Robert Triffin International
A watch on the international financial and monetary system

SDR NOTES
No. 3
July
2017

SDR: FROM A UNIT OF ACCOUNT AND A STORE OF VALUE TO A TRANSACTION CURRENCY

Dominique de Rambures *

Over the last ten years, the world economy has been experiencing a deep crisis – a financial crisis turned into a world crisis – the most severe since the Great Depression in the 30s which led millions of people to unemployment and misery. In order to cope with the world crisis, national governments and central banks used to get together to exchange information and cooperate through formal (IMF, World Bank, G7, 8, 20, …) and unofficial channels. Then each one got back home to run and tame the crisis as best as he could. The lack of instruments designed to operate at the level of the crisis, i.e. a worldwide crisis, did contribute to deepen and lengthen the crisis. However there exists a tool of monetary and financial stabilization: the Special Drawing Rights (SDR) issued by the International Monetary Fund (IMF). However like the former European Currency Unit (ECU) during the pre-euro period, SDR are nothing but an accounting unit to record the IMF loans to the countries running into a payment deficit or a liquidity crisis, and a reserve currency of the central banks holdings with the IMF. SDR are not yet used for business transactions.

The rebuilding of the international monetary system (IMS)

Taking account of the decreasing share of the US economy in the world GDP, the steadily diminishing US dollar share in the international trade, the growing (double) indebtedness – both public and private, budget deficit and foreign exchange deficit – of the USA, it is very likely that sooner or later, the whole international monetary system should be rebuilt along a multipolar system connecting three monetary areas: US dollar, Euro, Chinese renminbi, the other currencies being forced to align to one of the three dominant currencies. As a result the three governments : USA, EU, China, will have to cooperate to keep the key currencies within agreed limits with each other i.e. with a common currency which could and must be the SDR.

However to make the SDR an instrument of market intervention, it has to be not only a unit of account or a store of value- as it is today - but also a transaction currency based upon a well-supplied and well-organized market.

*** Honorary Chairman of the Ecu Banking Association**

The first step may be to tap the financial markets through SDR denominated bonds and to use the SDR for invoicing and settling trade transactions. The new currency will be highly beneficial to professionals thanks to a priceless asset: stability. Investors may buy SDR financial assets more stable since SDR by definition is more stable than anyone of the component currencies and more rewarding since it includes currencies enjoying higher interest rates. Borrowers may be ready to get committed in a currency more stable and often cheaper than any other currency but their own. It might be a suitable and attractive mix between investors and borrowers interests. To the companies involved in international trade, invoicing in SDR is a way to minimize the transaction costs that distort the international trade. It is a natural and costless hedging instrument. SDR is the best mix of stability v. return in a currency that provides the best liquidity, better than any other currency since it is backed by the five strongest central banks.

The second step is technical: SDR will not be a transaction currency as long as it is not backed upon an interbank clearing mechanism both strong and sound. In this respect the former ecu experience may be worthwhile as a step toward a full-fledged worldwide currency.

The ecu experience

How the European countries moved from a “public” ecu used between governments and central banks, to a “private” ecu used by individuals and companies in the normal course of business on the markets ?

Initially ecu was a unit of account bundling the component currencies on an agreed weighting based upon a given number of objective criteria (GDP, volume of inter-regional trade transactions). The component currencies were not authorized to move beyond a given fluctuation margin based upon the common currency (the “tunnel”) which in turn was free to fluctuate vis-à-vis the US dollar (the “snake”).

Initially ecu was used to denominate bond issues that were beneficial to both investors and borrowers as the ecu was more stable and cheaper than any other foreign currency but more rewarding than the strongest one (then the deutsche mark). An increasing number of companies highly involved in international trade (such as the Club Mediterranée) used the ecu to set up a more stable set of prices as well as an effective tool of managing the company cash flow by reducing the impact of the foreign exchange fluctuations.

To make the ecu a transaction currency, it had to be backed by a worldwide interbank clearing system. It was both a technical need to lower each bank commitment vis-à-vis all the other banks to the overall balance, but also and more importantly to reduce the risk involved at a time there was not yet a European central bank. A banking association (Ecu Banking Association, now Euro Banking Association) was formed and progressively extended to the top hundred banks in the world. The interbank payments were collected, centralized and netted through a telecommunication network (SWIFT). Due to the lack of European central bank, the interbank payment orders were cleared through a bank account opened by each bank with the Bank of International Settlement (BIS). In order to make the whole system safe and sound, a pool of fund was formed, each bank providing a credit line to each of the other member banks to ensure the finality and the security of the whole system. In case of liquidity shortage each bank may turn to its national central bank. Within a short while the ecu rate diverged from the rate based upon the computation of the component currencies and it was no longer needed to “create” ecu based upon component currencies.

The making of a SDR interbank market

In order to reach a critical level of transactions, it may be placed on the markets SDR denominated bond (and later stock) issues that may be of interest to both as ecu denominated bonds used to be in former time.

In order to feed up the SDR market, transaction costs should be equal if not lower than those of each component currencies. A worldwide SDR clearing center is indispensable to build up interbank monetary market and foreign exchange market. In terms of transaction costs using a common currency is cheaper than a multicurrency cash management.

A group of international banks should form a non-profit common organization to create and run an international clearing system of SDR interbank payments. To this end the SDR banking association may use the most advanced techniques in the field of telecommunication, data collection and management, and develop a range of *ad-hoc* services in SDR cash management, with the view to settle and finalize the worldwide bank payments. The payment will be settled through a bank account with the IMF.

In order to strengthen the interbank SDR payment system, it must be backed on a pool of funds provided by the member banks (through reciprocal credit line) as well as an external source of fund, the IMF acting as lender of last resort (out of nothing or through swap deals with the central banks of the component currencies).

Being at the cross-road of all the parties involved and all the SDR flows of funds, the IMF will be well suited to check the market forces and if need be to keep the market conditions (interest rates) within pre-agreed limits, the foreign exchange rates being monitored by the national central banks.

The above plan is the necessary path to build up a worldwide fully integrated common currency fit to anticipate upon the next financial crisis and to set up the foundations of a new and more stable international monetary order.