SiRuDoRealty, LLC

Special Drawing Rights

Paving the road to a new universal reserve currency.

By

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Introduction

The IMF created Special Drawing Rights or SDRs in 1969 after the Bretton Woods agreement in support of the agreed upon fixed exchange rate system.
Any member could draw upon the IMF to support its local currency based on the country's reserve in gold and other widely accepted foreign currencies, placed with and held by the IMF.
The two key reserve assets, the USD and gold, were not sufficient to support the expanding world trade and international financial markets.
After the collapse of the Bretton Woods exchange rate system in 1973, the IMF decided to create a new international reserve system to support the expansion of the global economy and trade.
The collapse of the Bretton Woods agreement resulted in a free floating foreign exchange market in addition to easier and more facilitated borrowing between creditworthy governments, which in turn lessened the need for SDRs.

The SDR is not considered a currency but rather a future or potential claim on freely exchangeable major currencies of participating IMF members. This can be achieved in two ways:
-The SDR holder can exchange its right directly with a participating member for one of the basket currencies.
-The IMF can designate one or more members to exchange positions between parties to balance the external currency positions in the market. This creates a balance between participating members and levels the strong external currency positions with the weaker ones.
The SDR is considered a supplement to reserve assets and is also used by other international organizations as a unit of accounting.

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The Value of the SDR

At inception, the value of an SDR was defined as 0.888671 grams of gold, which was also the equivalent of 1 USD at the time.
After the collapse of the Bretton Woods agreement, the value of an SDR was redefined as a basket of currencies, currently consisting of the Euro, JPY, GBP and USD.
Each day the IMF calculates the real value of the SDR based on midday closing prices of the basket currencies versus the USD.
They compare the midday quote in the foreign exchange markets and rebalance its value based on the sum of specific amounts of all four currencies.

Every five years, the IMF reviews the composition of the basket of currencies to adjust its value according to changing economic climates and currency fluctuations. The last revision took place in November 2005 and was primarily based on the value of exported goods and services in comparison to the reserves held in the respective currencies as held by the IMF members.
The next revision will be implemented late 2010 and will go into effect at the beginning of 2011.

SDR Interest Rates

The interest rate on regular (non-concessional) loans is based on the weighted average of the short-term interest rates prevailing in the money market of the SDR basket currencies. Rates are set on a weekly basis.

Below is an example of the basis, as used by the IMF.
Note that an average of a 3-month basis is used rather than the O/N (overnight) or T/N (tom-next) rates.
Data source: IMF weekly report.

SDR Interest Rate Calculation

For the week of August 24, 2009 to August 30, 2009 (Data as of Friday, August 21, 2009)				
Currency	Currency amount under Rule O-1 (A)	Exchange rate against the SDR [1] (B)	Interest rate [2] (C)	Product (A) x (B) x (C)
Euro	0.4100	0.915635	0.4157	0.1561
Japanese Yen	18.4000	0.00680473	0.1400	0.0175
U.K. Pound Sterling	0.0903	1.05908	0.3800	0.0363
U.S. Dollar	0.6320	0.638964	0.1700	0.0687
			Total	0.2786
			SDR Interest Rate [3]	**0.28**

Notes:

(1) SDR per currency rates are based on the representative exchange rate for each currency.

(2) 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; three-month Japanese Treasury Discount bills (effective February 5, 2009, replacing the thirteen-week Japanese Government financing bills); three-month UK Treasury bills; and three-month US Treasury bills.

(3) 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.

Allocations

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Members receive an SDR allocation based on their previously established quota. Interest is received by the member or has to be paid depending on whether the allocation exceeds or is less than the quota.

There are two types of allocations:

-General allocations

These are based on the long-term global need to add to the existing reserve assets. Such are revised and distributed over time.

The next allocation takes place on August 28, 2009 in the amount of 161.2 billion and represents a 74.1% increase of current and cumulative SDR allocations of the members.

-Special allocations

These special allocations were approved by the IMF in 1997 to allow a more equitable distribution of SDRs among all members, especially those that joined the IMF after 1981 (the last date of general allocation)

When the US joined all the other members in support of what is known as the Fourth Amendment on August 5, 2009, the amendment became effective five days later and will be implemented on September 09, 2009.

<u>The Future of SDRs</u>

While the new Fourth Amendment allows for an equitable distribution among all IMF members and certainly for those that joined the IMF after 1981 and therefore never received an allocation prior to this, it also may create some doubts and complications for the future.

The free exchange of SDRs for major reserve currencies among members can be viewed as normal market practice and does not necessarily create risk or exposure.

But how will the future look after September 2009 or January 2010?

In my opinion, it will create a secondary synthetic market among members whereby SDRs will be traded freely.

This will create two risk issues going forward.

-Lack of regulation

There is no regulatory body in such synthetic market that will control the pricing of the SDRs between buyers and sellers of the instruments and contracts.

-Lack of underlying assets

The counterparts will be able to trade fictitious contracts without holding the underlying assets, similar to the CDS market.

In essence this means that the SDRs in the secondary market will become another securitized product that will trade independent of the underwriting contract and will ultimately price itself based on intrinsic value, which in turn is solely based on supply and demand, and will omit the necessary time value based on the duration of the original instrument because of the lack of a clearinghouse.

The second consequence I predict for the future is that such unregulated and securitized exchange of an artificial product will ultimately lead to the perfect platform upon which to build a new universal reserve currency.

The latter may not be a bad thing for a global economy and will certainly alleviate any risk in the inter-currency markets as well as control the pricing of commodities, but the platform cannot consist of a synthetic market.
If such is our goal for the future, then it should be built on a well-structured platform and should be regulated by an international regulatory agency.

The Potential Impact on Major Currencies

I do not foresee an immediate impact on the USD, Euro, JPY or GBP. I believe that such legacy currencies will continue to exist for the next two decades, if not longer.
The SDR, or a variation of such, will co-exist until the basket of currencies is assimilated into a universal currency that can be traded freely worldwide and will replace the existing ones.
The role of the IMF will shift towards the role of a global central bank with lending and borrowing capacities based on reserves held.
In addition, the IMF will be able to intervene in the global market through buy-back programs and tightening or easing monetary policy on a global scale.
While some economists may find this a scary prediction, I do not see what the immediate danger to such a large-scale change.
In my opinion it will reduce the foreign exchange exposure in the markets and it will streamline the individual monetary policies that currently may contradict each other during this global economic crisis.
If we wish to continue our 1947 effort to globalize and intend to trade goods and services amongst a multitude of nations, then we should be able to look beyond the boundaries of

our own territorial economies.

A universal reserve currency may very well be a big part of the solution for future economic downturns and avoid large cyclical disruptions.

We may not see this happen in our lifetime, but I predict that our children and grandchildren will witness a major change in the global economic climate as well as the international monetary world.

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