Reforming the International Monetary System

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The primary challenges for the existing international monetary system are: a) the weakness of market pressures to adjust international payment's imbalances for surplus countries and for deficit countries that supply international reserve assets, b) potential inability of the U.S. and the EU to supply all of the reserves likely to be demanded, and c) the risk of exchange rate instability arising from a sudden loss of confidence in the system's key reserve currencies.

The last two of these weaknesses reflect stock and flow dimensions of the system's primary reliance on the currency of one of countries participating in the system—the United States—for cross boarder payments and reserves. The replacement of the U.S. dollar with the SDR in international reserves would subject the U.S. to the same market pressure to adjust to external imbalances as is faced by non reserve currency countries. If international reserve holdings were in SDRs or some other internationally issued reserve asset, they could be supplied in any amount demanded and there would be no risk of exchange rate movements in response to changes in their demand. A loss of confidence in the ability of the U.S. to service its domestic and its external debts and to preserve the external value of the dollar would not result in the dumping of dollar reserves with dramatic exchange rate consequences. Even a partial but significant replacement of dollars with SDRs in the stock of reserve holdings and in the supply of new reserves would reduce these weaknesses with the current system.

How can we move from here to there? The supply of SDRs needs to be increased, the stock of dollar reserves needs to be reduced, and the SDR should be made more attractive in its uses and its valuation.

a) Annual allocations of SDRs should be sizable, say 50% of the forecast for the growth in reserve demand.
b) Some form of SDR substitution for existing dollar and Euro reserves should be established. This will require an agreed burden sharing of the maintenance of the SDR value of the substitution account's USD, and Euro assets.

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[reduce demand for reserves via IMF facilities]

c) The development of private SDR's should be facilitated and encouraged.
d) The SDR's valuation should be changed from a currency basket to a commodity and goods basket.

Ultimately the SDR should be issued rather than allocated by an international currency board. It should be bought and sold in response to market demand for the current day's currency value of a fix, representative basket of internationally produced goods adjusted and rebalanced every five years.

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