CHAPTER 4

SPECIAL DRAWING RIGHTS

The SDR as an International Reserve Asset

The SDR was created as a result of the First Amendment of the Articles of Agreement, which became effective in 1969. It was created as a supplement to existing reserve assets as the demand for reserves was expected to grow substantially over time in line with growing world trade. Specifically, there were concerns that the growth in the supply of reserves (which comprised mainly gold and the U.S. dollar) would be insufficient since it depended on a diminishing supply of newly-mined gold entering into official reserves and on continued and unsustainable deficits in the balance of payments of the United States. It was also thought that U.S. gold stocks would decline relative to U.S. dollar liabilities, which would eventually make the par value of the U.S. dollar relative to gold unsustainable and precipitate an international monetary crisis. The intention was therefore to establish the SDR system to expand world reserves independently of the growth of official holdings of gold and foreign exchange. Further changes to the SDR system came about as a result of the Second Amendment of the Articles of Agreement, which had as an objective to make the SDR the principal reserve asset in the international monetary system. The SDR is also the unit of account that is used by the IMF.

However, the role of the SDR as a reserve asset has been very limited and SDRs currently comprise only a small fraction of members’ international reserves. To date, only two series of SDR allocations have been made, totaling SDR 21.4 billion. International monetary conditions did not evolve as envisaged at the time of creation of the SDR. The Bretton Woods par value system broke down in the early 1970s and was replaced by a system of managed floating exchange rates. Furthermore, the growth of international capital markets meant that many countries could augment their international reserves through borrowing. Consequently, a shortage of international reserves did not materialize as expected. In addition, the SDR can only be held by official entities or approved official holders, and used in official transactions and operations. While these factors limited the role of the SDR as a reserve asset, the SDR helps lower the cost of holding reserves by reducing the need for borrowed reserves.

Main Characteristics of the SDR System

Separation of SDR and GRA Accounts

All operations and transactions involving SDRs are conducted through a Special Drawing Rights Department. All other operations and transactions on account of the IMF, including those involving the use of IMF resources, are conducted through the General Department. Assets held in the SDR Department are not available to finance the operations of the General Department, and vice-versa, except that the General Department pays the expenses of conducting the business of the SDR Department and is reimbursed in SDRs by the SDR Department. Separate financial statements are produced for the two departments.

Holders of SDRs

All IMF members have chosen to participate in the SDR Department. Participants receive allocations of SDRs, and only participants, the IMF, and prescribed official entities may hold or use SDRs. There are currently 15 prescribed official holders. The IMF and prescribed holders acquire and use SDRs through transactions with participants and with each other. The IMF receives and disburses SDRs in transactions conducted through the GRA, and holds SDRs in the GRA. Sources of IMF holdings include quota subscriptions, repurchases, interest on loans to members and on GRA holdings, and re-imbursements for the cost of conducting the business of the SDR Department. Uses of SDRs by the IMF include purchases, remuneration on members’ creditor
positions, repayments of and interest on IMF borrowing, and acquisition by members to pay charges and assessments.

**Allocation and Cancellation of SDRs**

Decisions on the allocation and cancellation of SDRs are usually made for successive basic periods of five years each. To date there has not been any cancellation. Decisions to allocate SDRs are based on a judgment that a long-term global need to augment international liquidity exists, and require approval by an 85 percent majority of the total voting power of the SDR Department. A participant that votes against the allocation or notifies the IMF that it does not wish to receive any allocation will not participate in the allocation. The IMF cannot allocate SDRs to itself or to other prescribed official holders.

Allocations or cancellations within a basic period take place at yearly intervals, although the IMF can decide to put in place other intervals. Members who become participants after a basic period starts receive allocations beginning with the next basic period in which allocations are made, unless the IMF decides that the new participant shall start to receive allocations beginning with the next allocation within the current basic period.

A proposal for a special one-time allocation of SDRs was approved by the IMF's Board of Governors in September 1997 through the proposed Fourth Amendment of the Articles of Agreement. This amendment has not yet entered into effect. The allocation would double cumulative SDR allocations to SDR 42.8 billion. Its intent is to enable all members of the IMF to participate in the SDR system on an equitable basis and correct for the fact that countries that joined the IMF subsequent to 1981—more than one fifth of the current IMF membership—have never received an SDR allocation. The Fourth Amendment will become effective when three fifths of the IMF membership (111 members) with 85 percent of the total voting power accept it. Approval by the United States is necessary to put the amendment into effect.

**Use of SDRs**

The SDR serves as the unit of account of the IMF and a number of other international organizations. In addition, some countries peg their currencies to the SDR or to a basket of currencies including the SDR. To serve its purpose as a reserve asset, the SDR must be fully convertible into foreign currency. The Articles of Agreement provide for two mechanisms to ensure the SDRs convertibility: by designating IMF members with a strong external position to purchase SDRs on demand, and by arranging voluntary exchanges between participants.

**Transactions by Designation**

Under the designation mechanism, participants whose balance of payments and reserve positions are deemed sufficiently strong may be obliged, when designated by the IMF, to provide freely usable currencies in exchange for SDRs, up to specified amounts. Members are expected to use transactions by designation only if they have a balance of payments or reserve need, not for the sole purpose of changing the composition of their reserves. The IMF prepares a quarterly designation plan to facilitate transactions by designation. The amount of designation is determined so as to promote over time a balanced distribution of holdings of SDRs among individual participants. This plan designates participants in such manner as to achieve a common lowest excess holdings ratio (that is, holdings of SDRs in excess of net cumulative allocations as a percent of their quota). Since September 1987 no transactions by designation have taken place; all exchanges of SDRs for currency have been executed through voluntary transactions by agreement.

**Transactions by Agreement**

A member may enter into an agreement with another member to use its SDRs to obtain an equivalent amount of currency from that member. Members may use this mechanism whether or not they have a balance of payments or reserve need. Transactions by agreement are facilitated by voluntary arrangements under which members commit to buy or sell SDRs if their holdings fall within a specified range, or to sell SDRs if their holdings rise above a specified upper limit. Currently there are 12 members and one prescribed holder (the European Central Bank) with buy-sell arrangements, and one member with a sell-only arrangement. There are currently no buy-only arrangements. Transactions by agreement between these members and others wishing to sell or buy SDRs are arranged by the IMF. The IMF initiates sales and purchases on behalf of members and matches sellers and buyers to ensure that all demands for currency and SDRs are satisfied. These arrangements have helped ensure the liquidity of the SDR system.
Operations

Besides transactions by designation or agreement, the IMF has also listed seven types of operations in which members and prescribed holders may use their SDRs, and the terms and conditions under which these operations may take place. These operations are: to settle financial obligations, to make loans, to make pledges, as security for the settlement of financial obligations, in swap operations, in forward operations, and to make donations. Operations take place by agreement among participants and prescribed holders. All transactions and operations in SDRs are conducted at the fixed SDR exchange rate set by the IMF using a basket of four currencies, as explained below.

Valuation of the SDR

The value of the SDR is the sum of the values of specified amounts of the four currencies that satisfy the following criteria: (i) they are issued by IMF members, or by monetary unions that include IMF members, that have the largest value of exports of goods and services; and (ii) they have been deemed by the IMF to be freely usable currencies. These four currencies currently are the U.S. dollar, the Euro, the Japanese yen, and the pound sterling (Table 4.1). The SDR value is calculated daily in terms of the U.S. dollar, using the midpoint of the buying and selling spot exchange rates for each currency against the U.S. dollar at noon on the London exchange market as determined by the Bank of England.

To fix the specified amounts of each currency referred to above, first the percentage weight of each currency in the SDR basket is determined. The percentage weight is determined by (i) the value of the balances of that currency held by monetary authorities other than those of the issuing member (the relative importance of the currency as a reserve asset) and (ii) the value of the exports of goods and services of the issuing member (the relative importance of the issuing member in world trade). The specified amount of each currency used in the calculation of the SDR value is then the amount of each currency, valued at the average exchange rate for the three-month period ending on the date on which the calculation is being made, required to give the percentage weight of that currency in the SDR basket. The list of currencies, and the amount of each, used to calculate the SDR value is reviewed every five years and are specified in Rule O-1 of the By-Laws, Rules, and Regulations of the IMF.

Yield and Cost of SDRs

The IMF pays interest on the SDR holdings by member countries to increase its attractiveness as a reserve asset. It also levies a charge on the cumulative SDR allocations to members. The rate of charge is equal to the rate of interest. Therefore, members whose holdings equal their cumulative allocation neither earn nor pay interest on SDRs on a net basis. Members who use their SDRs and thus hold less than their cumulative allocation—such as net debtors to the SDR Department—pay net charges, while members that hold more than their cumulative allocation—such as net creditors to the SDR Department—receive net interest on their excess holdings. For all members taken together, SDR interest and charges cancel out so that the net income of the SDR Department is always zero. To cover the operating cost of the SDR Department, the IMF levies an annual assessment, at the same rate for all participants in the SDR Department, on a participant’s cumulative SDR allocations.

The SDR interest rate is the weighted average of short-term market interest rates in the four countries or monetary areas whose currencies are used to determine the SDR exchange rate (Table 4.2). The interest rates used are the market yield for three-month U.S. Treasury bills, the three-month Euribor rate, the thirteen-week Japanese Government financing bills rate, and the market yield for three-month U.K. treasury bills. The weights are the SDR equivalents of the currency amounts that are in the SDR valuation basket. As in the SDR valuation, the weights are fixed for a five-year period. The SDR interest rate is calculated weekly.
### Table 4.1 Calculation of the SDR Value \(^1\)

<table>
<thead>
<tr>
<th>Currency</th>
<th>Initial weight (^2) (in percent)</th>
<th>Currency amount (^3)</th>
<th>Exchange rate (^4)</th>
<th>U.S. dollar equivalent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Euro</td>
<td>34</td>
<td>0.4100</td>
<td>1.26590</td>
<td>0.519019</td>
</tr>
<tr>
<td>Japanese yen</td>
<td>11</td>
<td>18.4000</td>
<td>117.59000</td>
<td>0.156476</td>
</tr>
<tr>
<td>Pound sterling</td>
<td>11</td>
<td>0.0903</td>
<td>1.88090</td>
<td>0.169845</td>
</tr>
<tr>
<td>U.S. dollar</td>
<td>44</td>
<td>0.6320</td>
<td>1.00000</td>
<td>0.632000</td>
</tr>
<tr>
<td>SDR</td>
<td></td>
<td></td>
<td></td>
<td>1.483151</td>
</tr>
</tbody>
</table>

Source: IMF, Finance Department.

1/ Data as of September 19, 2006.
2/ Decision No. 13595-(05/99), effective January 1, 2006.
4/ The exchange rate for the Japanese yen is expressed in terms of currency units per U.S. dollar; other rates are expressed as U.S. dollars per currency unit.

### Table 4.2. Calculation of the SDR Interest Rate \(^1\)

<table>
<thead>
<tr>
<th>Currency</th>
<th>Currency amount (^2) (against the SDR (^3))</th>
<th>Exchange rate (^4) (in percent)</th>
<th>Interest rate (^5) (in percent)</th>
<th>Product (A x B x C)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Euro</td>
<td>0.4100</td>
<td>0.857314</td>
<td>3.3053</td>
<td>0.519019</td>
</tr>
<tr>
<td>Japanese yen</td>
<td>18.4000</td>
<td>0.00574471</td>
<td>0.3350</td>
<td>0.156476</td>
</tr>
<tr>
<td>Pound sterling</td>
<td>0.0903</td>
<td>1.27268</td>
<td>4.8700</td>
<td>0.169845</td>
</tr>
<tr>
<td>U.S. dollar</td>
<td>0.6320</td>
<td>0.676382</td>
<td>4.9500</td>
<td>0.632000</td>
</tr>
<tr>
<td><strong>SDR Interest Rate (^5)</strong></td>
<td></td>
<td></td>
<td><strong>3.87</strong></td>
<td></td>
</tr>
</tbody>
</table>

Source: IMF, Finance Department.

1/ For the week of September 18 to 24, 2006. Data as of Friday, September 15, 2006.
2/ Under rule O-1.
3/ SDR per currency rates are based on the representative exchange rate for each currency.
4/ Interest rate on the financial instrument of each component currency in the SDR basket, expressed as an equivalent annual bond yield: three-month Eurepo rate; Japanese Government thirteen-week financing bills; three-month UK Treasury bills; and three-month US Treasury bills.
5/ IMF Rule T-1(b) specifies that the SDR interest rate for each weekly period commencing each Monday shall be equal to the combined market interest rate as determined by the Fund. Under IMF Rule T-1(c), the combined market interest rate is the sum, as of the Friday preceding each weekly period, rounded to the two nearest decimal places, of the products that result from multiplying each yield or rate listed above by the value in terms of SDRs of the amount of the corresponding currency specified in Rule O-1. If a yield or rate is not available for a particular Friday, the calculation shall be made on the basis of the latest available yield or rate.