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The Role of the SDR in the International Financial System

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Introduction

The Special Drawing Right (SDR), created by the IMF in 1969, was designed as an international reserve asset to supplement Fund members' reserve holdings. SDRs were intended to provide a permanent increase in the world stock of reserves, without the need for countries to run surpluses or deficits - thereby contributing to international financial stability. The rationale for creating the SDR in the context of the Bretton Woods system was related to the recognition that the supply of gold would probably be constrained. There was also the concern, most eloquently reflected in the Triffin dilemma, that if the ratio of official holdings of US dollars relative to gold reserves of the US became too high, this could be a source of major international instability (Mussa:1996 and Triffin:1960)

There have been only two allocations of SDRs since their creation. The most recent allocation was made in 1981, bringing the total of SDR allocations to SDR 21.4 billion; equivalent to around 1.5 per cent of global reserves in 2000. The decision to allocate SDRs requires an 85 per cent majority of the total IMF membership. Since the last allocation, important differences of opinion have developed between the Fund management and the majority of its membership, on the one hand, and the major IMF shareholders, on the other, over the form any new allocations should take.

Different perspectives on the need for SDRs in the current international financial system lie at the heart of this disagreement. The major industrialised countries believe that the development of international capital markets have eclipsed the role of SDRs, arguing that markets are well able to meet the global demand for reserves. This view, together with the perennial preoccupation with avoiding inflationary pressures in the global economy and preference for combining IMF lending with conditionality, has meant that the major industrialised countries have repeatedly opposed a general allocation of SDRs.

The failure to reach agreement on new SDR allocations since the early 1980s has had a detrimental effect on the developing and transition countries, and importantly, on the global economy as a whole. This paper will argue that the time is ripe for a re-evaluation of the SDR. SDRs could play an extremely useful role in the current and evolving international financial system in two major ways.

First, temporary SDR allocations could help meet the challenge posed by the problem of liquidity shortages during currency crises that have impacted so negatively on many developing and transition economies during the 1990s and have threatened international financial stability. These crises are increasingly capital account led. Severe and sudden reversals of capital flows can easily develop into deep financial and economic crises, as private flows pull out just as countries most need liquidity. Crises such as those in Mexico and East Asia have raised concerns about the adequacy of IMF funds to respond to them effectively, even though the Fund's resources have been increased and new IMF facilities created. An emergency financing facility funded by temporary SDR allocations could help the IMF provide liquidity more effectively during financial crises. If such an emergency facility took the form of an enhanced CCL-type facility, financing could be disbursed automatically, and funded through SDRs, the facility could be sufficiently large to restore market confidence.

Second, SDRs could more effectively fulfil their original purpose of supplementing Fund members' reserve holdings, taking into account the evolving nature of the international financial system. While private capital markets are arguably able to meet the total global demand for reserves, the distribution of reserves across countries shows a very different picture. Many developing and transition countries, that make up the majority of the Fund's membership, either face high costs in acquiring and holding reserves from borrowed sources - or worse, are excluded from private capital markets altogether. Recent structural changes in financial markets have added to cyclical factors to produce, in the year 2000, far lower levels of net private capital flows to emerging markets. This is likely to exacerbate the already inequitable distribution of reserves across countries. Periodic SDR allocations could help all countries meet the demand for reserves, without implying costs for the system as a whole.

The paper begins with a brief overview of the evolution of the SDR since it was created in 1969. Section I will look at the two allocations of SDRs, in the early and late 1970s, and the more recent impasse over further SDR allocations. Section II then analyses the role of the SDR in the current and evolving international financial system. This section re-evaluates the major arguments for and against SDR allocations in the current context. Section III puts the case for an Emergency Financing Facility funded through the temporary allocation of SDRs to help reduce the frequency and severity of liquidity and financial crises. Section IV then makes the case for periodic allocations of SDRs, principally to help those countries that face constraints in building reserves from alternative sources.

I The Evolution of the SDR

The Special Drawing Right (SDR), an artificial currency unit defined using a basket of currencies, was created in 1969 by the IMF. It was designed as an international reserve asset, to supplement Fund members' reserve holdings. The SDR is also the IMF's unit of account; with Fund voting shares and loans denominated in SDRs. Fund members are allocated SDRs in proportion to their quotas in the IMF. Special Drawing Rights are created through a process of allocation, the principles of which are set out in the Fund's Articles of Agreement. Article XVIII sets out the conditions under which an allocation of SDRs should be made:

> *In all its decisions with respect to the allocation and cancellation of special drawing rights the Fund shall seek to meet the long-term global need, as and when it arises, to supplement existing reserve assets in such a manner as will promote the attainment of its purposes and will avoid economic stagnation and deflation as well as excess demand and inflation in the world.*

Article XXII then urges the co-operation of the Fund's membership in order to achieve '*the objective of making the special drawing right the principal reserve asset in the international monetary system*'.

The wording on SDRs in the Fund's Articles is ambiguous enough to be open to interpretation, and differences of opinion have arisen over when SDRs should be allocated and what their purpose should be. As Ahluwalia (1996) points out, it is unclear whether the SDR should be considered an instrument of last resort, or whether it should fill the gap between the demand for reserves and the optimal supply of reserves from various sources (eg: through adjustment, borrowing, and SDRs).

Equally, there is ambiguity in the need to demonstrate '*long-term global need*' on the one hand, and the objective of the SDR being the global principal reserve asset on the other. The criteria of demonstrating global need has often been cited by those industrialised countries that oppose SDR allocations, arguing that international capital markets are able to meet current and projected demand for global reserves. However, quite apart from the distributional inequalities of access to reserve assets through global markets (explored in the following section), if the SDR is to come even close to being a principal reserve asset this would imply the need for a steady process of SDR allocation to match growing levels of world reserves (Ahluwalia:1996).

It is useful at this point to examine the circumstances surrounding the two allocations of SDRs, the first one taking place shortly after the SDR was created and the second one made in the late 1970s.

Agreement on the first SDR allocation was reached in 1969, when it was decided to allocate SDR 9.5 billion during 1970-72. At that time the global economic environment was very different than it is today. In the late 1960s, the Bretton Woods system of fixed exchange rates and restricted capital movements still prevailed. The principal concern at that time - linked to the original rationale for creating SDRs - was the problem of possible shortages of reserves given the limited gold supply, and the instability of depending on dollar reserves based on the US deficit.

The second allocation was made in the late 1970s, when SDR 12 billion were allocated between 1979 and 1981. By then, the Bretton Woods system had collapsed and the world economy had moved to a system of floating exchange rates and multiple currency reserves. At the same time, the growth of international capital markets meant that many countries could create reserves by borrowing from global financial markets.

In the late 1970s, opposing views, very similar to those that exist today, arose over the issue of the SDR allocation. The major industrialised countries argued that there was no demonstrable global need for liquidity, as demand for reserves could be met by holdings of reserve currencies. Some Fund member countries believed that any further increases in liquidity should be conditional (ie. through quota increases) rather than unconditional (through SDRs). Their argument being that the provision of unconditional liquidity would provide those countries with 'bad' policies with a disincentive to adjust.

Agreement was eventually reached; the SDR allocation was made, together with a 50 per cent increase in Fund quotas that provided the basis for increased conditional liquidity from the Fund. The relevance of these negotiations to today's situation being that the need for an allocation was recognised, despite the capacity of most countries to build reserves through international capital markets (Ahluwalia:1996).

Since 1981, no agreement has been reached to allocate SDRs, despite repeated demands from many developing countries for further allocations. The 1980s, the years of the debt crisis, was a period of severe reserve shortages in many developing countries, yet the major industrialised countries remained opposed to SDR allocations. One clear reason was the concern among the industrialised countries not to take any actions that could potentially increased inflationary pressures in the global economy, in a context when the developed countries gave top priority to inflation control. Another possible reason, put forward by Ahluwalia (op.cit), was the belief in the international community that developing countries needed to implement strong structural adjustment policies, and that any easing of their liquidity constraints through an SDR allocation might encourage postponement.

Disagreements over the SDR issue arose most recently in the context of the 1994 IMF Interim Committee meeting in Madrid. On this occasion, the G7 countries proposed a selective SDR allocation of around SDR 12 to 16 billion that would mainly benefit those countries that had no SDR allocations because they had joined the Fund since the last allocation in 1981. This proposal would have entailed a change to the Fund's Articles of Agreement, which currently only provide for general SDR allocations to all members in line with quotas. Despite their considerable weight in terms of IMF voting shares, the G-7 countries would have had to secure the support of the developing countries for their proposal to be implemented as a change to the IMF articles requires an 85 per cent majority. However, the developing countries and the IMF had an alternative proposal for a general allocation of around SDR 30 to 36 billion. Again, the developing country proposal needed the support of the major industrialised countries as an SDR issue also requires a majority of 85 per cent. In the end, the two sides failed to reach agreement and the Madrid meeting ended in stalemate.

II The SDR in the current International Financial System

This section will outline the case for a stronger role for the SDR in the international financial system. In doing so, it is interesting to re-evaluate the arguments that have been made both for and against SDR allocations in the past, bearing in mind the ever-changing nature of the global economy.

As we have seen, the global economic environment has changed markedly since the SDR was created in the late 1960s. Between the first SDR allocation in 1969 and the last allocation in 1981, the world moved to a system of floating exchange rates and multiple currency reserves and international capital markets developed. A number of significant changes also took place in the period between the last SDR allocation and the impasse over SDRs that arose at the 1994 Madrid meeting of the Interim Committee. Inflation, which had been a very real concern at the global level, had been brought under control in the majority of countries; the reach of global capital markets broadened to encompass most of the world's countries; many economies in Latin America and Sub Sahara Africa had undergone stabilisation and structural adjustment programmes under the tutelage of the IMF and World Bank; the East Asian economies rose to prominence in the world economy; and a number of new countries in Eastern Europe and the former Soviet Union had joined the Fund.

In the period since 1994, further monumental changes have taken place and new concerns have taken over from older ones. The crash of the East Asian economies and the other financial crises of the 1990s revealed the substantial risks that accompany the rapid movement of international capital; since late 2000, fear of global recession has now taken over from concerns over inflation in the forefront of policymaker's minds; and structural changes in financial markets are adding to cyclical factors to further reduce lending and investment to developing and transition economies, with net private flows currently at their lowest level since 1992.

It is against this backdrop that the case for SDR allocations has to be evaluated. Perhaps more importantly, it is essential to take account of the constantly changing nature of the global economy and the need for facilities and instruments that can evolve and adapt to respond effectively to new challenges as they arise. SDRs were originally intended to supplement global reserve assets, and to become the principal reserve asset in the international monetary system. So are these objectives still relevant in today's global economy?

First, it is uncontroversial to assume that the global demand for reserves will continue to grow, as world trade and international capital flows increase. In fact, many Emerging Market developing countries now feel they have to hold very high levels of reserves in order to protect themselves against the risks of rapid swings in the current account associated with private international capital movements.[1] The contentious issue is whether there is a need for SDR allocations to meet some part of the global demand for reserves.

As we have seen, since the development of international capital markets, those industrialised countries that are opposed to SDR allocations have argued that any current or projected increase in the demand for reserves can be met by private flows. While this may be the case for the global aggregate demand for reserves in normal times, the situation is very different when the distribution of reserves across different types of countries is examined, and when market reactions during episodes of financial disturbance are taken into account.

Access to world capital markets as a source for acquiring reserves is extremely varied across countries. The reserve currency countries (the US, Germany and Japan) and other industrialised countries are able to easily access liquid funds to hold as reserves. Middle-income developing countries normally have access to world capital markets as a source of building reserves, but this imposes a significant cost as the rate of

[1] Asia now has around $1,000 billion in reserves.

borrowing is higher than the rate of return on reserve assets. Furthermore, the experience of the currency crises of the 1990s has driven many emerging market countries to build very high levels of reserves, to try to protect themselves from the risk of future crises. There are also a large number of low-income developing countries that have little or no market access. These countries are forced to rely on exports to meet their demand for reserves, and to restrict domestic demand or constrain their imports to their limited supply of foreign exchange (Buira:1996). The lack of international liquidity available therefore implies the adoption of contractionary policies in many low-income countries, that in turn impede growth and development. It also obliges middle-income countries to hold large reserves acquired at high costs. Furthermore, as discussed below, both low-income and middle-income countries are subject to large reversals of capital flows that can lead to crises that are very costly in terms of output and development.

Those industrialised countries opposed to SDR allocations have recognised that there are a number of developing and transition countries that do not have access to world capital markets to build reserves. However, they have traditionally argued that this is due to inappropriate economic policies in the countries themselves. Reminiscent of the discussions on SDR allocations in the late 1970s, it is argued that the provision of unconditional liquidity in the form of SDRs would interrupt valuable market signals and act as a disincentive on these countries to carry out needed economic reforms.

As Ahluwalia (1996) has noted, this argument is partly based on misconceptions. First, reserves obtained through SDR allocations are a lower-cost, but not a cost free, alternative. Second, the modest levels of SDR allocations that have been proposed would not represent a large supply of unconditional liquidity that could interrupt market signals; most low-income countries would still require the conditional liquidity supplied through IMF programmes.

Perhaps more importantly, the market signals that the opponents of SDR allocations are so keen to protect are often themselves far from perfect. International financial markets suffer from a number of imperfections that have a negative impact on the capacity of developing and transition economies to access stable and sufficient private capital. Information asymmetries and herding behaviour can drive a wedge between actual risk and the market's evaluation of creditworthiness and the way risk is priced. This pushes up the cost of borrowing for many poorer countries, making it very costly to supplement reserves with borrowed funds, even when countries do have access (see Bhinda, Griffith-Jones, Leape, and Martin:1998).

While there are undoubtedly cases, for example the low-income countries in conflict, where risk is rationally perceived as very high, there are also a number of developing countries that are excluded from private capital because the market is simply unable to quantify the risk. This problem is also likely to worsen, as structural changes in financial markets mean that banks and other financial actors are paying more attention to different types of risk - market risk, credit risk, operational risk - in a way that they did not do before. These structural changes are reinforcing cyclical factors that have brought a significant decrease in the levels of net lending and investment going to developing countries in recent years, linked to the frequency and depth of recent crises.

The pro-cyclical nature of international capital flows is also a very important impediment to markets being a reliable source of liquidity for all but the industrialised countries. The financial crises in Mexico, East Asia, and Brazil as well as the more recent problems in Turkey and Argentina, have provided a salient reminder of the dangers involved when countries have a high dependence on borrowed funds for liquidity, as this makes them extremely vulnerable to sudden changes in market sentiment. These crises showed how a country's creditworthiness can deteriorate rapidly, for reasons that have little to do with any shift in their 'fundamentals'.

This can result in sudden changes to the availability and cost of funds available to meet the demand for reserves. Even those middle-income developing and transition economies that can normally access international capital markets to help meet their demand for reserves can see their cost of borrowing shoot up during crises, or even find themselves excluded from global markets. Both the Mexican and East Asian crises, and their associated contagion effects, showed how what are essentially liquidity crises can rapidly develop into deeper financial, economic and social crises due to the pro-cyclical nature of liquidity provision in international financial markets.[2]

In sum, the position of the G-7 countries that markets can amply meet the demand for reserves is based only on their own reality. For while it is clearly the case that the reserve currency and other major industrialised countries can rely on financial markets, the majority of Fund members face substantial costs in acquiring and holding reserves. This lack of reliable sources of liquidity impedes economic development in many countries, and increases instability in the international financial system. Indeed, there is even a risk for industrialised countries, in that crises in emerging markets can - and for a very limited period in the Autumn of 1998 did - spread to these countries. So even from the point of view of self-interest of developed countries, there is a case for keeping the issue of SDRs active.

Another reason that the industrialised countries have opposed SDR allocations in the past is their fear that they would increase inflationary pressures in the global economy. It is believed that strengthening an international reserve asset that would be independent of the polices of the major economies' central banks could increase the global rate of inflation. However, with SDR allocations of the size that have been proposed, the cumulative stock of SDRs would still only represent a small proportion of the global money supply. Mussa (1996) clearly argues, even a fairly large allocation of SDRs - for example, on a scale similar to those proposed by the IMF - would be unlikely to induce industrialised countries to change their monetary policy, as changes caused by use of SDRs would be sterilised. SDR allocations would have little impact on global inflation at any time, but inflationary fears are particularly inappropriate during episodes of financial crisis when strong deflationary forces are present. Moreover, concerns over inflationary pressures in the global economy generally have receded recently, with the major concern now being the prospect of recession in some of the major industrialised countries, or even a global recession.

[2] For more on this, see the following section.

The costs, then, both to individual countries and to the system as a whole of insufficient stable sources of funds for building reserves are clearly considerable. Many developing and transition economies face high costs, either through borrowing - where borrowing is possible - or through contractionary policies, of acquiring and holding reserves. On the other hand, the costs, both to individual countries and to the system as whole, of SDR allocations are relatively low. As Mussa (1996) writes:

> *'..the vast majority of the Fund's membership accounting for about half of Fund quotas faces net costs of holding reserves that are higher, in many cases significantly higher, than the true economic cost of creating reserves through SDR allocations.'*

As will be argued in Section IV, periodic, modest allocations of SDRs could help to eliminate the liquidity constraints faced by many developing countries, thereby encouraging economic growth. In those cases where countries face severe liquidity shortages, the temporary allocation of SDRs could help address these problems and prevent what should be short-term liquidity crises from developing into full-blown financial and economic crises. It is to this application of SDR allocations that the paper now turns, in Section III.

III An Emergency Financing Facility funded through Temporary Allocations of SDRs

III.i Introduction

The provision of emergency financing during crises is an essential element of the international system to prevent and manage financial crises. Inadequacies of the current method of provision of systemic emergency financing were made clear during the recent crises in East Asia, Russia, and Latin America. One of the major problems highlighted was inadequate funding of such financing. The sheer scale of international capital flows and their volatility, means that large-scale official emergency funding is required in times of crisis in order to restore confidence. Under the present system of IMF-led rescues supported by bilateral financing, official resources are unlikely to come anywhere near the level necessary. In 2000, Michel Camdessus said:

> *'In the crises of 1997-98, when several systemically important countries simultaneously needed large support, the resources of the IMF were stretched to the limit. In a more widespread conflagration, a truly systemic crisis, what would happen? The IMF's resources substantial though they are, could be completely inadequate.' (Camdessus: 2000)*

The current inadequacy of funding for emergency facilities is a crucial issue, as it undermines the effectiveness of rescue packages if the market believes that sufficient financing will not be forthcoming.[3] As IMF funding and bilateral financing are likely to continue to be insufficient and unreliable in times of financial crisis, the temporary use of SDRs to finance a systemic emergency facility could be a solution.

[3] See also Ocampo, 2001

III.ii The Case for the Temporary Use of SDRs during Crises

The provision of sufficient international official liquidity during crises is an essential element of a new global financial architecture, hopefully at a speed and at a level that would prevent such crises developing and/or spreading to other countries. If the IMF were able to adequately support individual countries facing severe short-term liquidity problems, this would also be more cost-effective as the international community would benefit from the efficiency gains of collective insurance, provided by sufficient official international liquidity. This as opposed to the less efficient and more costly method of individual insurance - in this case, the holding of very high levels of reserves at the national level.

The contingency financing mechanisms that have been created in recent years, and in particular the CCL, could be further developed to form the basis of an emergency financing facility for countries facing financial crisis and contagion effects. The temporary creation of SDRs could help ensure that such a systemic emergency facility is properly financed, and therefore truly effective. SDRs would provide relatively rapid additional global liquidity in times of crisis, reducing the risk of delays involved in negotiating Fund quota increases or arrangements to borrow.[4]

Additional issues of SDRs could be allowed specifically to respond to crisis episodes when several countries face financial distress simultaneously. The SDRs created could then be destroyed when the crises subsides and as borrowings are repaid.[5] An emergency facility mechanism such as this, based on the temporary use of SDRs, could provide a vital anti-cyclical element in global liquidity.

Some G-7 countries have been extremely hesitant over the use of SDRs in the past, chiefly due to fears that increased global liquidity would have inflationary consequences. In crisis conditions, these fears are unfounded as there is a contraction of private liquidity going to emerging countries during crises, which the SDRs would replace. As soon as the crisis subsides, SDRs would be repaid ensuring that there would be no inflationary impact.

An emergency financing facility of this type would bring some of the benefits associated with the lender of last resort (LLR) function at the national level, to the international level – although it would not function exactly as an international lender of last resort. In the national context, the lender of last resort (usually the Central Bank) can automatically disperse unlimited sums to support the banking industry. Since the introduction of the LLR function at the national level, the incidence of bank runs has decreased significantly. The existence of the LLR facility, even if it is not used, upholds market confidence in times of financial disturbance, making a rush to withdraw deposits unnecessary. While an emergency facility at the international level would not replicate the LLR at the national level, SDR allocations would be superior to limited IMF funds in providing the large-scale support that is needed during a crisis

[4] See UN, 1999

[5] See also UN, 1999

to restore market confidence. By helping countries avoid contagion from financial crises and reducing their adverse economic effects, the case for SDRs increasing the stability of the global economy is a very strong one.

III.iii Response to Crises under the Current Arrangements, and the Cost of Crises

During financial crisis episodes, IMF funds come under stress and new arrangements to borrow have to be negotiated. Despite a marked improvement in the IMF's liquidity position due to the recent quota increase, the Fund's resources would still be insufficient to deal with a systemic financial crisis involving a number of emerging market and developing countries. Table 1 shows the scale of some of the Fund-led rescue packages of the 1990s.

Table 1. Scale and Composition of IMF-led Rescue Packages (in US$ billions)

	IMF	World Bank and Reg. Development Banks	Bilateral	Total
Mexico – 1995	17.7	-	31.1	48.8
Thailand – 1997	4.0	2.7	10.5	17.2
Indonesia – 1997	11.2	10.0	21.1	42.3
Korea – 1998	21.1	14.2	23.1	58.4
Russia – 1998	15.1	6.0	1.5	22.6
Brazil – 1998	18.1	9.0	14.5	41.6

Source: Mohammed, 1999

In the absence of sufficient resources available at the IMF itself, the Fund's ability to provide sufficient liquidity in crisis depends on arranging funding from different sources. These negotiations, when a crisis is already under-way, introduces harmful uncertainty on the timing, the scale, and the conditions of lending. This has a number of negative impacts.

Uncertainty about resource availability during a crisis, in terms of both the timing and the scale of financing, can deepen market instability. In the past, there have been instances where the need to negotiate bilateral deals for additional funding has caused serious delays in the release of funds to the IMF, and therefore to the countries in distress. This at a time when the rapid release of funds is absolutely crucial. When financial markets panic and rush to withdraw from a country, the situation can deteriorate extremely quickly. This means that a delayed response can make the difference between a short-lived episode of financial difficulty and a full-blown financial and economic crisis.

The IMF conditionality attached to rescue packages has also come under wide-spread criticism in recent years for straying into a range of areas that are not directly related to the crisis and its causes; sometimes reflecting the specific interests of bilateral contributors of funds. During the Asian crisis, reportedly some of the conditions attached to rescue packages for crisis-hit countries reflected more the interests of the US than the interests of the international community or the country concerned.[6] This actually goes against the principle of multilateralism, which should imply that the IMF be able to draw on the resources it needs, subject only to approval by the Fund Board (Ahluwalia:2000).

The Cost of Crises

Recent experience of financial crises has shown that what began as crises of liquidity, such as in Mexico and some of the East Asian countries, can rapidly develop into deeper financial, economic and social crises as economies are starved of funds when they most need them. Due to herding behaviour in financial markets, contagion effects mean that countries can be hit by crises when there has been little or no deterioration in their fundamentals – they simply become victims of changing perceptions of risk. Crises and contagion effects originating in developing countries also pose a threat to the industrialised countries, and the global financial system as a whole, as was evidenced with the LTCM episode.

The negative impacts of crises in developing countries, in terms of economic development and poverty reduction, can be very pronounced. GDP decline is often very sharp following financial crises. An IMF study looking at 50 crisis episodes over the period 1975-95 found that the average output loss following a currency crisis is 15 per cent of GDP, and that average recovery time is 3 years.

Crisis-hit countries often have to undergo a brutal adjustment and deep recession before recovery can begin. In the light of capital outflows, the countries affected by the financial crisis needed to generate large current account surpluses. This requires cutting domestic spending and investment through a combination of high interest rates, public spending cuts and increased revenue. Contractionary responses such as these often produce substantial economic and social costs for the country, as well for the global economy.

There are a number of channels through which the macroeconomic shocks associated with liquidity and financial crises impact on the real economy and the lives of poor people. Interest rates rise, hurting domestic banks and local firms. A devaluation of the currency means that firms and banks which have borrowed in foreign currency to finance domestic activity see the value of their external debt stock rise and their interest payments shoot up. Firms then have difficulty meeting interest payments and obtaining new credit. The negative impact on local firms and banks becomes self-reinforcing. Banks are affected not only by higher interest payments on their own borrowing, but also by the higher levels of non-performing loans as their customers are affected by the economic downturn. Higher interest rates and bank restructuring lead to a significant tightening of credit - or a 'credit crunch'.

[6] For example, some of the conditions attached to Korea's loan.

This deepens the recession, and creates further problems for banks and firms – reinforcing a vicious circle of recession and lack of credit. Recession leads to widespread bankruptcies, with small-scale enterprises most adversely affected by the more difficult operating environment. These impacts directly effect peoples lives as demand for labour is reduced, which results in lower employment levels and wage rates, which together with higher prices impacts negatively on household incomes. Crises also have a negative impact on the level of public transfers, with cuts in government spending and the provision of basic services.

A badly hit economy can be constrained for years following a crisis, with very negative consequences for poverty. Delays in responding to liquidity shortages in developing and transition economies, and insufficient funding of emergency facilities, can mean the difference between temporary liquidity difficulties and full-blown financial, economic and social crises. An efficient emergency financing facility is therefore one of the most essential elements of the international financial architecture.

III.iv Mechanisms for the use of SDRs in an Emergency Financing Facility

The international community could create a new contagion facility that would be managed by the IMF, and funded by a general allocation of SDRs to all members (see also The Council on Foreign Relations:1999 and Camdessus:2000).

An effective contagion facility could have the following elements: i) large-scale resources, sufficient to restore market confidence during systemic crises affecting a number of emerging market countries simultaneously ; ii) short-term lending, at high interest rates; and iii) rapid disbursal. Indeed, automaticity should be a key characteristic of an emergency financing facility and could be made practicable by a system of pre-qualification.

The Contigency Credit Line (CCL) could be adapted to overcome its current limitations. This improved CCL could be partly of fully funded by temporary allocations of SDRs. To remove the stigma associated with the CCL in its current form, countries could pre-qualify through the regular Article IV consultations with the Fund. Countries with a very good Article IV, could automatically qualify for the CCL after a set period of time (for example, three months) of continued good performance. This pre-qualification would allow lending to be disbursed to countries automatically once a crisis breaks – thus preventing the costly delays that have interfered with the effectiveness of crisis responses in the past.

Within this context, a general allocation of SDRs would be a special tool at the Fund’s disposal when it had to deal with exceptional crises. Those emerging market countries at risk from contagion would use their allocation of SDRs, while the industrialised countries would contribute their share of SDRs to a common pool that would be used to fund the new facility. A general allocation of SDRs to all members[7] would be superior, in legal terms, to an ad-hoc scheme of releasing SDRs for a particular group of countries; in this case, countries suffering crises. While a special allocation of SDRs to the IMF would require an Amendment to the Fund's Articles, and would therefore be difficult to secure, a general allocation of SDRs only requires a super-majority (85 per cent) at the Fund Board. The disadvantage of a special allocation of SDRs is well illustrated in the recent UN High-Level Panel Report (2001): in 1997 the IMF agreed to a one-time allocation of SDRs for a specific purpose, four years later the required amendment to the Articles is still in the process of ratification.

IV The Case for Periodic Allocations of SDRs

As we saw in Section II of this paper, the costs of insufficient stable sources for building reserves, both to individual countries and to global system as a whole, are considerable.

Access to international capital markets to supplement reserves is restricted to the industrialised, and some middle-income, countries. The majority of Fund member countries - especially low-income and small economies - are therefore forced to acquire reserves either through expensive borrowing – where that is possible – or through some sacrifice of growth. This very often hampers reform efforts and slows economic growth. This is of increasing concern, as many developing and transition economies now feel obliged to hold high levels of reserves to reduce their vulnerability to crises. As the Zedillo report states:

> *The additional reserves not financed by current account surpluses have been borrowed on terms distinctly more onerous than they would receive on SDR issues; indeed, emerging markets are currently paying an average premium of about 8 per cent over U.S. Treasury bond rates. The result is a large flow of what is sometimes called 'reverse aid', which in the aggregate is not far short of the flow of conventional aid from the DAC countries.*[8]

Moreover, if a large proportion of reserves are made-up of borrowed funds, vulnerability to financial crises and contagion effects can actually increase.

Financial fragility in the reserve issuing countries is the other side of the same coin. Explaining that despite the fact that, historically, this has not been perceived as a particularly pressing problem, the Zedillo Report goes on to say: '..the unprecedented size of the U.S. current account deficit that has emerged, in part as the counterpart to this desire to build up dollar reserves, is now too large for comfort.'[9]

On the other hand, the costs of SDR allocations are relatively low. SDR allocations of the size that have been proposed would still only represent a small proportion of the

[7] Ie, in exact proportion to IMF quotas
[8] Technical Report of the High-Level Panel on Financing for Development, UN, 2000
[9] The Technical Report of the High-Level Panel on Financing for Development.

global money supply, and would not have an impact on the global rate of inflation. There is, therefore, a strong case for periodic allocations of SDRs to improve the quality of the global stock of reserves, and to increase global financial stability. This is particularly the case when global inflationary pressure is low, as it is at the moment.

If there were periodic SDR allocations, countries – especially developing countries – would be more willing to reduce current account surpluses, as the larger issue of SDRs would help them build up the high reserves they feel they need to counter the instability and volatility of international capital flows.[10] Increasing the ratio of SDRs would also increase the quality of global reserves, reducing the vulnerability to changes in market perceptions that is associated with a high level of dependence on borrowed funds. SDR allocations could also facilitate a reduction of the US current account deficit, or any similar future imbalances.

Developing countries would be able to grow more as imports could be higher, due to a lower level of required reserves that were either earned via exports or borrowed from international capital markets. More rapid growth in developing countries would not only be beneficial for them and their people, but would help encourage and sustain growth globally. In the middle of 2001, this seems a particularly powerful argument.

Conclusions

In recent years there have been major differences about the future role of the SDR in the international financial system. The major industrialised countries have repeatedly blocked moves for a new allocation of SDRs. For the reserve currency issuing countries, other industrialised countries and even some of the middle-income countries - during some or most of the time - , international capital markets can meet their liquidity requirements.

However, for the vast majority of developing and transition economies, the cost of acquiring and holding reserves is very high, whether it be through borrowing - where this is possible - or through adjustment. This has a negative impact on the capacity of many countries to finance growth and poverty reduction. Large deficits in reserve-issuing currencies can also bring their own problems, and may threaten global financial stability. Indeed, the very large and growing size of the US current account deficit could become very problematic and destabilising.

The time has come, therefore, to revisit the case for using SDRs to increase world reserves in a way that would not oblige countries to run either large surpluses or large deficits, as these are costly and potentially destabilising. Periodic SDR allocations could play a useful role in improving the distribution and quality of total global reserves.

A more specific role for SDRs in the international financial system could be the provision of sufficient resources to the IMF for financing large-scale official

[10] For a proposal on allocations of SDRs in accordance with the reserve needs of individual countries, see Buira 1996.

emergency lending in times of crisis. The current level of IMF resources, despite recent increases, cannot be relied upon to provide the scale of lending necessary to restore market confidence during periods of intense financial panic. In this sense, it is welcome that the G-24, at their September 2000 meeting in Prague, reiterated their call for a study on a systemic emergency facility financed through the temporary creation of SDRs.[11]

The SDR could therefore usefully play a stronger role in the international financial system, encouraging greater stability and bringing net benefits for both developing countries and the global system as a whole.

[11] The G-24 Communiqué proposes that the study be prepared in time for discussion at the autumn 2001 Bank-Fund meetings.

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