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SPECIAL DRAWING RIGHTS AND THEIR IMPLICATIONS FOR DOMESTIC AND EXTERNAL FINANCE

WHAT SPECIAL DRAWING RIGHTS ARE

The need to create the new international monetary asset called Special Drawing Rights (SDRs) arose largely from the widening gap between the volume of world trade and the means of financing it (that is, international monetary reserves). Such reserves (collectively comprising international liquidity) constitute those over which the monetary authorities of the individual countries have unconditional and immediate command. They are made up of monetary gold,[1] convertible currencies (mainly U.S. dollars and £'s sterling) and members' reserve positions in the International Monetary Fund.[2] The major functions of these reserves are to facilitate trade and exchange, and to provide means of financing the temporary imbalance which arises between international payments and receipts. However, since 1960, the volume of world trade has been rising at a faster rate than international reserves. While world imports rose at an annual growth rate of 11·3 per cent from $119·4 billion in 1960 to $254·4 billion in 1969, total world reserves only rose at an annual growth rate of 2·8 per cent from $60·2 billion in 1960 to $76·9 billion in 1969. The idea of creating SDRs was conceived to avert any shortage of international liquidity arising from the widening gap between world trade and the means of financing it. The Special Drawing Rights scheme was first adopted by the International Monetary Fund in Rio de Janeiro in September 1966. To accommodate the scheme the I.M.F. Articles of Agreement were amended and approved by the Board of Governors, in resolution No. 23-5 adopted on 31st May, 1968. Two separate accounts were created under the amendment :—

(*a*) a General Account for the existing I.M.F. operations;

(*b*) a Special Account for Special Drawing Rights.

Transactions in the Special Account can be used to meet obligations in the General Account. The scheme was activated on 1st January 1970 when the first allocations totalling $3·5 billion were made to member-countries. Subsequent issues for 1971 and 1972 were fixed at $3 billion each. Allocations were made on the basis of, and in proportion to, the quotas of member-countries. Thus in 1970, Nigeria, with a quota of $100 million, received a total allocations of $16·8 million Special Drawing Rights.

LIQUIDITY OF SDRS

Special Drawing Rights are 'paper gold', transferable among the participating countries who are committed to accept them in exchange for convertible currencies (that is, currencies that can be used in international payments and exchange). Special Drawing Rights are guaranteed in terms of gold carrying a rate of interest fixed at 1·5 per cent per annum. Any country's acquisition and use of Special Drawing Rights would have exactly the same function, effect, and liquidity as its acquisition and use of gold and foreign exchange. Special Drawing Rights therefore constitute additional genuine foreign exchange reserves since national monetary authorities stand ready to accept them in settlement of international transactions.

FUNCTIONS AND OPERATIONS OF SDRS

Every participating country is entitled to use its Special Drawing Rights to acquire an equivalent amount of convertible currencies unconditionally for balance of payments or reserve needs. A country can be in balance of payments surplus and still use Special Drawing Rights : if it is redeeming liabilities at a more rapid rate than the rate of increase of its surplus on all transactions, it can use a combination of its "reserves" and Special

[1] A distinction is usually made between gold held by a monetary authority (e.g., a central bank) and that held by private individuals. The former is "monetary gold" while the latter is "non-monetary gold". Gold can however move from a private individual to a monetary authority through purchase and vice versa.

[2] This comprises both the unconditional and conditional positions in the I.M.F. The unconditional position is the "gold tranche" position of a country, that is, its gold subscription to the I.M.F. Nigeria's gold tranche position is currently $11·3 million.

Drawing Rights to meet the difference. On the other hand, a country cannot use its Special Drawing Rights when its total holdings of gold, foreign exchange and its reserve position in the Fund are increasing, or would increase thereby. Participating countries cannot use Special Drawing Rights merely to change the composition of their reserve assets. The outline of the plan for Special Drawing Rights states that except under the guidance of the I.M.F. "a participant will be expected to use its Special Drawing Rights only for balance of payments needs or in the light of developments in its total reserves and not for the sole purpose of changing the composition of its reserves". This proviso is designed to ensure that participating countries use other reserve assets as well as Special Drawing Rights to meet their obligations. Otherwise, participants could, for example, use their Special Drawing Rights to acquire dollars on sterling and then use these to acquire gold, which in certain circumstances may appear more attractive than other reserve assets. For this reason participants in Special Drawing Rights must maintain, over time, a balanced relationship between their holdings of Special Drawing Rights on the one hand, and their holdings of gold, convertible currencies and reserve position in the Fund, on the other.

A participant with a need to use Special Drawing Rights as defined by the Articles of Agreement has the right to transfer them to participants designated by the Fund as transferees. The Fund would then make arrangements for the exchange of such SDRs into needed currencies convertible in fact.

Special Drawing Rights may also be exchanged for convertible currencies in bilateral transactions. For example, participant *A* may enter negotiations with participant *B* to exchange *A's* Special Drawing Rights for *B's* currency. In such a case both parties to the agreement are required to inform the Fund of the details of the transaction which they are entering into and at the same time indicate the legal authority for the transaction. Special Drawing Rights can also be used to meet repurchase and other obligations in the Fund.

THE "RECONSTITUTION" PROVISION

Over a five-year period, a country can use up to 70 per cent of its net cumulative allocations of Special Drawing Rights to meet balance of payments needs. That is, such use of Special Drawing Rights should not exceed 70 per cent of the country's average cumulative net allocations. In effect, a participant would not be expected, on a daily average basis, to hold Special Drawing Rights of less than 30 per cent of the average of its net cumulative allocations over a specified period of five years. If a participant should use more than 70 per cent of its SDRs during this period it would be expected to restore its minimum position to 30 per cent of holdings of SDRs (i.e., to buy back Special Drawing Rights in order not to exceed the maximum use of 70 per cent). This procedure, whereby a participant acquires Special Drawings Rights to meet its required minimum holdings is referred to in the Fund's technical parlance as "reconstitution". Its purpose is to prevent a country from financing persistent deficits on reserve losses by the exclusive use of Special Drawing Rights.

The net holdings of the participants' Special Drawing Rights are to be determined over each calendar quarter after the first five years following the initial allocation. However, two years after the first allocation, i.e. January 1972, the Fund will make monthly calculations to determine if the monthly ratios of participants' net holdings of Special Drawing Rights would enable them to fulfil the requirement to hold not less than 30 per cent of the average of their daily net cumulative holdings over the period of the first five years. A participant will be notified by the Fund when its holdings of Special Drawing Rights are found to be less than 30 per cent of its average daily net cumulative allocation over the basic period, and it will be the participant's responsibility to acquire Special Drawing Rights to meet the requirements for average minimum holdings. A country can use its entire allocation, but it must either spend a smaller proportion of the subsequent year's allocation or buy back Special Drawing Rights from other countries so as to keep its average use down to 70 per cent. For example, Nigeria, **which received $16·8 million Special Drawing Rights in January 1970, may receive $14.1 million for 1971 and 1972, respectively, on the basis of the existing quota of $100 million, could make use of all its SDRs but would later have to reconstitute or reacquire $13.5 million within five years.**[1]

[1] **Effective 30th October, 1970, new quota increases were made to member countries of the Fund which may affect SDRs allocations in 1971 and 1972.**

Thus, designated participants in the scheme are obliged to accept Special Drawing Rights in exchange for other designated currencies. When a country's holdings of Special Drawing Rights total three times its original allocation, it is entitled to refuse any additional accumulation.

INTERNAL ACCOUNTING FOR THE SDRS

The I.M.F. prepared an illustrative system of accounting, showing the following features which each country can adapt to local conditions.[1] There are four processes involved :—

(*a*) Initial allocation of 100 SDRs should be recorded thus—

	Dr.	*Cr.*
Holdings of Special Drawing Rights	100	
Allocations of Special Drawing Rights		100

That is, holdings appear on the assets side and allocations on the liabilities side[2]. This procedure was suggested to make Special Drawing Rights accounting correspond with the Fund's own account title. Thus, when the Central Bank in its balance sheet shows the asset item, "Holdings of SDRs", to record allocations, the debit entry will correspond to a credit entry in the Special Drawing account, "Holdings of SDRs by participants" and the credit entry in the Central Bank's books to the account, "Allocations of SDRs", will correspond to the debit entry in the Special Drawing account, "Net Cumulative Allocations of Special Drawing Rights to Participants."

It is also suggested that the asset item, "Holdings of SDRs", should be included in the category, "Gold, foreign currencies, etc.", in the balance sheet because of the reserve characteristics of this asset. For all participants, it is recognised that the Special Drawing Rights are international assets as good as gold or foreign exchange, though not tangible or physical.

(*b*) Use of SDRs: If a participant uses its SDRs, say 50, to acquire foreign exchange, the result is an increase in one asset (foreign exchange) and a decrease in another asset (SDRs) so that the liabilities side remains unchanged.

Assets		*Liabilities*
Holdings of SDRs (decline by 50)	50	100
Foreign exchange (x + 50)		
x + 100		x + 100

(*c*) Settlement of net charges and assets = 10

A participant must use Special Drawing Rights to settle net charges or assessments levied at the end of the Fund's financial year. A participant can also use Special Drawing Rights to pay charges to the Fund in connection with the transactions on the General Account. Payment of charges implies a net use of SDRs which may cause the average holdings to fall below the net cumulative allocation. Profit and loss (expense account) is debited and holdings of SDRs credited, Thus—

Assets		*Liabilities*
Holdings of SDRs (decline by 10)	40	
Profit and loss		x=10

(*d*) Repurchase of participant's currency from I.M.F. General Account = 10

A participant can transfer SDRs to the general account in settlement of repurchase obligations as shown below :

	Dr.	*Cr.*
Other liabilities (I.M.F. deposit account) ...	10	
Holdings of Special Drawing Rights		10

EXTERNAL FINANCIAL IMPLICATIONS OF SDRS

Earlier, mention was made of the liquidity of the Special Drawing Rights. Also, as shown earlier, the participant in the Special Drawing Rights is the country concerned, and the SDRs are allocated to the government of the country through its fiscal agent. In Nigeria, the Federal Ministry of Finance acts as fiscal agent to the I.M.F. on behalf of the Federal Government under Article V, section 1 of the Fund's Articles of Agreement. However, by domestic arrangement, the Central Bank of Nigeria meets the Government's obligations to the Fund, thus assuming full responsibility for rights and obligations to the I.M.F. One can

[1] See I.M.F. "Accounting for Special Drawing Rights", SM/69/147, September 26, 1969.
[2] The accounting system here is based on balance of payments accounting where an increase in assets is debited and an increase in liabilities is credited.

assume that this arrangement will be extended to the SDRs. The Central Bank, as the holder of the country's gold and foreign exchange, will thus be enabled to carry Special Drawing Rights so acquired as part of its assets. As shown earlier, Special Drawing Rights can be used to obtain foreign currency to meet balance of payments needs. Once total SDRs allocated to Nigeria have been added to total reserves, the use of holdings of Special Drawing Rights by the Central Bank to acquire foreign currency will only change the distribution of the Bank's foreign assets among different types of assets, without changing the total.[1] If the Central Bank should sell foreign exchange to domestic users in exchange for domestic currency, and the deficit in the balance of payments should persist, the instantaneous reduction in foreign assets and the attendant balance of payments deficit would be brought about by the use of a combination of the various forms of foreign assets - - - gold, foreign exchange and Special Drawing Rights. If the reduction in net foreign assets should also lead to a reduction in money supply, it would also be because of the use of various forms of foreign assets.

Similarly, the increase in Special Drawing Rights against a corresponding reduction in the Central Bank's holdings of foreign exchange would only result in a redistribution of foreign assets and not in a change in the aggregate. If a country's balance of payments is in equilibrium and there should be an increase in holdings of Special Drawing Rights, the result would be an overall balance of payments surplus, which could, depending upon policy decision, lead to an increase in money supply.

The totality of the argument points to the liquidity of Special Drawing Rights and to the fact that they are as good for currency cover requirements as gold and foreign exchange. Thus, the inclusion of Special Drawing Rights in the currency cover requirement would enable the Central Bank to increase its capacity to create currency when the volume of Special Drawing Rights increases, either by direct allocation or by way of balance of payments surplus.

DOMESTIC FINANCIAL IMPLICATIONS OF SDRS

Depending on policy decision, domestic monetary expansion can also result from an increase in the volume of Special Drawing Rights acquired either by direct allocation or by way of balance of payments surplus. The reverse would be true if holdings of Special Drawing Rights decrease. As shown earlier, while allocation of Special Drawing Rights is made to the country through its fiscal agent, the transfer of SDRs by the Federal Government to the Central Bank poses a different question. As the Central Bank would then hold the international asset, the Federal Government might insist on an equal amount of local currency. The effect would be expansionary of money supply if the Government should decide to spend the local currency. In order to avoid such a situation, the I.M.F. has made a suggestion that the Government could hold a special deposit in a blocked account with the Central Bank in local currency equal in value to the country's net cumulative allocation, so that the money supply effect would be neutral. If the country should finally withdraw from participation in Special Drawing Rights, or if the allocations should be recalled, the blocked account could then be used to acquire the Special Drawing Rights without affecting money supply.[2]

SUMMARY

The Special Drawing Rights have been presented here as a new, additional instrument of international means of payment. They perform the same function as gold and foreign exchange which constitute the foreign exchange reserves of a country and therefore are as liquid as those assets. The Special Drawing Rights are also as good as gold and foreign exchange for the purpose of local currency cover. They can be used to acquire an equivalent amount of convertible currencies from other participants in the Fund in order to meet balance of payments or reserve needs. They can also be used to meet other repurchase obligations in the Fund, including interest charges. For all these purposes, a country can, on the average, use 70 per cent of all holdings of Special Drawing Rights over a period of five years.

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[1] See the section, "Internal Accounting for the SDRs", *supra*.
[2] See I.M.F., "Certain Domestic Financial Aspects of Special Drawing Rights", SM/68/131, July 31, 1968