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Challenging the US Dollar's Role as a Reserve Currency: Is the SDR a Credible Alternative?

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The discussions on alternative reserve currency have been reopened when People's Bank of China (PBC) Governor Zhou Xiaochuan proposed an overhaul of the global monetary system, suggesting that the US dollar could eventually be replaced by the IMF's Special Drawing Rights (SDR) as the main global reserve currency.[2,3] Governor Zhou noted that the crisis "reflect the inherent vulnerabilities and systemic risks" in the current global financial system (the Triffin Dillemma, i.e., the issuing countries of reserve currencies are constantly confronted with the dilemma between achieving their domestic monetary policy goals and meeting other countries' demand for reserve currencies) and emphasized that reform must create "an international reserve currency with a stable value, rule-based issuance and manageable supply". To bring about this reform, Governor Zhou recommended giving the SDR a greater role, i.e., by increasing settlement between other currencies and SDR, promoting its use in trade, creating SDR-denominated securities, and expanding the basket of currencies forming the basis for SDR valuation. Russia has made a similar proposal on the creation of a new global reserve currency with broad support from other emerging economies including Brazil, India, South Korea and South Africa.

GENERALIZED PLANS TO SHIFT FROM US DOLLAR (USD) TO SDR: PROS AND CONS

Arguments for having a new global reserve currency

- The future value of the US dollar may be eroded by the US government's massive debt. This will debase the value of US-dollar assets and the foreign exchange reserves of other countries.
- Countries are constrained in their monetary policy to maintain a stable exchange rate with the US dollar. They are also more vulnerable to the domestic economic problems of the US.
- The US dollar's global reserve currency status has allowed the country to have access to easy credit from other countries. This kept interest rates low and encouraged excessive spending in the US—leading to the current crisis.

Arguments for keeping the US dollar as the global reserve currency

- Great disruption in the global marketplace. Major commodities, cross-border transactions and trade deals are denominated in US dollars.
- Enormous costs. A new global reserve currency may require some countries to subsidize the cost of bringing buyers and sellers together, until a critical number of countries have adopted a new currency.

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[2] Zhou Xiaochuan, Reform the international monetary system, BIS Review 41/2009.
[3] The SDR is an international reserve asset, created by the IMF in 1969 to supplement the existing official reserves of member countries. SDRs are allocated to member countries in proportion to their IMF quotas. The SDR also serves as the unit of account of the IMF and some other international organizations. Its value is based on a basket of key international currencies (currently consisting of the euro, Japanese yen, pound sterling and US dollar). The weights of the currencies in the SDR basket (reviewed every five years) are based on the value of the exports of goods and services and the amount of reserves denominated in the respective currencies which are held by other members of the IMF. Based on the most recent review in November 2005, the currencies in the SDR basket have been assigned the following weights: US dollar (44 percent), euro (34 percent), Japanese yen (11 percent) and pound sterling (11 percent).

REASSESSING THE RESERVE CURRENCY STATUS OF THE USD

In assessing the merit of a currency (e.g., US dollar or SDR) as the dominant international currency, it is important to consider the various roles a reserve currency has to fulfill (i.e., unit of account, medium of exchange and store of value) from the perspective of both the government and private sectors.

- **Unit of account.** From the perspective of the government sector, a country uses an international money as a unit of international account when it pegs to such an international currency. On the other hand, from the perspective of the private sector, an international currency is used as a unit of account in cross-border trades in goods and services, as they are often priced, invoiced and settled in currencies other than those of the two trading countries (e.g., trade between Hungary and the Philippines being priced in USD). This helps keep prices in line with competitors and simplifies price comparisons.

- **Medium of exchange.** International monies are also held by both the government and private sectors for settlement purposes. For the government sector, a key reason for holding a certain international currency is for intervention purposes. For countries that are pegged to a certain international currency, usually the intervention currency is the anchor currency and thus, the central bank of the pegging country stores up most of its reserves in this anchor currency. For the private sector, a certain international currency is preferred over others because exchange rates are quoted in bilateral terms and one particular bilateral exchange rate is almost always significantly more liquid than others. For example, it is cheaper to convert Thai baht into Icelandic krona through the dollar. The US dollar, therefore, is the medium of exchange through its role as the 'vehicle' currency, and the private sector holds these 'vehicle' currencies because of their convenience of use.[4]

- **Store of value.** Preserving and enhancing the value of the reserves and private portfolios are important to the government and the private sector and thus they tend not to accumulate international currencies that do not hold their value over time or are volatile. While the USD has retained its qualities as a unit of account and medium of exchange, its role as a store of value is potentially under threat as international investors worry about the impact of financial sector distress, macroeconomic weaknesses and the impact of domestic policies (e.g., quantitative easing) on domestic inflation and the external value of the US dollar.

DOES THE SDR FULFILL THE VARIOUS ROLES OF A RESERVE CURRENCY?

While the SDR is a naturally hedged currency, the SDR is not a currency in the accepted sense.[5] The SDR has only limited use as a reserve asset, and its main function is to serve as the unit of account of the IMF (used for the IMF's assets and lending programs) and some other international organizations. Moreover, the SDR has no current role as a medium of exchange (asking for settlement in SDRs would thus require agents to settle in all four currencies that make up the SDR basket) and its use as a store of value is questionable (considering that there is no SDR debt market). Thus, generating widespread

[4] As a medium of exchange, the USD constitutes about 86 percent of one side of all currency transactions, the euro about 36 percent, the yen, 16 percent, yuan, 0.47 percent and the SDR, zero (Bank for International Settlements Triennial Central Bank Survey, December 2007). [Note: Because two currencies are involved in each transaction, the sum of the percentage shares of individual currencies totals 200% instead of 100%]

[5] The SDR is neither a currency, nor a claim on the IMF. Rather, it is a potential claim on the freely usable currencies of IMF members. Holders of SDRs can obtain these currencies in exchange for their SDRs in two ways: first, through the arrangement of voluntary exchanges between members; and second, by the IMF designating members with strong external positions to purchase SDRs from members with weak external positions.

acceptance of the SDR in preference over the USD would entail extreme difficulty and would require the creation of SDR capital markets and a change in the structure and function of the IMF (from lender of last resort in cases of balance of payments difficulties to an international clearing house for foreign exchange reserves).

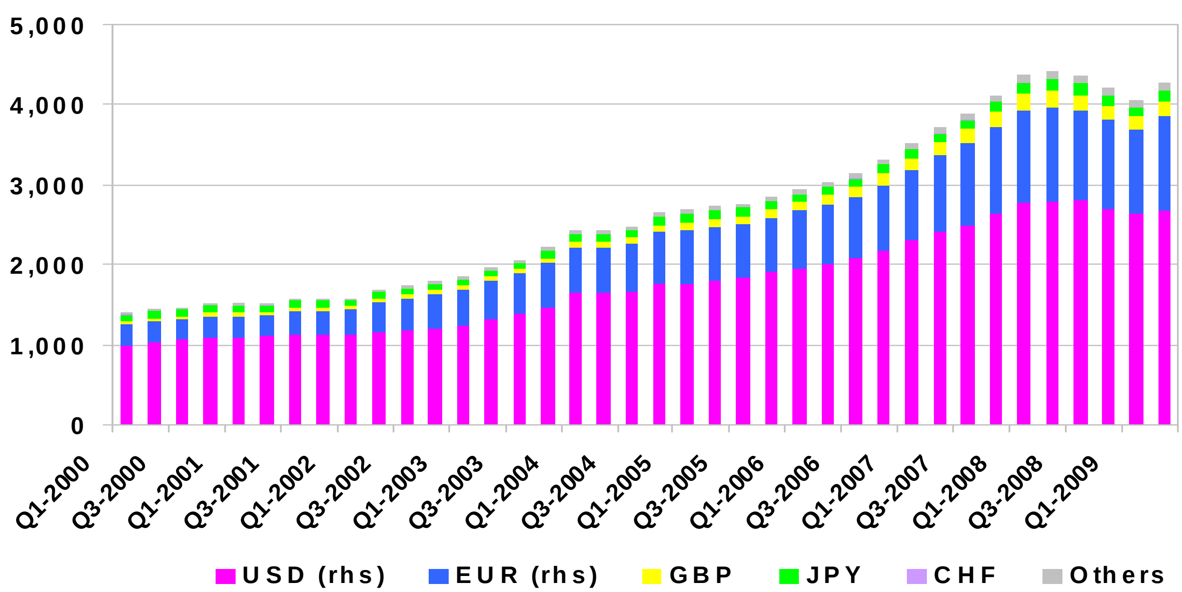
CONCLUSION

While the status of the USD as an international store of value has deteriorated, it has retained its international roles as the unit of account and medium of exchange. Available data do not clearly support the view that central banks in the world have been aggressively diversifying from the USD. While the USD's share in total world foreign reserves has declined from 72.7 percent in end-June 2001 to 62.8 percent as of end-June 2009, this decline can be attributed mainly to changes in the exchange rate (i.e., USD share was low in 2009 mainly because of the weak dollar and its share was high, for example in 2001, due to the strong dollar).

The Euro seems to provide a serious challenge to the USD's reserve currency status given the former's marked improvement in liquidity and depth since the establishment of the European Economic and Monetary Union (EMU). However, Asia, for instance, continues to rely on the USD as the medium of exchange and unit of account (even if few Asian currencies are now pegged to the USD), reflecting mainly the less-than-full convertibility of most currencies in the region.

Meanwhile, although the SDR is a naturally hedged "currency", it is not a currency in the accepted sense and therefore its acceptance as a currency standard may not find support outside central banks and some large sovereign wealth funds.

Chart 1. Composition of Foreign Exchange Reserves by Currency (in billion USD)



Source: International Monetary Fund (IMF)

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