad principles have guided Board decisions on the valuation of the SDR since the 1970s with the aim of enhancing the attractiveness of the SDR as a reserve asset. According to these principles, the SDR's value should be *stable in terms of the major currencie*s, and the currencies included in the basket should *be representative of those used in international transactions*.

In addition:

- the relative weights of currencies included in the basket should reflect their *relative importance in the world's trading and financial system*;
- the *composition of the SDR currency basket should be stable* and change only as a result of significant developments from one review to the next; and
- there should be *continuity in the method of SDR valuation* such that revisions in the method of valuation occur only as a result of major changes in the roles of currencies in the world economy.

2. **In practice, there has been a high degree of stability in the method of SDR valuation.** Revisions in the method have been linked to major changes in the roles of currencies in the world economy; for example, the current currency-specific criteria for SDR valuation were adopted in 2000 following the introduction of the euro. The 2000 decision, in turn, modified criteria that had been in place since 1980, when the SDR valuation basket was streamlined from 16 to 5 currencies.

Issue No. 1. *Are the broad principles guiding SDR valuation decisions still valid or are changes needed?*

II. Current Criteria

3. **The 2000 decision on SDR basket composition has three key elements (Box 2)**:

(i) ***Exports***: Countries or monetary unions are ranked based on export data. This "gateway" criterion has been in place since the adoption of the basket formula for SDR valuation in 1974;

(ii) ***Freely usable currency***: The 2000 decision added the requirement that eligible currencies must be determined by the Fund to be freely usable. This change was based on the following considerations: a country's share of world exports is not necessarily a reliable indicator of the use of its currency in international transactions, nor an accurate gauge of the depth and breadth of its financial markets; and it would allow for the consideration of several other relevant indicators, including the existence of a suitable short-term interest rate instrument that conforms with the guidelines for inclusion in the SDR interest rate basket;

(iii) ***Number***: the decision provides for a specific number of basket currencies (4).

Box 2. Current Decision on SDR Basket Composition

Under the decision adopted in 2000, the SDR basket comprises *the four currencies*:

(a) issued by Fund members (or by monetary unions that include Fund members), whose *exports of goods and services* during the five-year period had the largest value, and

(b) which have been determined by the Fund to be *freely usable currencies* in accordance with Article XXX (f), which reads:

"A freely usable currency means a member's currency that the Fund determines
(i) is, in fact, widely used to make payments for international transactions, and
(ii) is widely traded in the principal exchange markets."

In addition, "a currency shall not replace another currency included in the list at the time of the determination unless the value of the exports of goods and services of the member or of members of a monetary union, whose currency is not included in the list, during the relevant period exceeds that of the member or the monetary union issuing the currency included in the list by at least 1 percent."

4. **The freely usable currency concept lies at the core of the Fund's financial operations.** It was developed in the context of the second amendment of the Articles in 1978 to ensure that the Fund could use all currencies held in the GRA in its operations.[3] It provides members making a purchase from the Fund with the assurance that they will receive a currency that they can use to meet their balance of payments need. Thus, freely usable currencies reduce the potential risks (and costs) for members receiving and using these currencies in transactions with the Fund.[4]

5. **It is important to note that the concept of freely usable currencies was established for the Fund's operations.** It was not related to the SDR valuation basket, and the link between the two was only established in 2000, as noted above (although considerations underlying decisions on the SDR basket even before that time had in fact taken account of currency use and trading). The criteria used to assess which currencies should be determined by the Fund to be freely usable have not been explicitly revisited since

[3] The usability of currencies is ensured by Article V, Section 3(e), under which Fund members issuing a currency not determined by the Fund to be freely usable have the obligation to exchange their currencies for currencies deemed by the Fund to be freely usable, if requested by the purchasing member.

[4] A full discussion on the background to the concept is provided in chapter 8 of *Use, Conversion, and Exchange of Currency Under the Second Amendment of the Fund's Articles*, Pamphlet Series No. 23, Joseph Gold, 1978.

the late 1970s, with various indicators proposed by staff for use in that context (see below and Box 3).

III. Reform Options

6. **Reform of SDR valuation would seek to enhance the attractiveness of the SDR as a reserve asset.** Such reform should be supportive of efforts to achieve a broader role for the SDR in the international monetary system (IMS), and encourage members to implement policies that would help enhance the overall stability of the IMS. It should also take account of the SDR's important role in the Fund's finances, including in the denomination of Fund credit and determining the rate of charge on Fund lending.

7. **A review of the current criteria for inclusion in the SDR basket needs to address two broad issues.** First, there is a question of whether the current tight link between the composition of the SDR basket and the currencies considered freely usable for the purpose of the Fund's operations remains appropriate. As discussed further below, the requirement of a finding that a currency is in fact widely used and also widely traded sets a high bar that may preclude a currency from inclusion that may otherwise have helped promote the role of the SDR as a reserve asset. Second, there is a question of whether the current criteria provide sufficient guidance on the indicators used to assess eligibility for inclusion in the basket. While the export criterion is clear, the indicators used for assessing the freely usable currency criterion are not. Board decisions on freely usable currencies and Board consideration of indicators to use in assessing wide use in fact and wide trading for purposes of the freely usable currency concept have not taken place since 1978, except in a limited way following the introduction of the euro. Members, some of which may be undertaking reforms, thus have relatively little guidance on whether their currencies have achieved a degree of use and trading that could potentially qualify them for inclusion in the SDR basket and on how much progress they are making toward this end.

8. **A more transparent and updated framework could help provide greater predictability and enhance the attractiveness of the SDR.** Clarifying the indicators that the Fund would consider when assessing eligibility for inclusion in the basket could both encourage countries to implement reforms aimed at promoting greater internationalization of their currency and provide a degree of predictability for members and markets on potential changes in the basket composition, thus improving the attractiveness of the SDR. This said, the Board may still wish to retain the scope to exercise some judgment regarding the inclusion of currencies in the basket.

A. Reform Options for the Freely Usable Currency Criterion

9. **There are two main options regarding reform of this criterion**:

i. *Maintain "freely usable currency" as the criterion but update and clarify the conditions for meeting this criterion.* Under this approach, the link between the SDR basket and the concept of freely usable currencies used for the Fund's operations would be maintained. Work would focus on updating and clarifying the metrics for assessing that a currency is freely usable in light of developments in financial markets since these issues were last considered.

ii. *Replace the freely usable currency criterion with a modified criterion*. This approach would de-link the freely-usable concept from the assessment of currency eligibility for the SDR basket, and would leave the Fund's operations unaffected. It would partly revert to the situation prior to 2000. However, it would be necessary to develop alternative metrics to assess the new criterion that would replace the freely usable concept and ensure that currencies would only qualify for inclusion in the basket when they have sufficiently liquid and deep foreign exchange and financial markets. This would allow holders of SDRs and of SDR-denominated claims to manage their currency exposures and thus preserve the reserve asset character of the SDR.

Box 3. Assessing Freely Usable Currencies

In 1977, staff proposed the following criteria to determine which currencies are freely usable:[1]

- *the assessment of the use of a currency for international transactions should be based on the extent to which trade in goods and services is paid for in that currency, as well as on the relative volume of capital transactions denominated in that currency*. Given the limited data availability, however, the staff suggested to use the shares in members' exports of goods and services and the currency denomination of official reserve holdings as the relevant indicators of the degree to which a currency was widely used in international payments;

- *the assessment of whether a currency was widely traded in the principal foreign exchange markets should be based on the volume of transactions, the existence of forward markets, and the spread between buying and selling quotations for transactions denominated in that currency*. A sufficiently deep and broad foreign exchange market was considered as being necessary to ensure that a member country would be able to sell or buy a sizable amount of the currency at any time without occurrence of an appreciable change in the exchange rate in the transaction.

Following discussion of the staff paper, the Executive Board determined, in 1978, that the deutsche mark, French franc, Japanese yen, pound sterling, and the U.S. dollar were freely usable currencies. In 1998, the euro was added to the list of freely usable currencies and the deutsche mark and French franc were removed from the list.[2]

[1] See *Freely Usable Currency* (SM/77/273, 11/18/77), *The Legal Concept of Freely Usable Currency* (SM/77/267, 11/9/77), and *Freely Usable Currencies* (SM/78/87, 3/22/78 and Supplement 1, 4/4/78).

[2] See *The EMU and the Fund—Operational Issues* (EBS/98/219, 12/11/98).

10. **The first approach would maintain a very high bar for basket inclusion.** The Articles require that freely usable currencies are *in fact* widely used for international

transactions and are widely traded in the principal exchange markets.[5] Also the wide use criterion refers to use in payments by transacting parties *other than the issuer*.[6] While the concept of wide use appears well suited to the needs of Fund borrowers, who are seeking to address a balance of payments need, it may be attained by relatively few currencies in practice owing to network externalities and inertia. Thus, a case could be made for considering the inclusion of a currency in the SDR basket before it qualifies as a freely usable currency for the purposes of the Fund's operations. It is also worth noting that Fund borrowers in the recent period have preferred to receive only two of the four existing freely usable currencies (the US dollar and the euro) in most transactions, suggesting that there has not been a strong demand for more freely usable currencies from an operational perspective.

11. **In practice, there would likely be significant overlap between the metrics developed under both approaches.** However, de-linking the freely usable currency from the criteria for the SDR basket currency selection could allow a more tailored assessment of the respective indicators, including of the degree of market development required to support the role of the SDR as a reserve asset. For example, the latter could focus more on the conditions that are most relevant for inclusion in the SDR basket, including the liquidity and depth of markets, the scope for hedging exposures, and the existence of assets available for reserve managers to invest in. In either case, further work will be needed to develop specific indicators, which would also need to take account of limitations on data quality and availability.[7] Possible candidates, subject to the data limitations, could include:

- Currency shares in two-way trade settlement;
- Bid-offer spreads in currency markets;
- Depth of foreign exchange, forward, and derivatives markets and availability of suitable hedging instruments;[8]
- Role of currencies in central bank reserve holdings;

---

[5] One could in principle consider maintaining the freely usable criterion for basket selection, but weakening the conditions required to meet the criterion. However, this approach would raise important concerns given the core role played by freely usable currencies in Fund operations (it would also require an amendment of the Articles if the new conditions were not consistent with the wide use and trading that is currently contemplated in the Articles).

[6] See *"The Legal Concept of "Freely Usable Currency"* (SM/77/267, 11/9/77).

[7] It is important to note that there are considerable limitations on the availability of data, particularly for emerging market currencies. For instance, there is no information on emerging market currencies that are included in countries' official reserves; and the BIS survey on currency trading and currency use is undertaken only every three years.

[8] The size of the non-deliverable forward (NDF) market could be considered to represent a hedging option in the absence of on-shore forward and future markets. This market, particularly for emerging market currencies, has grown rapidly in recent years. However, the NDFs exist only for non-deliverable currencies and represent only a partial hedge, with a substantial proportion of market turnover often driven by speculative activity.

- Currency use in international debt issuance and banking liabilities (recognizing that stock data may be slow to capture changes in underlying currency use patterns, and therefore a lagging indicator), or share in total global financial claims more broadly;

- Availability of suitable domestic interest rate instruments, possibly reflected in indicators of financial depth.

12. **Other potential indicators, which have been noted in recent public discussions, could also be explored.** Careful assessment will be needed as to why such indicators would be relevant going forward, when they are not considered now. Possible options, which would require the formulation of clear definitions and could also involve a significant element of judgment, include:

- *Capital account convertibility*: Full convertibility would seem to be neither a necessary nor sufficient condition, nor is it required by the principles of SDR valuation. However, some degree of convertibility may be relevant to ensure that basket currencies meet the characteristics of a reserve asset and to give sufficient confidence that steps toward the development of foreign exchange and financial markets will be enduring.[9]

- *Exchange rate flexibility*: Flexibility vis-à-vis other basket currencies would promote the goal of ensuring that the SDR's value is stable in terms of the major currencies. Conversely, including a currency that is pegged to one of the existing basket currencies would effectively increase the weight of that currency.

- *Institutional framework*: The existence of a robust institutional framework could give further confidence that market-oriented reforms will be enduring, consistent with the goal of stability of the SDR's value. Central bank independence has been suggested as one possible indicator in this regard.

Issue No 2: *Should the explicit link between freely usable currencies and the SDR basket be maintained, or should the focus be on developing alternative metrics that could substitute for that criterion? If the former approach were taken, is there a need to clarify the metrics used to assess the freely usable currency criterion?*

Issue No 3: *Does the above list provide a reasonable basis for future staff work on indicators that could inform assessments under the alternative criterion? What role, if any, should be assigned to assessments relating to capital account convertibility, exchange rate flexibility and institutional frameworks?*

[9] Some aspects of convertibility may in any case be captured by the indicators noted in paragraph 11.

B. Reform Options for the Exports Criterion

13. **As noted, export shares have long played a central role in determining the composition of the SDR basket.** Such an approach was motivated by a desire to ensure that the currencies included in the basket are representative of those used in international transactions. Maintaining this criterion would have advantages in terms of stability and continuity. It also brings an important dimension of size to the assessment and in principle could help ensure that the SDR basket comprises the major currencies in the global financial system.

14. **However, using export shares also has limitations.** It has long been recognized that exports may not be a reliable indicator of the use of a currency in international transactions, with data on trade invoicing suggesting the U.S. dollar and euro predominate in practice (Box III.1, SM/10/292). Reliance on export data also gives no role to financial transactions, which have grown more rapidly than international trade. Data issues also arise. Notably, the planned reform of external trade data to exclude goods for processing from exports raises conceptual issues and may lead to issues of comparability during the upcoming transition period.

15. **Alternative variables could be considered** (Table 1). These may help address some of the limitations of exports as a criterion, though all have shortcomings:

- *Total trade:* In a few cases, a country's imports (rather than its exports) are more commonly invoiced in its own currency.[10] This could suggest considering a trade measure that includes imports as the gateway criterion. However, available evidence for import invoicing remains scant and including import data may simply end up doubling the value of the indicator.

- *Total balance of payments flows:* Including financial account flows provides a broader indicator of a member's role in international financial transactions. However, the link to a currency's actual use is weak and there are data limitations in capturing financial flows. Moreover, the use of this variable would pose particular issues in the case of international financial centers.

- *GDP:* GDP provides a simple indicator of economic size and therefore may have transparency advantages. It may also provide a better measure of representativeness in the global economy by capturing the importance of large and often dynamic (but relatively closed) economies. However, GDP does not measure a currency's use in international transactions, and could therefore be considered less directly relevant for the valuation of the SDR.

[10] See *Review of the Method of Valuation of the SDR* (SM/10/292, 10/26/10), Appendix 3, Box 2.

Table 1. Exports, Trade, Financial account flows and GDP
(Average 2005 - 2009) 1/

	Exports of Goods and Services 2/		Trade of Goods and Services 3/		Trade and Financial Account Flows 4/		Nominal GDP	
Currency	Levels	Shares	Levels	Shares	Levels	Shares	Levels	Shares
Euro Area	2,090	29.2	4,403	31.3	6,729	32.2	7,778	29.7
United States	1,474	20.6	3,038	21.6	4,740	22.7	9,020	34.4
China 5/	857	12.0	1,621	11.5	1,827	8.7	2,373	9.1
United Kingdom	721	10.1	1,291	9.2	3,127	15.0	1,626	6.2
Japan	615	8.6	1,065	7.6	1,765	8.4	3,057	11.7
Canada	341	4.8	646	4.6	809	3.9	875	3.3
Korea	288	4.0	556	4.0	664	3.2	607	2.3
Singapore	270	3.8	517	3.7	611	2.9	108	0.4
Russia	269	3.8	481	3.4	634	3.0	779	3.0
Switzerland	232	3.2	443	3.2	754	3.6	288	1.1
Total	7,157	100	14,061	100	20,905	100	26,223	100

Sources: Finance and Statistics Departments; IMF International Financial Statistics

1/ Levels are in SDR billions; shares are in percentages of the total.

2/ Includes income credit. Data for the euro area adjusted to exclude intra euro trade.

3/ Sum of exports and imports of goods and services.

4/ Sum of trade of goods and services and the absolute values of direct investment abroad and in the reporting economy, portfolio investment assets and liabilities, and other investment assets and liabilities.

5/ Mainland China.

Issue No 4: *Should goods and services exports remain the main gateway criterion or should consideration be given to alternative measures as part of the review?*

C. Number of Currencies

16. **Under the 2000 decision, the SDR basket comprises the four currencies issued by the largest exporters and which are deemed freely usable.** Furthermore, it also specifies that a new currency meeting the requirements for inclusion would be added to the basket in replacement of another currency only if at the time of determination its relevant exports exceeded those of the currency to be replaced by more than 1 percent.

17. **The call for a criteria-based path to broadening the basket suggests a need to revisit the 4 currency rule.** It is not clear a priori that there is an optimal number for the size of the basket, though past decisions (the reduction in the number of currencies from 16 to 5 in 1980 and from 5 to 4 in 1999) point to the desirability of keeping the SDR basket relatively small to avoid adding undue costs and complexity for SDR users. The stability principle is also relevant as a basket with a large number of currencies would tend to be less stable over time (as the ranking of currencies will be more likely to change), and adding new currencies with small weights may offer little benefit in terms of the overall stability of the SDR.

18. **One possible approach would be to decide in advance that the size of the basket should not be larger than, say 5 or 6 currencies.** A basket of this size would remain relatively simple to replicate, limiting the complexity of hedging operations and the costs for SDR users, and would likely capture the major global currencies.

19. **An alternative approach would be not to prejudge the future size of the basket.** Rather, the issue of whether a new currency should be added to the basket or replace an existing currency could be considered on a case by case basis in light of the circumstances at the time. Among others, consideration could be given to a minimum weight threshold before a currency is considered for inclusion in the basket. Such a determination could involve an assessment of which approach appears more consistent with the broad principles of SDR valuation—namely stability of the basket and of its value in terms of the major currencies, and representativeness of currencies used in international transactions. Such judgments could be informed by technical work, involving simulations and/or calculation of a shadow basket based on the agreed weighting scheme.

Issue No 5: *Should the future size of the SDR basket be left open at this stage and considered when a new currency meets the eligibility criteria, or should guidance on the maximum size of the basket be given now?*

IV. NEXT STEPS

20. **This note highlights several issues involved in reforming the criteria for inclusion in the SDR valuation basket.** Based on the feedback obtained, staff will come back to the Board with more specific proposals. As part of this work, consideration will also need to be given to the scope for addressing existing limitations on currency coverage in several key areas (e.g., some BIS international financial indicators, bid-offer spreads, currency invoicing, and the COFER database on official reserve holdings). A number of other issues will need to be addressed as part of the broader work program on SDR valuation, including the methodology for determining the weights of basket currencies and issues relating to the SDR interest rate. Finally, a more detailed criteria-based approach along the lines discussed above could help in developing a clearer roadmap for currencies' eligibility for inclusion in the basket (e.g., for the RMB, which already meets the export criterion).