China, the U.S. Dollar, and SDRs

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There has been a great deal of interest recently in China's call, issued on March 26 by Governor Zhou of the People's Bank of China, for the International Monetary Fund's SDR (Special Drawing Rights) to gradually replace the dollar as the world's main international reserve currency. As the various issues involved are importantly related to U.S. and Chinese monetary policy, it is important for us to comment on the matter, in an attempt to sort out these issues and positions taken regarding this rather confusing topic.

Governor Zhou's talk was ostensibly intended to discuss "what kind of international reserve currency … [is needed] … to secure global financial stability and facilitate world economic growth." But of course his discussion strongly reflects China's position as a holder of about one trillion U.S. dollars, that is, securities denominated in terms of dollars. Certainly, as a recent article by Jim Dorn emphasizes, Governor Zhou is worried that the current and continuing explosion of U.S. fiscal deficits will lead to a major U.S. inflation that would sharply reduce the real value of China's dollar holdings. That is not a foolish concern and does in fact suggest that the international monetary system could be facing a period of major stress.

But Governor Zhou's emphasis on a "super-sovereign international reserve currency" is not entirely appropriate. The present system is primarily based on floating exchange rates, and nations that have floating rates have in principle little need for large reserves. China has huge international reserves precisely because they do <u>not</u> permit exchange-rate flexibility but instead have <u>chosen</u> to manage their exchange rate so as to run large current account surpluses—which result in large buildups of international reserves, which they have <u>chosen</u> to hold as dollars. Their problem is thus, in part, of their own making, and reflects an export bias that works against the welfare of their own citizens.

The Governor's statement promotes the idea that "the SDR has the features and potential to act as a super-sovereign reserve currency." To think about that idea clearly, one needs to be clear about what the SDR is—or, to be more precise, what the SDR arrangements are. In that regard, the IMF's SDR provisions have two aspects: (i) a line of credit for each member country and (ii) an accounting <u>unit</u>. At the present, the accounting unit is a hypothetical "basket" consisting of 0.632 dollars, 0.41 euros, 18.4 yen, and 0.0903 pounds. At current exchange rates, one SDR has a value of about 1.49 dollars. That value fluctuates from day to day, of course, as the exchange rates of the other three component currencies move around in relation to the dollar. Now, obviously, since a unit of account is just a non-tangible accounting device, anyone can use it. That is, any loan can in principle be denominated in terms of SDR units if both parties agree to do that.

Next, how does the IMF "line of credit" work? Each IMF member country with a SDR allocation can convert its SDR credits into desired currencies of other IMF member countries at prevailing exchange rates. When a country, say Venezuela, converts its SDR claims into (e.g.) dollars or Euros, it pays interest to the IMF, while the country whose currency is "borrowed" earns interest from the organization. Membership both permits and requires countries to participate in this arrangement. So a country whose currency is in demand by others will typically have a cumulative surplus of SDR credits, with borrowing countries having a deficit. The latter will be paying interest to the former, but at <u>below-market</u> rates. Thus the SDR-surplus countries will be, to an extent, subsidizing the SDR-deficit countries (year after year) as long as the accounts of the latter remain in deficit.

Armed with this understanding, we see that the SDR is actually not a currency at all; it is not a tangible medium of exchange or a claim to one. Let us then consider how one should interpret Governor Zhou's proposal. Given the danger of U.S. inflation described above, what he wants, I would think, is for China's accumulation of dollars—i.e., China's accumulated dollar-denominated claims—to be gradually replaced with SDR credits with the IMF. It is not, as mentioned above, foolish for China to have such a desire. But it would be foolish for the U.S. to support a reorganization of the international monetary system that turns control over to the IMF, especially as the political structure of that organization will likely be changing over time in ways that will reduce the influence of the U.S. on its decisions and actions. Such support would also, arguably, be foolish from the standpoint of the world as a whole. In this regard, one needs to imagine how the world's international monetary system would function if it were managed by an agency of the United Nations.

For its own good, and for the good of the world, the U.S. can resist the SDRization of the international system. It can do so politically, but only to an extent. What can be done economically? The answer is to avoid the inflation that the Chinese fear, and which we should fear. How might that goal be promoted? By the adoption, by the Federal Reserve System, of a viable monetary standard designed to prevent inflation (either positive or negative.) A major step in that direction would be the adoption of a target inflation rate, e.g., 1.5% per year for the CPI, to be maintained as the Fed's primary monetary responsibility. The SOMC has argued before in behalf of such a commitment. It appears now that the need is greater than at any time in the past 25 years.