Enhanced Special Drawing Rights: How China Could Contribute to a Reformed International Monetary Architecture

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Abstract

Since the end of the Bretton Woods era, the world has operated on a de facto system of free-floating exchange rates, with the US dollar as the dominant international currency. The system, characterized by large pro-cyclical capital flows and chronic imbalances, is inherently unstable, and has contributed to repeated crises, recessions and geopolitical tensions. One potentially "least-difficult" line of reform would be to allow the evolution of a multi-currency system, underpinned by an expanded role for Special Drawing Rights (SDRs). Attempts to promote wider use of the SDR have foundered on the liquidity premium. However, for Chinese corporations and institutions, at present restricted in their capital account activities, the SDR liquidity premium would appear less daunting. The Chinese authorities could provide policy encouragement for the use of SDRs by their institutions. This initiative, supported by China's Special Administrative Region Hong Kong, would kick-start an international SDR ecosystem, and encourage even broader use of SDRs, to the benefit of international monetary stability.

Key words: imbalances, international monetary architecture, monetary stability, reform, Special Drawing Rights
JEL codes: F33, G15, N20

I. Introduction

In the 10 years since the global financial crisis (GFC), while efforts have been made to reform banks and regulators, little has been done to improve the international monetary system. Global indebtedness has risen, trade and monetary imbalances are as high as ever, a trade war looms, and potential flash points for a further financial crisis range from Italy to emerging economies to the bond markets. Initiatives to reform the

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international monetary system are needed to provide a more stable foundation for the world's economies.

This paper sets out an initial analysis of the potential for enhanced Special Drawing Rights (SDRs) to play a role in reducing the tensions and anomalies in the present international monetary system. At present, SDRs are little more than a reserves-accounting mechanism of the International Monetary Fund (IMF); however, SDRs could be used as a fully-fledged currency alongside the dollar and the euro. To reach this desirable state would require navigating an "investment phase" during which SDR instruments are relatively illiquid and costly. Moreover, building consensus for reform in the present fractious international environment would be difficult. However, this paper suggests that actions taken by China alone could be sufficient to make a start. The Chinese mainland is in the most favorable position to promote greater use of the SDR, and this would kick-start the initiative. Hong Kong, as a Special Administrative Region of China and an international financial center in its own right, is well-placed to provide support.

The paper describes the international monetary architecture, with emphasis on its inherent problems which lead to recurrent instability and crisis. Proposals for reform of the architecture are outlined; these include a larger role for SDRs. SDR development is also described. The Chinese mainland's and Hong Kong's respective exposures to the problems of the international monetary system are explained: the Chinese mainland's being associated with its very large trade and monetary imbalances, and Hong Kong's with its currency link to the US dollar. These exposures make for large benefits for both entities if global use of the SDR can be enhanced. The present paper goes on to recommend actions to be taken by the Chinese mainland, Hong Kong and other stakeholders in the reform process in accordance with their respective situations.

The Chinese mainland would introduce policies to encourage the use of SDRs as a medium for its institutions to access international finance. Actions by the Hong Kong authorities would include supporting the use of SDRs in the international financial system, initiating a cryptocurrency version of the SDR, E-SDRs, and consideration at an appropriate point in the future of linking the Hong Kong dollar to the SDR. The benefits of these actions for the international community, as well as the stakeholders individually, are described.

II. The Present International Monetary Architecture and Its Problems

1. Architecture and Problems

Under the 1944 Bretton Woods Agreement, as subsequently ratified by numerous states not represented at the original meeting, signatories subscribed to a rules-based system

of fixed exchange rates set by reference to a US dollar linked to gold, with the IMF tasked with counteracting destabilizing speculative flows. However, with the expansion of international trade and finance, shortages of reserves (i.e. of gold and US dollars) emerged. The IMF responded to the shortage of reserves by creating SDRs in 1969 (see the following section), but within 2 years the USA had withdrawn from the gold standard, and shortly afterwards the system of fixed exchange rates collapsed.

The resultant monetary architecture, which has been in place since, has the following features (Ocampo, 2015):

1 A global reserve system essentially based on the US dollar.

2 Freedom for each country to choose its exchange rate regime, as long as it avoids "manipulation" (although the term remains undefined).

3 Current account convertibility for most countries.

4 Significant capital account liberalization since the mid-1970s, although allowing countries to control capital flows.

5 Increase in the size of IMF official balance-of-payments support.

6 Ineffective surveillance and limited macroeconomic policy coordination (now mainly through the G20, albeit with IMF support).

This era of floating exchange rates has been characterized by large international flows of capital, imbalances between nations and recurrent crises. Major episodes include the Latin American debt crisis of the 1980s, the East Asian financial crisis of 1997–1998 and the GFC of September 2007. Although monetary expansion by the world's leading central banks, aided by limited fiscal action from their respective governments, brought recovery from the GFC, it has led to increased global indebtedness (as well as rising inequality), which may lead to further crises in the future (D'Arista, 2018).

The present de facto international monetary system of floating exchange rates has been described as a "deficient nonsystem" (White, 2015). It is not rule-based, it is characterized by dangerous imbalances, and it has no oversight authority. The IMF's power for action is mainly limited to member countries facing difficulties; it has little leverage over stronger countries that may be causing the problems.

The international monetary architecture has the following major drawbacks, among others.

1 Recessionary bias. As identified by Keynes, when payments imbalances arise, deficit countries have to take action, when they are generally in the worst position to do so (corrective action exacerbates their recessions, hence the recessionary bias), while creditor countries face no such pressure. Furthermore, imbalances can persist for long periods and even deepen because speculative flows (momentum trading), "safe haven"

considerations, and other factors overwhelm fundamentals.

2 Use of national currency as international currency. As identified by Triffin, the use of a national currency (the US dollar) as the main international reserve asset requires the USA to run continuous deficits (to make sufficient dollars available to the world), which leads to recurrent crises of confidence in the dollar and consequent volatility: the Triffin dilemma. A second disadvantage is that the world is held hostage to US monetary policy, which is set based almost entirely on domestic considerations. Loose monetary policy in the USA following the GFC has had to be copied by other economies, including Hong Kong, to forestall upward pressure on their respective exchange rates, despite the unsuitability in many cases for those economies' conditions.

3 Inequity bias. To protect themselves against a balance of payments crisis, emerging economies seek to self-insure by accumulating reserves, which are mainly in US dollars. This amounts to a subsidy from less well-off countries to the largest and richest economy on Earth (inequity bias). Reserves accumulation is usually accompanied by current account surpluses, which, in turn, worsen imbalances.

Some commentators predict a long-term decline in the US dollar's value, although the "safe haven" effect and substantial network benefits are mitigating factors. The argument has been made that such widespread use of the US dollar does not even truly serve US interests in the long run because by providing easy money (creditor nations have to recycle their surpluses into US dollar assets), it masks structural problems, allowing US politicians to avoid dealing with them. This is arguably illustrated by the US tax cuts of December 2017, which increased the fiscal deficit while adding pro-cyclical impetus to the risk of inflation.

2. Reform Proposals

In 2009, the then-governor of the People's Bank of China (PBOC), Zhou Xiaochuan, voiced his dissatisfaction with the existing international monetary system's reliance on the US dollar, and expressed support for developing the SDR as an international reserve currency (Zhou, 2009). The IMF supported Zhou's stance and produced a paper on further developing the role of the SDR to reduce exchange rate volatility and excessive reserve accumulation (IMF, 2011). Yet overall, and despite the efforts of the IMF and the recent initiatives of the G-20 and the Financial Stability Forum, there has been still little action or even discussion at multilateral/inter-governmental level to address the shortcomings of the international monetary architecture.

Commentators have been more forthright. Recent comprehensive proposals to reform the international monetary architecture include the Palais-Royale Initiative (PR Initiative, 2011), which led to the Triffin International Foundation commissioning

a review of the potential role of the SDR. One recent comprehensive commentary proposes: provision of international liquidity through more active use of the SDR; stronger mechanisms of macroeconomic policy cooperation, including greater cooperation in exchange rate management and freedom to manage capital flows; additional automatic balance-of-payments financing facilities and the complementary use of swap and regional arrangements; a multilateral sovereign debt workout mechanism; and major reforms of the system's governance (Ocampo, 2017). Another commentary similarly proposes a larger role for the IMF and the SDR, with the SDR ultimately becoming the only reserve asset (Williamson, 2016). There has been a call for the creation of "real SDRs"; that is, SDRs with their value linked to a basket of commodities (recalling the Bretton Woods gold standard) through a currency board operating with underlying SDR currencies (Coats, 2011).

Conceptually, the strongest solution would appear to be some version of Keynes's "clearing union," coupled with issuance of an international currency by a supranational body. Under the clearing union, countries would be forced to balance exports and imports over time, with creditor countries automatically financing debtor countries via a global clearing house or settlement system for trade and payments on the current account. Countries would receive credits or debits in a notional unit of account fixed to national currency, with such a unit of account not constituting an international reserve currency because it could not be bought or sold. Credits, if not used, would eventually be extinguished, thus forcing the burden of adjustment equally upon creditors as well as debtors. A recent paper, indeed, advocates a global clearing house as the foundation of a reformed international financial system (Kregel, 2015).

However, neither the clearing union nor a new international currency appear to be practical propositions for the time being. On the one hand, the genie of large speculative capital flows is out of the bottle; on the other hand, the willingness of states to cooperate and to support multilateral agencies like the IMF is, if anything, declining.

In this environment, the most promising approach may be that advocated in Ocampo (2015): to let the international monetary architecture evolve into a multi-currency arrangement, and to fully exploit the potential of SDRs so as to approach the aspirations of the 1969 amendment to the IMF Articles, which brought the SDR into being. More active use by central banks of non-dollar currencies as reserves would make for greater flexibility than the present dollar-centric system. It would also be beneficial if major currencies had agreed reference bands, which would help manage expectations, guide intervention (towards the band) and flag manipulation (deviations from the band). However, switching among currencies could lead to instability: and here a more prominent role for SDRs would be helpful if supported by a substitution account

(an IMF-managed facility for converting between fiat currencies and SDRs). In this way, Ocampo's two-pronged approach would, to some extent, coalesce into a single initiative.

Implementation of even Ocampo's proposals would depend on fundamental steps being taken by the IMF (requiring the authorization of its members) and by major sovereigns, which may be unlikely in the current environment. Enhancement and propagation of the SDR alone will not solve the world's monetary problems. Nonetheless, the present paper suggests that enhancement of the role of the SDR, even pursued in isolation and to a limited extent, would be helpful. Moreover, it is an initiative that could be taken by the Chinese mainland unilaterally: assuming passive cooperation from the IMF and major sovereigns, and Hong Kong's support in implementation. If progress could be made via such unilateral action on the SDR, it would be beneficial and might help create favorable conditions for more general reform.

III. Development of Special Drawing Rights

1. Present Role

There is significant agreement among experts that the SDR could play a major role in reforming the international monetary architecture. However, for this to be possible, the SDR must develop substantially from the relatively minor scale and limited scope of its present role.

The SDR is a unit of account originally created by the IMF in 1969 to support the reserves management of its member states. With the expansion of international trade and finance, members faced a shortage of the existing reserve assets (gold and US dollars); the SDR was to be a supplement. The second amendment to the IMF's articles in 1978 intended to make the SDR "the principal reserve asset in the international financial system." There were proposals for a substitution account to replace currency reserves with SDRs; however, this would have exposed the IMF to currency risk and the risk of loss on differential interest rates and was not pursued.

An initial round of SDR allocations was made in the amount of SDR9.3bn; however, the Bretton Woods system did not survive the 1971 delinkage of the US dollar from the gold standard. Nonetheless, SDR-denominated assets were issued from 1975. By the early 1980s some 50 banks were prepared to accept SDR deposits, such deposits amounting to SDR5–7bn, while SDR563mn in SDR-denominated bonds had been issued, and SDR908mn of syndicated loans had been made. Overall, the SDR has been of minor importance, although in 2009, SDR allocations totaling SDR182.6bn helped provide liquidity to the global economy during the GFC (IMF, 2016).

The SDR is not a currency, but merely an accounting unit, and for developed

country members it is essentially just a factor to consider in their reserves management (witness recent initiatives of central banks to acquire RMB assets following the inclusion of the RMB in the SDR). The SDR represents reserves denominated in US dollars (41.73 percent), euros (30.93 percent), British pounds sterling (10.92 percent), Chinese RMB (8.33 percent) and Japanese yen (8.09 percent). The RMB element was newly introduced in October 2016, although the RMB is not as freely convertible as the other four currencies. The current amount is SDR204.2bn (US$291bn).[1]

Members may need to buy or sell SDRs to maintain their obligations to the IMF. Since 1987, SDR transactions for these purposes have been voluntary among the members themselves, but the IMF has the power to designate members with strong external positions to buy SDRs from members with weak external positions, subject to given limits. In the past, several countries pegged their currency to the SDR, although ideally such a basket should be trade-weighted and the SDR is probably no country's ideal basket.

Private parties do not generally use SDRs. A few SDR bond issues (by the World Bank, the Standard Chartered Bank and China Development Bank [CDB]) took place after the 2016 announcement that the RMB would be included in the SDR.[2] The issues were made in the Chinese mainland, in the interbank market (in CDB's case in the Shanghai Free Trade Zone), and were settled in RMB.

2. Expanding Use of Special Drawing Rights

The IMF sees four benefits to expanded use of Special Drawing Rights (IMF, 2011):

1 Reduced reserves imbalances and strengthened global safety net. SDR allocations would be a lower-cost alternative to reserves accumulation via trade surplus or borrowing. SDR allocations, analogous to swap lines, would obviate the need to liquidate assets in a crisis with the associated destabilizing effects, and would help reduce the incentive to accumulate reserves in the first place.

2 New reserve asset, allowing the Fund flexibility in augmenting its resources, and preventing the disorderly liquidation of the existing stock of assets. (In fact, the IMF made a small issue of SDR notes in 2009 [SDR3.2bn] to the official sector.)

3 Reduced impact of exchange rate swings if the SDR is used as a unit of account for pricing trade and financial assets, pegging currencies, and keeping accounts and official statistics.

4 Accommodating emerging market currencies in the international monetary

[1]Data are from the IMF website.

[2]See the World Bank (2016), Reuters (2016) and China Daily (2016) for details of these cases.

system if SDR composition is expanded to include such currencies (it was subsequently expanded to include the RMB in 2016). This would come at a cost if the currencies concerned are less readily available or have more volatile exchange rates.

The IMF highlights the difficulties in implementation, including the need for 85 percent of its members to approve substantial increases in SDR allocations. There are also possible perverse incentives if SDR allocations are expanded, and possible mis-use of the SDR (e.g. to fund procyclical expansion). Given the liquidity deficiency of SDRs, market making support for official sector SDR assets would be desirable, with perhaps the IMF acting as a market maker.

Ocampo (2015) proposes that SDR allocations be made by the IMF countercyclically, in amounts averaging perhaps the equivalent of US$200–300bn per year.[3] This would have the following advantages. First, all IMF members would enjoy seigniorage. Second, counter-cyclical issuance would help counteract the abovementioned problem of recessionary bias in the current system. Third, it would provide members with a less-costly method of building up reserves for self-insurance, reducing their need for self-insurance in the first place.

All IMF lending and operations would be denominated in SDRs, with the SDR liabilities extinguished on repayment of the loan from the Fund, making SDR creation analogous to money creation by central banks, and obviating the need for the present system of IMF member quotas. The allocation of SDRs could be fine-tuned to favor developing countries, and perhaps also to penalize countries that accumulate excessive reserves or run up substantial current account surpluses.

Under Ocampo (2015), the core role of the SDR would be to act as the reserve asset and transaction medium for central banks, and perhaps also for financial institutions interacting with their central bank. In such case, central banks would need to convert SDRs into the underlying currencies to intervene in foreign exchange markets. This, in turn, would require the IMF to operate a substitution account, enabling conversion between SDRs and the underlying national currencies. When the idea of a substitution account was raised in the 1970s, it stalled on the question of who should bear the costs and risks of conversion. However, Ocampo considers the costs to be small (zero for the world as a whole); if so, the issue should be manageable.[4]

In the private sector, there is generally no natural demand for or supply of SDRs, given the powerful network effects of existing currencies. Attempts to develop a private sector SDR bond market in the 1980s were not successful, partly because issuers were

[3]The IMF itself suggests issuance of US$200bn-equivalent annually (IMF, 2016).

[4]It should be noted that other commentators are not so sanguine; see McCauley (2015).

reluctant to issue SDR bonds unless they could see other issuers doing the same (the coordination problem). Accordingly, investment in SDR assets would have to be led by the official sector, with large buy-and-hold institutional investors following. Large global corporations would come next to the extent that global trade became denominated in SDRs. Fund managers, other corporations and retail investors would come last, once a level of liquidity and market acceptance had been achieved.

If general private use of the SDR were permitted, this would raise the problem of speculative flows, and would perhaps also arouse US resistance because it would detract from private sector use of the dollar. There would also be a need for SDR infrastructure, such as clearing facilities, and an "SDR window" or repo facility to discount SDR assets and provide daily interest rate setting. An SDR liquidity premium of 80–100 basis points might be necessary to attract investors. Liquidity would be enhanced by a yield curve (which, in turn, would require issuance across the maturity spectrum).

Although the SDR is more stable than any individual currency, and so performs well on a risk-adjusted basis, there are challenges for potential users. In addition to a lack of liquidity, there are the difficulties of hedging (hence a need for SDR derivatives, which, in turn, would face liquidity challenges), and of SDR rebalancing. To encourage holding, the SDR should be inflation-proofed, and because not all governments of SDR-constituent currencies issue inflation-linked bonds, this would mean tracking the inflation in the underlying currencies and setting an interest rate appropriately. Because the SDR can be replicated by holding the underlying currencies individually, it would also be necessary for the SDR to be in such widespread use in the private sector that its utility exceeded that of self-replication. As the IMF has noted, this is the major obstacle to take-up of SDRs by the private sector in the first place: the lack of network benefits that are attached to incumbent reserve currencies, particularly the US dollar.

In 2016, in the context of the RMB's pending inclusion, the IMF produced a briefing note on the SDR (IMF, 2016). The *2016 IMF Note* distinguishes between the (existing) composite reserve asset used by the official sector (O-SDR), SDR-denominated assets and liabilities used by anyone (M-SDR), and the SDR used as a unit of account. In regard to M-SDRs, the IMF suggests that SDR assets may be attractive to investors in a regime with capital controls (IMF, 2016, p. 8):

> For example, in China, there may be untapped demand among domestic investors for exposure to reserve currencies as capital controls are gradually lifted. From this perspective, M-SDRs issued in the onshore market could potentially reduce demand for foreign currency and reduce capital outflows by allowing domestic market participants to diversify their foreign exchange risk.

The idea of potential demand in the Chinese mainland for SDRs is taken further in

Section IV of the present paper.

In March 2018, a small boost to the SDR was given by the announcement of the launch by private parties of Saga (SGA), a cryptocurrency backed by SDR (Nelson and Wong, 2018), although the currency is not yet in issuance and take-up remains to be seen.

3. Possible Way Forward

In summary, enhancement of SDRs would be beneficial to the global community and would be perhaps the least difficult path to needed broad reform of the international monetary architecture. However, in the current environment it would be very difficult to build international consensus for even limited reforms. In addition, in practical terms, the liquidity premium, a cost of using SDRs in the near and medium term (in effect, the "investment phase" of SDR enhancement), would discourage both official and non-official sectors from participating in the SDR markets. Is there any way around this conundrum?

It is suggested that the investment phase can be partly funded and kick-started by motivated parties of appropriate scale and capability. In their respective ways, as discussed in the following section, the Chinese mainland and China's Special Administrative Region Hong Kong would be parties meeting these criteria. Together, the Chinese mainland and Hong Kong could initiate enhancement of SDRs on a largely unilateral basis, assuming passive support from the IMF and the major sovereigns which have their currencies in the SDR basket.

If a successful start could be made, broader use of SDRs by the international community should follow under some favorable conditions. In the ideal case, the pace of expansion of SDR use would be gradual enough to allow all parties to adjust without shocks. Overreaction by the currency markets could not be ruled out: for example, a crisis of confidence in the dollar, or an unwarranted appreciation of the euro. Nonetheless, it should be possible to set boundaries on any such instability by clear communication of the "end-point" of a rebalanced international monetary system. In any case, the risks should be lower than those to which the international monetary system is subject in its present imbalanced state.

IV. The Chinese Mainland, Hong Kong and Other Stakeholders in the Special Drawing Right Development

In this section, the readiness and capability of the Chinese mainland and Hong Kong to act unilaterally on SDRs are considered.

1. The Chinese Mainland

It is suggested that the Chinese mainland would benefit from, and is capable of, taking unilateral action to enhance SDRs. Indeed, in 2009, then PBOC governor Zhou Xiaochuan advocated for the SDR to take a greater role in the world monetary system.

The Chinese mainland has benefitted greatly from the international trading and financial system, particularly since its accession to the World Trade Organization (WTO) in 2000, with the Chinese mainland's imports and exports totaling US$4.1tn and its utilized foreign direct investment reaching US$131bn in 2017. Yet with its foreign exchange reserves surging at one point to US$4tn and its current account surplus to 10 percent of GDP under a regime of tight capital controls and aggressive export-oriented policy, the Chinese mainland has been one of the major contributors in global monetary and trade imbalances. Both problems have diminished in recent years, with reserves down to US$3.1tn in April 2018 and the current account surplus down to 1.3 percent of GDP (US$172bn) for 2017.[5] However, the trajectory may still be unsustainable, with commitments to greater openness[6] potentially offset by the new industrial policies such as "Made in China 2025" and the RMB internationalization strategies.

Despite the gradual moderation of the Chinese mainland's overall trade balance, in 2017 it, nonetheless, had a record US$376bn trade surplus with the US according to US statistics (Swanson, 2018). This has led the US authorities to initiate a number of trade protection measures against the Chinese mainland since March 2018. The US trade deficit relates substantially to the shortfall in US savings (which the US administration's recent tax cuts may exacerbate), and this, in turn, relates to the ease with which the USA, as issuer of the world's dominant reserve currency, can finance its deficits. Moreover, strictly speaking, it is a country's overall balance that matters, not its bilateral balance with another individual country. So, to a certain extent, the Chinese mainland is being penalized unfairly as its bilateral trade surplus with the USA includes other countries' net exports to the USA. Nonetheless, the issue of global trade imbalance is real, and a trade war would harm the Chinese mainland, the USA and the rest of the world.

The Chinese mainland has so far responded to the US threats of tariffs on the Chinese mainland's exports with tariff threats of its own. However, positive actions (carrot as well as stick) would be helpful to reach a peaceful resolution. In this context, an announced commitment by the Chinese mainland to enhance the use of SDRs would appear relatively "carrot-like," in that the SDR comprises 42 percent of US dollars

[5]Data listed are collected from *Xinhua News*, the Economist Intelligence Unit (EIU) and the Hong Kong Trade Development Council.
[6]See Xi (2018).

and only 8.33 percent of RMB, as well as the other constituent currencies. In fact, greater use of the SDR would create new space for cooperation and mutually beneficial development and contribute to reduced imbalances in the global system.

How would a commitment to SDRs reconcile with the Chinese mainland's existing strategy of RMB internationalization? RMB internationalization has made significant progress, albeit with some weakening in the past couple of years associated with the reinforcement of capital controls. RMB-settled transactions accounted for 1.6 percent of total international payments in 2017, and the RMB made up 1.1 percent of global foreign exchange reserves.[7] However, there are limits to which non-Chinese parties can hold and use RMB unless the Chinese mainland is prepared to run prolonged trade deficits and open its capital account much further. More fundamentally, the RMB is a national currency, like the US dollar. If, indeed, international use of the RMB were to increase to the point where it rivalled or exceeded that of the dollar, the world would merely exchange one problem (one national currency) for another, and would not escape "the inherent deficiencies caused by using credit-based national currencies" (Zhou, 2009, p. 8). It is, therefore, suggested that RMB internationalization should receive less emphasis while the Chinese mainland initiates SDR development. In any case, the RMB currently makes up 8.33 percent of the SDR, which compares favorably with the RMB's current share of global foreign exchange reserves at 1.1 percent.[8]

It is, therefore, suggested that the Chinese mainland would benefit from SDR enhancement. What about its capability?

First, the Chinese mainland can promote SDR use by its institutions at low or negative cost because of its intermediate stage of financial liberalization. Where international parties contemplating use of the SDR face opportunity costs, the cost is low or non-existent for many Chinese mainland parties because they do not presently have unlimited access to international currency. Indeed, many Chinese mainland parties desiring international currency exposure would face an SDR "benefit" rather than a cost: to the extent that to maintain its existing capital account controls the Chinese mainland might have to "restrict" its institutions from excessive use of SDR (and other foreign currencies) rather than having to encourage or oblige them.

Second, because of the Chinese mainland's size, even marginal use of SDRs by its institutions would have significant impacts, drawing global attention to the SDR and stimulating the emergence of an international ecosystem of SDR-denominated assets and services.

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[7]Source: SWIFT RMB Tracker and IMF data.on "currency composition of official foreign currency assets."

[8]Source: IMF factsheet on SDR.

Overall, it appears that the Chinese mainland would benefit from and be capable of supporting SDR development.

2. Hong Kong

Hong Kong would also benefit from and be capable of unilateral action to promote usage of SDRs.

As described in Section II above, the post-Bretton Woods era of floating exchange rates has been characterized by recurrent crises and chronic imbalances among trading nations, which, in turn, lead to recessions and geopolitical tension. Hong Kong had its own monetary crises in the 1970s and early 1980s, but since adoption in 1983 of a modified currency board mechanism linking the Hong Kong dollar to the US dollar, it has enjoyed financial system stability. However, systemic stability has come at the cost of considerable economic volatility and, in recent years, social tensions associated with a widening wealth gap have been closely related to low interest rates. Even on a status quo basis, Hong Kong has an interest in potential reform of the international monetary architecture that would yield greater stability.

A second reason for Hong Kong to focus on international monetary reform is the currency (US dollar) to which the Hong Kong dollar is linked. At present, the US dollar is overwhelmingly the currency of choice internationally as a unit of account, a medium of exchange and a store of value. However, it is the US national currency, managed by the US authorities with predominantly US interests in mind, and generating benefits which flow disproportionately to US parties. This is difficult for rival powers such as the Chinese mainland and Russia to swallow, and it raises concerns even among "non-aligned" countries. It is possible that at some point Hong Kong, as a Special Administrative Region of China, will come under pressure to delink the Hong Kong dollar from the US dollar.

China's RMB is unlikely to be a serviceable substitute. The Chinese mainland has made some progress with RMB internationalization, but it appears unlikely to be able to accept the openness that global currency dominance would entail. Linking the Hong Kong dollar to a partially-restricted currency would handicap Hong Kong's core financial and trading activities.

The SDR would be a possible candidate to anchor the Hong Kong dollar if the SDR becomes an international currency. The SDR includes the RMB as one of its underlying currencies, as well as the US dollar, and so could be viewed as acceptable from all points of view.

Third, as an international financial center having played a leading role in the process of RMB internationalization, Hong Kong would be well-placed to facilitate, and profit

from, the growth of the more Chinese mainland-orientated SDR ecosystem than the current US dollar ecosystem referred to in Subsection IV.1 above.

Overall, Hong Kong has strong reasons to consider a role for itself in SDR enhancement. A proactive approach to this issue now could turn it from a pending (indeed, a current) problem for Hong Kong into an opportunity for securing its role in future international monetary and financial systems.

3. Other Stakeholders

As discussed in Section III above, the IMF is favorably disposed to SDR enhancement. It cannot take substantial action without the votes of its members, which may be difficult to obtain; however, it may be able to offer some accommodative action and moral support in the initial stages.

The EU, Japan and Britain would benefit from SDR development as their currencies constitute a larger proportion of the SDR than they presently do of global foreign exchange reserves. The euro's present share of global forex reserves is 20.4 percent, compared with its 30.93 percent share in the SDR; the Japanese yen's present reserves share is 4.5 percent compared with its 8.09-percent SDR share, while sterling has a 4.5-percent reserves share compared with a 10.92-percent SDR share.[9] The composition of the SDR may, of course, change in future, but this is a favorable starting point.

The USA is the most important stakeholder. The US currency, the dollar, is the leading component of the SDR, with 41.73 percent of the total, but this is substantially lower than its 63.5-percent share of foreign exchange reserves.[10] At first glance, the USA would be the loser in any large-scale shift to the SDR. However, as discussed above, the role of issuer of the de facto global currency is not an entirely healthy one for the USA itself. Arguably, SDR enhancement would help the USA confront a problem (that of prolonged and deepening *fiscal* deficits) that it has not proved able to tackle by itself, and potentially avert a major crisis. In addition, the USA would benefit from a more balanced global monetary system.

A gradual reduction of the US dollar's share in the Chinese mainland's forex reserves from the present 60 percent to the 42 percent mandated by the SDR proportion would be preferable to the shock of a sudden sell-off of US Treasuries if the Chinese mainland chose to make such a "warlike" move (although this is unlikely). More fundamentally, the Chinese mainland's use and promotion of SDR would be "friendlier" than its present use and promotion of RMB. Nonetheless, a large-scale and sudden shift

[9]Source: IMF data.on "currency composition of official foreign currency assets" and IMF factsheet on SDR.
[10]Source: IMF data.on "currency composition of official foreign currency assets."

into the SDR, although unlikely, would tend to put upward pressure on US interest rates, with significant impact on the US economy and society.

A number of emerging and developed economies (in addition to Hong Kong) peg their currencies to the US dollar to varying degrees. This dollar bloc would be affected by any shift into SDRs. Issuers and borrowers of international debt denominated in US dollars would also be impacted. Over time, the Belt and Road countries might prefer the SDR to the RMB and US dollar.

V. Actions to Be Taken

1. Overall

While it would be the Chinese mainland making the main substantive moves to develop the SDR, supportive actions or at least passive accommodation by other states and entities would be needed for the Chinese mainland's initiatives to bear fruit. There is the potential for a "rosy" scenario in which international players see the value in cooperating over SDRs and work together to improve the international financial architecture for the long-term benefit of all. Even short of this scenario, unilateral action by the Chinese mainland and its partners (a "coalition of the willing" scenario) could make significant progress, which might, in turn, set the stage for more favorable development in a subsequent round.

2. Actions by the Chinese mainland

The Chinese mainland would make the main substantive moves to develop the SDR.

The Chinese mainland institutions, corporations and retail investors not yet fully able (because of exchange controls) to access international currency on an unrestricted basis would be the standard-bearers of SDR development. It is suggested that the Chinese authorities add an SDR component to the regime of quotas and rules that govern the use of international currency by Chinese mainland parties. Institutions approved for making an international currency bond issue could be encouraged to include an SDR tranche; institutions investing overseas could be encouraged to hold a portion of their funds in SDR assets. The rules could provide incentives rather than merely compel SDR usage: for example, an additional quota could be provided for SDR transactions. SDR usage would become a new incremental phase of the Chinese mainland's capital account opening.

Supportive actions by the Chinese government could include:

1 Issuance of SDR bonds by the PBOC and China Development Bank, and by other banks and corporates, both internationally and within the Chinese mainland.

2 SDR lending by the foregoing institutions.

3 Allowing overseas issuers to issue SDR bonds in the Chinese mainland.

4 Investment in SDR assets by the sovereign wealth fund CIC and other state and private institutions, and enterprises and retail investors.

5 Allowing holding of SDR deposits by Chinese individuals and enterprises (as for US dollars at present).

6 Incorporation of SDR-based transactions in the Belt and Road countries.

7 Consideration of allowing foreign (as well as domestic) enterprises to list and trade on the Shanghai and Shenzhen stock exchanges in SDR.

8 Establishment of infrastructure within the Chinese mainland for conversion and settlement among the currencies concerned.

9 Launch of SDR futures contracts (currency and interest rates) on the Chinese mainland Financial Futures Exchange.

10 Allowing free circulation of SDR within free trade zones and special economic zones, particularly in the Guangdong–Hong Kong–Macau Greater Bay Area and Hainan.

11 Establishment of linkage with Hong Kong (along the lines of the linkage supporting RMB transactions for RMB internationalization).

Communication and promotional efforts would be needed to explain the reasons for the SDR initiative, and to encourage other states and parties to participate. The Chinese mainland could use its soft power to promote the use of SDRs, enhancing its role as a responsible stakeholder in the global monetary and financial ecosystem.

3. Actions by Hong Kong

As argued above, Hong Kong is motivated to consider the SDR by virtue of the Hong Kong dollar's link to the US dollar, and as a leading international financial and trading center. With its RMB internationalization experience, Hong Kong has the capability to contribute.

It is suggested that the Hong Kong authorities consider actions along three lines:

1 Supporting the development of an international SDR ecosystem.

2 Creating a cryptocurrency, E-SDR, and promulgating its use.

3 Eventual linkage of the Hong Kong dollar to the SDR.

These strategies are considered in turn below.

More speculatively, if Hong Kong were to launch an international development bank, HKIDB (which, it is suggested, could help meet existing vast global needs for infrastructure, enhance the territory's profile and secure its future competitiveness as an international financial center), such a bank could be funded significantly by SDR bond issuance.

(1) Supporting the Development of an International Special Drawing Rights Ecosystem

This would be the key value that Hong Kong could add to the SDR enhancement strategy. With its financial know-how, its international network, and its experience as the main channel for RMB internationalization (accounting for 76 percent of RMB cross-border payments in 2017), Hong Kong would be well-placed to support promulgation of the Chinese mainland-led SDR development.

The main role would be played by Hong Kong-based private sector banks and financial institutions and service providers, which would respond to the business opportunities presented by the Chinese mainland's SDR development drive. Relevant Hong Kong parties could help create SDR products, handle SDR bond issues, provide legal, accounting and other business services, and, if possible list and trade SDR instruments on HKEX, and trade and settle them through the Stock Connect and Bond Connect platforms. The Hong Kong authorities would promote and facilitate such response, considering, for example, any regulatory changes needed (e.g. to remove unwarranted regulatory barriers).

Other specific initiatives the Hong Kong authorities may consider are suggested as follows:

1 Linkage with the Chinese mainland banking system. The existing link with the PBOC Shenzhen branch used for RMB transactions may perhaps be utilized for SDR purposes as well, or a separate link created in the Chinese mainland's free-trade zones.

2 Real time gross settlement (RTGS) systems for all SDR-underlying currencies. The Hong Kong Monetary Authority (HKMA) presently operates RTGS systems for three of the five SDR currencies: the euro, the US dollar and the RMB. Equivalent arrangements could be established for Sterling and Japanese yen (and/or any future SDR currencies).

3 Issuance of SDR bonds by the Hong Kong Government. Because the government does not need the money (being in persistent fiscal surplus that has accumulated to more than 2 years of its fiscal revenues), such issuance would be of limited size and largely symbolic for facilitating pricing and provision of global public goods (see HKIDB idea discussed briefly above).

Consideration could be given to creating tax and other incentives to promote SDR use on the grounds of contributing to global public goods, although incentives do not mesh well with Hong Kong's free market ethos and can cause some distortions.

(2) E-SDR Initiative

There may be opportunity for a "bottom-up" SDR initiative to be taken by Hong Kong to complement "top-down" SDR actions by the Chinese authorities. The idea is for Hong

Kong, in consultation with the relevant parties, to develop a tradeable cryptocurrency version of the SDR, and promote its use, particularly in relation to the Chinese mainland-initiated SDR assets and liabilities as discussed in Subsection V.2 above.

"Enhanced SDRs" or E-SDRs would be backed by, with its value tied to, a basket of the SDR underlying currencies according to the SDR composite ratio; that is, it would be a "stable coin." E-SDRs would be a cryptocurrency with the blockchain technology providing new functions that make E-SDRs useful in a digital economy. E-SDRs would be created by banks authorized by the HKMA against deposit of the underlying currencies.

Who would use E-SDRs? The primary application of E-SDRs, once available to retail users and SMEs, as well as larger corporates and institutions, would be as an access product to facilitate participation in the Chinese mainland's SDR drive (see Subsection V.2). E-SDRs would be attractive in their own right as a means to settle transactions and store value in central bank money; however, because most transactions in Hong Kong are denominated in Hong Kong dollars, E-SDRs would be in the "wrong" currency for this purpose. Nonetheless, if interest in the SDR grows internationally, as perhaps indicated by the launch of the Swiss-based SDR cryptocurrency Saga, this core feature of E-SDRs might become significant in the future.

(3) Eventual Linkage of Hong Kong Dollar to Special Drawing Rights

The idea would be to replace the present US dollar-linked rate mechanism with an equivalent mechanism (a modified currency board) linking the Hong Kong dollar to the SDR. The three note-issuing banks creating Hong Kong dollar notes would be required to deposit equivalent sums in the underlying SDR currencies in the SDR ratio with the HKMA; cancellation would be by withdrawal of such currency deposits. For details, see the authors' 2016 paper on the same subject.[11]

Delinking from the US dollar and linking to an SDR basket would be a drastic ("nuclear") move with very high threshold conditions. The existing US dollar link works well and is accepted both within Hong Kong and internationally, although there are costs associated with economic volatility and interest rate levels inappropriate for Hong Kong's stage in the economic cycle. The SDR is not a currency, and conversion among the five underlying currencies (one of which, the RMB, is not even freely convertible) would impact Hong Kong's international financial and trade activities, although most of these activities are conducted in US dollars. Nonetheless, as discussed above, the linkage to the US dollar leaves Hong Kong exposed, while the RMB is not likely to be a viable option (on account of its convertibility restrictions) for the foreseeable future. If

[11]See Harrison and Geng (2016).

usage of the SDR should expand, according to the initiatives described in this paper, the SDR could be a good option for Hong Kong dollar linkage at some point in the future.

Normally, preparations for changing the value or basis of a currency are kept secret until implementation, which, in turn, is done overnight. However, developments in cryptocurrency raise the possibility of advance experimentation, namely issuance of a digital version of the SDR (E-SDRs), as discussed in Subsection V.3(2) above, while maintaining the existing US dollar link. Such experimentation would allow space for public discussion and preparation well in advance of any contemplated switch in the future.

Switching the Hong Kong dollar link from US dollars to SDRs is not imminent. However, if the SDR initiative progresses and international usage of the SDR expands, it could become a natural step for Hong Kong at some point in the future and would add impetus to global usage of the SDR.

4. Actions by Other Parties

It would be important for other states and entities in the international system to at least passively accept the SDR initiative and, if possible, support it.

Some principal actors and possible actions are suggested as follows:

1 The IMF should endorse the SDR strategy, and, if possible, be engaged in formulating the strategy and accommodating its implementation. Subject to the approval of its members, the IMF should consider creating an SDR substitution account, and acting as a market maker for SDR bonds issued by sovereigns. It should also make further issues of SDR notes, make more SDR allocations, denominate its statistics and accounts in SDR, and denominate its lending in SDR as far as possible.

2 The World Bank and the Asian Development Bank could both issue SDR bonds and lend in SDRs.

3 The Asian Infrastructure Investment Bank (AIIB) could consider bond issuance and lending denominated in SDRs.

4 Other sovereigns and corporates with capacity to do so can consider making SDR bond issues.

VI. Conclusion

Recognizing the problems inherent in the present international monetary architecture, this paper supports the reform proposals in Ocampo (2015) under which the international monetary architecture evolves to a multi-currency system underpinned by a larger role for the SDR reflecting the aspirations of the 1969 amendment to the IMF Articles. A widely-used SDR and a more independent IMF with the power to issue SDRs when the

global system needs liquidity (effectively as the world's lender of last resort or central bank) may be a key element for repairing the global financial "non-system."

Failing the formation of an international consensus on general reform, this paper suggests that a unilateral lead be taken by the Chinese mainland to adopt an SDR strategy. As a major stakeholder in global financial and trade imbalances, and currently facing a potential trade war with the USA, the Chinese mainland can benefit from constructive solutions to key challenges to global monetary and financial systems; and as a large but still restricted economy, it has the capacity to launch the SDR strategy without undue cost. The SDR strategy would involve the Chinese mainland issuers and investors being encouraged to create SDR assets and liabilities, under a tailored regulatory regime and with the support and guidance of the Chinese authorities.

Provided there was good communication, other sovereigns and multilateral agencies would come on board to contribute to SDR development in the mutual interest of all. Hong Kong could play a particularly important role, analogous to its present role in RMB internationalization, in promulgating the use of SDR internationally and supporting the emergence of an ecosystem around the RMB and the Belt and Road Initiatives. SDR enhancement would potentially be a long-run win–win situation for all parties concerned: a true realization of President Xi Jinping's "community of common destiny" (Mardell, 2017).

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