The place of Special Drawing Rights in the international monetary system

by L. P. Thompson-McCausland

The scheme for Special Drawing Rights within the framework of the International Monetary Fund is an important step in the development of the international monetary system. The Bank have therefore asked Mr. L. P. Thompson-McCausland to contribute an article explaining and giving his personal assessment of the scheme.

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The mechanisms of international payments are shaped by two processes: spontaneous evolution and deliberate construction. Of this latter process, the most recent example, and perhaps the most important so far, is the agreement reached at Stockholm among Ministers and Governors of the Group of Ten and subsequently accepted and expressed in treaty form by the Board of the International Monetary Fund, for the establishment of Special Drawing Rights. This note will try to assess the place of Special Drawing Rights within the general evolution of the international payments system of today.

The new asset

In name and in some procedures, the new drawing right suggests a credit facility rather than an international reserve asset. An asset and an assured credit facility are close brothers. Both give access to resources at will; and both depend for their validity on the contract or convention within which they are operated – even gold, whatever its value in the market as a commodity for industry, as a store of value for savers, as a hedging asset for investors or as a counter for speculators, derives its standing as a monetary asset from the convention that monetary authorities will give a fixed price for it in their own currency. But there is a distinction between an asset and a credit facility: an asset, unlike a credit, changes ownership without changing its form and is not subsequently extinguished by repayment. On this criterion there can be no doubt that the new drawing right is an international asset denominated in terms of a common accounting unit, the 1944 gold dollar, which is the accounting unit of the Fund.

The limitations placed on the asset's use do not invalidate this essential quality. The holder of a drawing right may not, indeed, transfer it merely because he or the buyer would like to change the form in which they hold their assets. That, however, is not an unreasonable limitation at a time when monetary authorities are more conscious than usual of the difficulties which shifts between one form of asset and another can present. Similarly with the rules governing the group of kindred obligations on 'designation' (determining which members are to provide the currency against transfer of the asset) on the maximum use of the asset (which, on a daily average over five years, must not exceed 70 per cent of the total average amount allocated to the member over the same period) and on 'reconstitution' of holdings (if the average daily net use does exceed 70 per cent) – none of these is an obligation to repay a credit. They are, rather, club rules to ensure that, so far as possible, ownership of the asset continues to be spread throughout the membership and does not get concentrated in the hands of a minority. Concentration could be dangerous. It could produce a conflict of interest between holders and non-holders and might give to the one or the other too much power over the scheme itself. Time may modify opinions and rules – there is specific provision for this in the Articles – but change in such things is best left to grow out of use. At the outset, these precautions are reasonable rather than restrictive. There are, of course, other rules in the scheme which may at some time and in some contexts greatly affect its working. But for the purposes of this note, which does not purport to be a digest of the Articles, they can be left aside. What matters is that, when the new Articles have come into force, the world will, for the first time, have a set of rules for creating and using an international reserve asset which is fiduciary, managed, deliberately created for the mechanism as a whole not for the needs of any individual member, and freely transferable within the provisions of the scheme.

The asset is designed for a particular contingency: "to meet the need, as and when it arises, for a supplement to existing reserve assets". New gold from the mines is no longer flowing into monetary reserves; and reserve currencies no longer should be flowing there. Something else will, therefore, be required when and if the growth of world trade and payments begin to demand a greater stock of reserve assets. This is the contingency. The new plan passes no judgment on whether there is now a shortage of assets or not. That is left for determination later by an 85 per cent majority vote of the participants. As the procedures of acceptance and ratification may well take up the rest of this year, an actual issue of Special Drawing Rights to the participants (which is to be 'across the board' in proportion to their Fund quotas) could scarcely come about before some time in 1969.

When issued, the new drawing right will be a reserve asset in the same sense as monetary gold now is, that is, it will not be traded directly in any market but will be transferred between central banks to acquire for the transferor the currency which he needs for his market interventions. It will thus take its place beside gold in an international payments system which is already far advanced in its evolution from the old gold procedures to a new system in which currencies, not gold, have the main operational role.

The phases of evolution

It is important to realise how far that evolution has gone and in what it consists. Under the old gold standard, gold was money itself. In minted form, it was used as money in the everyday transactions of business and of private life throughout most of the world. Notes were gold tokens convertible into gold on demand; and notes together with gold were the cash base on which the entire credit structure rested and by which its size was limited. Internationally, gold was the common underlying element of all national currencies. It was true international money and relatively small movements of gold from country to country served, in the system's heyday, to keep the international payments of the world in fair balance. The problems of the gold standard were not what we have come to know as balance of payments problems.

The general direction of subsequent evolution has been away from a prime concern with the gold content of the domestic currency towards a prime concern with its value against other currencies in the exchange markets of the world. But this has not merely been a matter of substituting market intervention for gold movements. The use of foreign currency by central banks to influence exchange rates is not, in itself, new. On the continent of Europe the practice was not uncommon in the latter part of the 19th century; and in London, which was then a heavy short-term creditor against the rest of the world, the same effect was produced by different means: a small upward movement of Bank rate sufficed to bring back funds to London and so to strengthen the demand for sterling in the exchange markets. The purpose of these operations, however, was not to defend the exchange rate as such but to defend the gold point at which gold would begin to flow out. Gold reserves were not looked on as a medium for supporting the exchange rate. They were held primarily for the domestic purpose of honouring the gold-convertibility of bank notes. The main impact of a gold outflow on the exchange rate was indirect, through the sharp contraction which it required in the note issue and hence, by linkages which multiplied its effect, in the banking system as a whole. Exchange rates against other currencies were left to the currency arbitrageurs and, ultimately, to the gold arbitrageurs who could use notes to get gold. When the central banks operated in the exchange markets, they did so to protect their domestic monetary systems against unnecessary or seasonal gold losses which, left to themselves, could have rather fierce consequences for the whole monetary structure of the country. The strategies of this system were those of the strongly defended central fortress with only light frontier patrols where domestic and foreign currencies bordered.

The extension of the gold exchange standard after the first war was an early and important, though unsuccessful, attempt at evolution in the modern direction. In the time of the full gold standard the problem exercising bankers and economists alike was the scarcity of gold which limited the expansion of the economy and cramped banking operations. This was a main concern of the Genoa Conference of 1922, whose report had no doubts about the need to re-establish the gold standard but sought for a way of relieving the scarcity and maldistribution of gold. To that end it made some far-sighted observations on the need for greater credit between central banks and for consultation and co-operation among them, but its main practical recommendation was that an international convention should be entered into embodying "some means of economising the use of gold by maintaining reserves in the form of foreign balances". This was to be the new development of the gold exchange standard. No convention was, in fact, set up, but many authorities took the opportunity to ease the scarcity of gold in their own reserves by including not only gold but also gold-convertible foreign exchange in the credit base of their domestic monetary system. The gold-cum-exchange credit base itself was to go on working just as the gold credit base had under the pre-war gold standard. The concept was still to be that of the strongly defended central fortress; but the base was to be enlarged. The enlargement, however, assumed that the additional gold-convertible currency holdings would not, in practice, be converted – an assumption which did not seem unreasonable in the light of general domestic experience that the gold cover for a note issue could safely be maintained at a fraction of the currency structure it supported. But when the assumption was put to the test in 1931, it proved false – not because central banks in general had failed to observe it (though Paris, since its recovery from monetary debility in 1926, had been putting intermittent pressures on the pound for political reasons and had been weakening the reserves and sapping confidence over a number of years) but because of the stresses in the market generally. The experience of 1931 taught a sharp lesson on the stresses to which a dual asset system may be subjected if it is based on a convertibility that is expected not to be exercised. Lessons, however, can be taught without being learned.

There was ample reason why this lesson should have been forgotten in the preoccupations of the following years up to and during the second war, in which evolution towards the present currency-orientated system began to move fast. First, when the gold standard came to an end, for sterling on 19th September 1931, and subsequently for almost every other currency in turn, gold began to move into the background and currency procedures of necessity came to the fore. In London, the whole gold reserve of the Bank of England was, by 19th September, either spent or pledged. On 21st September (the Monday) expedients had to be contrived. At first there was nothing to do but let the exchange rate find its own level in the markets. Fairly soon, however, the steepness of the fall began to bring a reverse flow of funds, of which the Bank of England were able to secure part. From then on, market intervention, whether to support the rate or to draw currencies into the reserves instead of letting the rate go on rising, became a continuous operation; and the exchange rate of the pound became the direct daily, even hourly concern of the monetary authority. Comparable things followed in other countries.

A second and not less important development in the new orientation on currencies rather than on gold arose in those parts of the world which then looked to London as their international monetary centre and to the British Isles as their main export market. Very soon these countries had to decide whether to peg their rate to a fluctuating pound or to align themselves with gold. The great majority decided that, whatever their monetary statutes might lay down, they were bound more closely to the pound than to the golden sovereign. Having taken the decision to peg to sterling, they were ready to accept sterling as their main reserve asset. They were still free to buy gold with it in the open market but generally preferred the asset to which they had attached their currency by a fixed link rather than the asset whose value was (for them) fluctuating. They also realised, not for the last time, that a scramble to buy gold could bring worse consequences still – the dilemma of a bear in a china shop. The immediate importance of this choice was not very great because most of the countries concerned did not, at that time, hold reserves of any size. But the acceptance of currency orientation rather than gold orientation opened the way for the unprecedented growth of sterling reserves during the war, to become the first example of reserve currency holdings on the modern scale.

A third current in the general tide of evolution which was flowing through those years was the belief that, with the statutory gold limits removed, governments were free to enlarge expenditures in their own currencies and within their own territories without specific limit and without suffering the former consequences of a loss of gold. Expenditures were accordingly increased, first to stimulate recovery and later in preparation for war, generally with good effect on the underemployed economies of that time. After war had broken out, Lend-lease embodied something of the same idea. Its object was to allow goods to be transferred without monetary settlement between governments, each government making itself responsible for the payments arising in its own territories. The success and remarkable smoothness with which Lend-lease worked seemed to give the idea the credentials of a notable example carried into practice; and in sundry forms and sundry places an opinion has survived that government expenditures at home need present no serious threat to the balance of payments, which is primarily an affair of the private sector.

Underlying assumptions after 1945

By the end of the war, these several currents of evolution had been flowing for a decade and a half and had transformed two of the underlying assumptions about the workings of an international monetary system. First, the gold standard concepts of a strongly guarded central fortress with only light patrols at the frontier had been replaced by concepts looking almost exclusively to frontier defences; and secondly the idea of a network of exchange rates each pegged to a chosen intervention currency and expressed in terms of that currency had, for practical purposes, superseded the idea of currencies related to each other through the gold content of each. These two ideas have been the main formative influence both in the further course and direction of evolution and on the deliberate constructions which have determined the shape and the problems of the international monetary system of today.

With the constraints of domestic gold convertibility gone, everything in those formative years combined to stress exchange rates as the prime monetary responsibility. To describe this as a change from the concept of a guarded central fortress to that of a defended frontier is not merely a fanciful metaphor. The gold convertibility of notes lay at the centre of the domestic monetary system; and responsibility for that convertibility did make the centre of the domestic system the point at which adjustments began. The exchange rate, on the contrary, is itself the frontier between domestic money and the monies of the rest of the world; and concern with the exchange rate does make for policies which look to that frontier. The change from the one concept to the other at first expressed itself in the expedients of the 1930's – floating rates, exchange controls, trade controls and trade currency blocs, all of them (even floating rates) being concerned with defences at the exchange rate frontier, and all of them embarked on with genuine hope that they would allow the benefits of managed money to be brought to the domestic economy within the frontiers. A world in which all, or most, governments were deploying these frontier defences, however, proved so uncomfortable that the post-war trade and payments treaties of the G.A.T.T. and Fund recognised a common interest in forswearing them. But the underlying idea of concentration on the frontiers continued. Only the instruments were changed. In substitution for the forsworn controls and fluctuating rates, the Fund Articles offered credit. But the credit is for use in the exchange markets; and the exchange markets are themselves the frontiers with which policy is concerned. At the centre, national sovereignty is still preserved.

The system which has evolved from these ideas can claim to have facilitated the greatest growth of international trade and, in many individual countries, the most striking expansion of wealth that history has yet recorded. But this will not continue if the international monetary system is not working smoothly. Being evolutionary, the monetary effects have been slow to declare themselves in recognisable form. The stages were gradual. Starting from the point that the exchange rate of each country is the common concern of all its economic neighbours, the international rate structure has become the foundation of the modern system as metallic gold was the foundation of its predecessor. This international rate structure is maintained by market intervention, predominantly with dollars. Secondly, credits for use in market intervention (for the most part ultimately in dollars) have been extended in unprecedented amounts, which attest the importance accorded to the international rate structure. Thirdly, the effect of all this has produced the modern phenomenon of reserve currency holdings as a major part of national reserves. At first, accruals of intervention currency into national reserves were welcomed, whether that currency was sterling during the war years or the dollar after the war. But in course of time, the surplus country found itself taking up the intervention currency in order to prevent a rise in its own exchange rate and consequent potential disturbance of the international rate structure. Thus the new importance of that structure, combined with the intervention system by which it is maintained, and with the unexampled size of credits which can be extended to support intervention, has presented the world with an unplanned *fait accompli* by which reserve currency balances have become a salient feature of the system. The balances have, of course, also been fed by the deficits of the reserve currency countries and have thus become, in themselves, part of the credit structure by which the network of the exchange rates is supported.

But the other main underlying concept in the post-gold-standard era has also been contributing powerfully to evolution, namely the concept of sovereignty to manage the domestic monetary system without a central constraint. In itself, this is a gain in freedom. But it carries consequences for the international system when the policies of important countries differ. The reports of the Group of Ten Deputies have already observed that, on the continent of Europe, the memories of destructive inflations after both wars enter into policy formation to a degree that does not apply in the reserve countries which have not experienced comparable inflations. Policy priorities in the monetary field, therefore, differ between the reserve currency countries, on the one hand, and continental Europe, on the other, with consequences for the balance of international payments, on both the surplus and the deficit side, which have become a besetting problem. In the earlier post-war years imbalance was thought to be a residual effect of the war, which would pass; and so it proved to be in many countries. But in the reserve currency countries imbalance on the deficit side has proved long lasting, and has become a problem of the system as a whole.

The unfinished transition

It is at this stage that the new reserve asset has been introduced. The system into which it is to be fitted shows the marks of an unfinished transition from the old gold standard to some successor system which has yet to be completed. Gold has lost most of its original functions. It has long since been demonetised for domestic purposes. It no longer sets any limit on the domestic money and credit structure. It no longer actuates adjustment processes. It can no longer be used freely to maintain the convertibility link between the gold element and the currency element. Of all its earlier functions it only retains two – that of a common denominator for defining the par value of national currencies, and that of a medium for gaining access to the currency of another country. And, of these two functions, the former has, in operational practice, been taken over by the dollar, and the latter has been almost supplanted by the array of credit facilities, which are soon to be supplemented by the new asset of Special Drawing Rights. In all these respects, gold itself is no longer necessary to the system. Once the world had enough experience of the new asset to feel confidence in it, there would be no technical difficulty in devising arrangements – indeed several have already been proposed – in which gold could be replaced by Special Drawing Rights or something like them. The present S.D.R. scheme was not, of course, designed for that purpose and would doubtless require some amendment if it were to extend its function more widely. But, if, at some future time, there were the will and the agreement, that could be done.[1] The mere fact that a plan for an international asset now exists is a notable example of a deliberate construction inserted at an important juncture of evolution.

Much more than the mere setting up of an international asset would, however, be needed before the transition from the old to the new system was complete. Two qualities of gold under the gold standard have been jettisoned without any substitute having been installed to take their place: first, gold, under the full gold standard, was the unique reserve asset; and, secondly, the adjustment processes which resulted from its function at the centre of national monetary systems provided a common international adjuster which protected the international payments system from gross imbalance. It did so at the cost of imbalance in other parts of the wider economic field which would not be tolerable today; but no permanent solution of the wider economic problem can be won until the problem of imbalance in the monetary field has been solved. The need for a solution is nowhere denied; but mere calls for discipline, surveillance, and hard policies will not produce a solution until the underlying sources of imbalance are more clearly understood.

The other gap left unfilled after the end of the gold standard (namely the lack of a unique reserve asset) was not wholly overlooked in the plan for a post-war system. Gold was relegated to the background as, in some sense, an ultimate reserve asset, an ultimate medium of settlement and a common denominator of currency values. But the need for a link by assured convertibility between gold and the new currency structures was recognised, and was thought to be sufficiently provided for in the impregnable strength of the dollar. The dollar was everywhere in demand, was a claim on the greatest industrial economy in the world, and was backed by most of the world's monetary gold. In 1944, the dollar of the day was made the equivalent of gold for the Articles of the Fund; and for years after the war, the dollar and gold were virtually synonymous. Indeed the dollar was preferable to gold; it could be invested in fully liquid securities to return a small income, and was, as a practical matter, at once the denominator by which exchange rates were, directly or indirectly, measured, and also the currency used for market intervention to maintain the rates of all the other major currencies of the world. Subsequent evolution proceeding from these assumptions has, however, modified the assumptions themselves, as has been seen, and has produced a system dually based on currency and gold which is beginning to display some of the characteristics long since exemplified under bimetallism.

To this the new asset has been hailed as offering hope of a solution. Experts of the highest distinction have proposed either that the asset (or something like it) should be issued in exchange for both gold and reserve currency holdings

1 A fiduciary reserve asset must ultimately rest on a political assumption that there will not be a war which would cut off important countries from the institution responsible for administering the asset. That is the assumption made in this article. Local outbreaks of war would be unlikely to invalidate it.

which would be merged in a pool as backing for the new single asset. Alternatively, schemes for converting currencies into the new asset have been suggested, coupled with a convention laying down an established proportionality between gold and other assets in national reserves, with periodic 'reshuffles' to maintain the proportions and to ensure that the transfer of one asset should be, in effect, a transfer of an appropriately proportioned mixture of all the assets – the principle of proportionality has, indeed, some recognition in the rules governing the Special Drawing Rights themselves. Effective conventions could, no doubt, be drafted to incorporate either of these principles. Or, less ambitiously, choice could be made from the considerable range of proposals, including the original Maudling Plan, to allow any excess of currencies beyond the individual monetary authority's working balance to be converted into a fiduciary asset having international acceptability.

There is no difficulty in devising schemes of this kind to widen the application of the new S.D.R. asset. But the problem of imbalance blocks the path – not merely for the general reason that no system can continue indefinitely to operate while imbalance continues, but for a more practical and direct reason. The practice of market intervention must continue – there is nothing at present to take its place – and must still require the central bank of a surplus country to pick up any excess of the intervention currency above what its own private sector wishes to retain. All plans for converting future accruals of intervention currency into an international reserve asset encounter the objection that they may merely ease the financing of continued deficits on the part of key currency countries. This conflict between what new deliberate construction can propose and what imbalance can oppose to it was seen by the Group of Ten Deputies in their first report which recommended that, concurrently with their own efforts to devise new instruments for international monetary use, the 'adjustment process' should be studied elsewhere. The study did not produce any new solution. But until a solution is found, the outward looking policies of the post-gold-standard system will not be able to take the further steps which suggest themselves along the road opened up by agreement on a new fiduciary international reserve asset.

Conclusion

A final paragraph may serve as summary. The new reserve asset is introduced at a time when evolution has carried the international monetary system far from the old international gold standard but has not yet made the transition to a complete system of another kind. Elements of the old and of the new exist side by side in some discomfort. Gold was the reserve asset proper to the gold standard but has lost its operational functions and its function as the unifying factor between national monetary systems, adjusting the balance of each, through the gold content of its own currency, to the international monetary system as a whole. The new system has substituted the international structure of exchange rates for the gold content as the unifying factor, and maintains that structure by market intervention. For this system, the intervention currency (which, except within the sterling area, virtually means the dollar) is the operational reserve asset, and must continue so. But it is not the sole reserve asset. The structure of exchange rates has been defended by very great extension of credits, both directly, in the form of loans, and indirectly, in the form of reserve currency holdings in excess of operational needs. This has built up the currency element in reserves to a level not greatly less than the gold element. The system has thus reached a point where it is dually based. The new asset, though designed as a supplement to the existing assets, could in theory (though not at once in practice) replace both gold and any excess of reserve currencies over and above the not inconsiderable amounts which must continue to be held for market intervention. But further evolution in that direction is prevented by the continuing and major fact of imbalance. It may be that the last service to be performed by the former gold standard before it is finally lost to memory will be to redirect the search for the cause and cure of imbalance from the frontiers to the centre of national monetary systems.