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Emerging SDR Standard?

There is a stirring in the air of international finance, as the SDR becomes more widely adopted as a unit of account in private as well as official international transactions. The role of SDRs—Special Drawing Rights at the International Monetary Fund—could become increasingly important if the U.S. dollar continues indefinitely to float in terms of major foreign currencies in the foreign-exchange market.

In the official world, both Iran and Burma recently announced that they would peg their national currencies to the SDR rather than to the dollar. In the area of private transactions, an Austrian bank received permission from the Austrian government to issue certificates of deposit denominated in SDRs, while the International Air Transportation Assn. began studying a proposal to set overseas air fares in terms of SDRs. Admittedly, these are only a few straws in the wind, but further developments of this type could have a far-reaching impact on the future course of world trade and finance.

SDRs are a form of reserve asset created by international agreement and used for official settlement of international imbalances among the member nations of the International Monetary Fund. They cannot be used for private transactions. Since the initial creation of SDRs in January 1970, 9.3 billion SDRs have been allocated to IMF members. The value of the SDR has fluctuated over time in terms of the U.S. dollar, most recently around the level of \$1.24 per one SDR.

Problems with dollars

The wide fluctuations in exchange rates occurring in the past several years have helped generate support for the SDR as a standard unit of international value. In the past six months alone, the dollar has dropped by more than 20 percent against the Swiss franc and by about 14 percent against the German mark and the Belgian franc. Over the longer span since May 1970, the decline in the international value of the dollar has been even larger—53 percent against the Swiss franc, 47 percent against the German mark, and by smaller amounts against other major currencies.

These declines in the value of the dollar have also meant declines in the exchange value of the many things tied to the dollar—national currencies, financial assets, international air fares, commodity prices, and so on. Such declines can have far-reaching effects on world trade and finance. For instance, when a foreign country depreciates its currency with the dollar against other major currencies, it tends to make its own exports cheaper, and its own imports more expensive, in terms of other currencies. This reduces the real income and increases the domestic inflation rate of the country with the depreciating currency. In private international transactions, both borrowers and lenders are exposed to considerable exchange risk when the financial instrument they are dealing with—say, an international bond—is denominated in dollars. International airlines are exposed to an assortment of problems

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arising from exchange-rate variations, such as the possibility of ticket arbitrage among different national currencies.

To a large extent, these risks can be adequately covered through the market mechanism: for instance, through futures transactions in the foreign-exchange market to cover trade risks, or through the matching of foreign-currency assets and liabilities to protect against balance-sheet risks. However, such avenues are not always available, or are available only at considerable cost. Hence the need for a more stable international unit of account than the U.S. dollar.

Stability through SDRs

The SDR increasingly seems to fill the bill. Since July 1974, the value of the SDR has been set daily by the International Monetary Fund according to a fixed formula which involves the exchange values of the sixteen "SDR-basket" currencies. At its inception in January 1970, the SDR was valued at one U.S. dollar (equivalent to 0.888671 grams of gold), but the two devaluations of the dollar in terms of gold, followed by the floating of the dollar against major currencies, persuaded the IMF to adopt the present method of SDR valuation.

Each day the IMF calculates the value of the SDR in terms of fixed amounts of the sixteen basic currencies—specifically, 40 U.S. cents, 38 German pfennigs, 4.5 British pence, 44 French centimes, 26 Japanese yen, and so on—each valued at its current market-exchange rate. The IMF also derives the SDR value of currencies which are not in the standard basket by translating their values in terms of some standard currency, such as the dollar. Thus, at its daily fixing on February 12, the SDR was set equal to 1.239 dollars, 2.913 marks, 361.9 Japanese yen, 83.8 Iranian rials, 0.359 Kuwaiti dinars, and so on.

By pegging its currency to the SDR rather than the dollar, a country increases the stability of its currency in terms of most non-dollar currencies, even though reducing it in terms of the dollar. Thus, Iran by its recent action achieved a greater stability for the value of the rial in terms of most currencies other than the dollar. Assume a 10-percent depreciation of the dollar against the German mark. In that case, an SDR-pegged rial would depreciate by only 3.3 percent against the mark—reflecting the dollar's one-third weight in the SDR basket—instead of the full 10-percent depreciation that would have occurred if the rial had remained tied to the dollar. In the same case, an SDR-pegged rial would appreciate by 1.25 percent against the dollar—reflecting the

mark's one-eighth weight in the SDR basket—instead of remaining unchanged in dollar terms.

Similar considerations apply to the denomination of international debt instruments in the SDR rather than the dollar. This action would reduce the exchange risk for both lenders and borrowers with respect to most non-dollar currencies, but would increase the risk with respect to the dollar. Again, setting international fares in terms of the SDR would mean smaller fluctuations of receipts in non-dollar currencies, but greater fluctuations in dollar receipts.

How widely used?

It is difficult to predict how widely the SDR might be adopted as a unit of account in international transactions. For governments, the decision will depend on the importance of each nation's trade with the United States, relative to its trade with other countries whose currencies now float against the dollar. For private businesses, it will depend on whether adequate exchange cover is readily available at reasonable cost. One major area of interest today concerns the world petroleum market. Oil-producing countries are reportedly considering a plan to price oil in terms of the SDR rather than the dollar. If they did so, the short-run dollar price of oil would then fluctuate with the dollar exchange rate; but the long-run price of oil would still be determined by

underlying supply-and-demand considerations, unaffected by the unit of account oil is priced in.

It should be emphasized that the increasing use of the SDR as an international **unit of account** would not necessarily diminish the use of the dollar as an international **means of payment**. As noted above, SDRs are transferable only among IMF members, and hence cannot be used in private transactions. The SDR thus is analogous to the quaint British unit of account, the guinea. (Formerly, one guinea equalled 21 shillings while one pound equalled 20 shillings.) In the British system, any change in the value of the pound in terms of guineas affected only the sterling prices of goods so denominated, but not the use of the pound in the British monetary system. Similarly, it is unlikely that the SDR might one day replace the dollar as an international means of payment.

In summary, the denomination of international values in terms of the SDR is an interesting indexing device—a device which may become widespread if exchange rates continue to float indefinitely. Continued use of the SDR would reduce, though by no means eliminate, exchange risks in international transactions.

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