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THE CONTRIBUTION OF SPECIAL DRAWING RIGHTS IN THE NATION'S FOREIGN EXCHANGE RESERVE

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Abstract: The balance of international payments usually referred to as the Balance of Payments (BOPs). It records commercial, financial and economic flows between the residents of a given country and those of the rest of the world during a certain period of time, generally a year. At macro level of economy of any country, the growing balance of payments weighs on its international business deals. In this context, this paper explore about the setbacks in maintaining the Foreign exchange reserve/International liquidity and the role of Special Drawing Rights (SDRs) in Foreign exchange reserve of a nation. International liquidity is the aggregate stock of internationally acceptable assets held by the central bank to settle a deficit in a country's balance of payments. It provides a measure of country's ability to finance its deficit in balance of payments without resorting to adjustment measures. The SDR mechanism is self-financing and levies charges on allocations which are then used to pay interest on SDR holdings. The allocations are General allocations and Special allocation. Today, the SDR has only limited use as a reserve asset, and its main function is to serve as the unit of account of the IMF and some other international organizations. It is need for all economies of the world.

Keywords: Balance of Payments, International liquidity, Special Drawing Rights, IMF, General allocations, Special allocations.

1. INTRODUCTION

The balance of international payments usually referred to as the Balance of Payments (BOP). It records commercial, financial and economic flows between the residents of a given country and those of the rest of the world during a certain period of time, generally a year. It measures *flows t*han *stock*. In the context of BOP, the resident of a country means any individual, business organization, government agency or any other institution legally domiciled in the country concerned; it does not necessarily means a citizen. For example, transactions with a subsidiary of a French company established in India form part of the records of BOP; transactions between only local residents are outside its purview. However, the exception occurs when a transaction involves a foreign currency that is exchanged between a private resident of the country and its monetary authority or the central bank. Even though both parties are residents of the same country , this transaction gets reflected in the balance of payments as offsetting entries in two different accounts, namely private capital flows and official reserves.

A BOP statement is kept in the form of *sources (credits) and uses (debits) of funds.* This record enables us to know whether the country has/had a net surplus or deficit during the referred period. If a country receives more funds from abroad than it spends, it has a surplus of BOP. If expenditures abroad by residents exceed what the residents earn or receive from abroad, the country has a deficit of BOP, ***P.K. Jain et. al., (2001).***

Disequilibria in BOP

At macro level of economy of any country, the growing balance of payments weighs on its international business deals. Balance of payments is credit and debit transactions of a country with other foreign countries and international institutions on (i) currency account and (ii) capital account. Whenever the current account, deficit and capital accounts are not in good position the BOP disequilibrium takes place. Disequilibrium is an economic crisis where a nation cannot service its debts. Some of the causes for disequilibrium of a nation may be like exports dwindling, imports increasing, foreign exchange reserves may not be favorable to pay for imports, too low of gold form of reserves, no FDI flows , no invisible account and so on**,** ***N.V. Badi (2012).***

In this context, this paper explore about the setbacks in maintaining the Foreign exchange reserve/ International liquidity and the role of Special Drawing Rights (SDRs) in Foreign exchange reserve of a nation. International liquidity is the aggregate stock of internationally acceptable assets held by the central bank to settle a deficit in a country's balance of payments. It provides a measure of country's ability to finance its deficit in balance of payments without resorting to adjustment measures. It is a reserve which includes:

(i) a country's official gold stock holdings

(ii) its convertible foreign currencies,

(iii) SDRs, and

(iv) its net position in the International Monetary Fund (IMF).

These reserves are created by either owned or borrowed reserves with conditional and Unconditional basis. In broad sense, it includes international borrowings, commercial credit operations, and the international financial structure in a country's reserves. Foreign exchange surpluses, after meeting all current and capital account obligations of the country with the rest of the world, are owned reserves. Similarly, the official gold stock of a country constitutes its owned reserves. Capital imports in the form of borrowings from abroad and direct investments by foreign countries constitute borrowed reserves.

Unconditional international liquidity consists of a country's official gold stock, holdings of its foreign currencies and SDRs, its net position in the IMF and private holding of international assets. In all these cases, liquidity assets are available to the country without any conditions or restrictions on their use. But in case borrowed reserves, the lender country may impose conditions or restrictions on the use of liquid assets to the borrowing country.

Setbacks in Maintaining International Liquidity

The problem of international liquidity arises because the demand for international liquidity is rising more than its supply, thereby implying shortage of international liquidity. This, in turn, is due to increasing balance of payment deficits of the majority of countries in the world. In particular, after the opening of LDCs [Low developed countries] to world markets, they have been facing persistent deficits in their balance of payments. Too much dependence on exports has exposed these economies to international fluctuations in the demand for and prices of their products. They have become unstable due to international cyclical instability. On the other hand, their import requirements have been on the increase in order to develop. As a result, they are faced with foreign exchange constraint. This has necessitated larger inflow of aid and foreign investment. Consequently, debt serving and interest on debt have risen and payments of dividends, profits and royalties on private direct foreign investment have grown, thereby leading to a decline in the net inflow of foreign capital. All these have led to further shortage of foreign exchange reserves. Another reason for the non-expansion of exports of LDCs has been high tariff barriers imposed by the developed countries on their exports. At the same time, the LDCs are trying to cut down their essential imports from the developed countries by means of exchange controls, high tariffs, import quotas and similar protectionist devices in order to conserve foreign exchange.

International Monetary Fund and International liquidity

There was no problem of international liquidity prior to 1960. This was because under the Bretton Woods Agreement the exchange rates of countries were fixed in terms of gold or the US dollar at $ 35per ounce of gold. Member countries were forbidden to impose restrictions on payments and trade, except for a transitional period.

They were allowed to hold their monetary reserves partly as gold and partly in dollars and sterling. These reserves were meant to incur temporary deficits by member countries while keeping their exchange rates stable . The IMF insisted on expenditure reducing policies and devaluation to correct deficit in balance of payments. Therefore, apart from adhoc loans made by the IMF, the growth in liquidity needed to finance the expansion of world trade had to be found in the expansion of gold and the supply of dollar and sterling. But the physical supply of gold is virtually limited to the output of the mines in South Africa and the Soviet Union. Since the dollar acted as a medium of exchange , a unit of account and a store of value of the IMF system, every country wanted to increase its reserves of dollar which led to dollar holdings to a greater extent than needed. Consequently, the US gold stock continued to decline and the US balance of payments continued to deteriorate. Also, the demand for world liquidity was mounting than the supply because the incremental supply of gold was increasing little. Since the dollar was convertible into gold, the supply of US dollars was inadequate in relation to the liquidity needs of countries. This causes to trade barriers by countries in order to have balance of payments surpluses and build up reserves.

Also, the pound had been devalued in November 1967. There was no control over the world gold market with the appearance of a separate price in the open market. On 15 August 1970, the US suspended the conversion of dollars into gold and refused to intervene in the foreign exchange markets to maintain exchange rate stability. The' Group of Ten' industrial countries met at the Smithsonian Institute in Washington in December 1971 and agreed to the realignment of major currencies by devaluating the dollar by 10percent and revaluing their currencies. The Smithsonian Agreement broke down following the US dollar devaluation of February 1973 again and number of countries had floating exchange rates and the EEC countries had a 'joint float' of their currencies, which tended to reduce the need for more reserves. The Fund has no control over the exchange rate adjustment policies of the member countries. But it exercises "surveillance" over the exchange rate policies of its members. Meanwhile, in 1969-1970, IMF introduced a scheme for the creation and issue of Special Drawing Rights (SDRs) as unconditional reserve (i.e their total reserve position with the Fund) assets to influence the level of world reserves and to solve the problems of international liquidity, ***Jhingan., M.L. (2007).*** **S**pecial Drawing Rights (SDRs), also known as the paper gold. SDRs as an artificial currency used by the IMF and defined as a "basket of national currencies". They are not paper notes or currency. The quotas of all currencies in the Fund General Account are valued in terms of the SDR.

Why was the SDR Created?

The name may actually derive from an early proposal for IMF "reserve drawing rights". The word "reserve" was later replaced with "special", ***https://en.wikipedia.org/.*** The concept of Special Drawing Rights is essential for understanding the working of International Monetary Fund. It creates SDRs and allocates them to members in proportion to their quotas. For this purpose the fund has established the Special Drawing Account. Thus SDRs are a new form of international monetary reserves which have been created to free the international monetary system from its exclusive dependence on the US dollar and fluctuations in gold prices. As the international monetary asset, SDRs are held in the international reserves of central banks and governments to finance improve international liquidity so as to correct fundamental disequilibria in the balance of payments of Fund members. The participants in the SDR scheme receive SDRs under "transactions with designation (members who have strong currency position)" and "transactions by agreement"(sale of SDR) unconditionally**, *Jhingan., M.L. (2007*).** Thus SDRs act both as an international unit of account and a means of payment.

The IMF was established on 27th December 1945 to promote international monetary cooperation, exchange rate stability, and orderly exchange arrangements; to foster economic growth and high levels of employment; and to provide temporary financial assistance to countries to help ease balance of payments adjustments. It was established as an outcome of the Bretton Woods Conference (year 1948) with an initial membership of 29 countries and has a present strength of 186 members. After six decades, the Bretton Woods II is the designation for the system of currency relations which developed during the 2000s, ***Sumati varma, (2011).***

SDR Allocations to IMF Members

Under its Articles of Agreement (Article XV, Section 1, and Article XVIII), the IMF may allocate SDRs to member countries in proportion to their IMF quotas. Such an allocation provides each member with a costless, unconditional international reserve asset. The SDR mechanism is self-financing and levies charges on allocations which are then used to pay interest on SDR holdings. If a member does not use any of its allocated SDR holdings, the charges are equal to the interest received. However, if a member's SDR holdings rise above its allocation, it effectively earns interest on the excess. Conversely, if it holds fewer SDRs than allocated, it pays interest on the shortfall. The Articles of Agreement also allow for cancellations of SDRs, but this provision has never been used. The allocations are General allocations and Special allocation.

General allocations of SDRs have to be based on a long-term global need to supplement existing reserve assets. Decisions on general allocations are made for successive basic periods of up to five years, although general SDR allocations have been made only three times, shown in Table 1. A general allocation of SDR equivalent to about US$250 billion became effective on August 28, 2009. The allocation is designed to provide liquidity to the global economic system by supplementing the Fund's member countries' foreign exchange reserves, ***imf, 2009.***

Special allocation: In September 1997, however, in light of the IMF's expanded membership-which included countries that had not received an allocation-the Board of Governors proposed separately the Fourth Amendment to the Articles of Agreement which became effective only on August 10, 2009 and provided for a special one-time allocation of SDR 21.5 billion (i.e in US$34 billion) ***Francis, 2014.*** The purpose of the Fourth Amendment was to enable all members of the IMF to participate in the SDR system on an equitable basis and rectify the fact that countries that joined the IMF after 1981—more than one fifth of the current IMF membership—never received an SDR allocation until 2009.

Table 1
General and Special allocations

Category	*Year*	*SDR allocation (billion)*
General	1970-72	9.3
	1979-81	12.1
	2009-10	161.2
Special	2009 (one-time)	21.5
Total		204.1

Source: imf, 2009.

The 2009 general and special SDR allocations together raised total cumulative SDR allocations to 204.1 billion SDRs (equivalent to about $285 billion) had been created and allocated to members. The SDR basket put into place in the 2010 Review was extended through September 30, 2016 in August 2015. The respective weights at the time of the 2010 Review of the U.S. dollar, euro, Japanese yen, and pound sterling were 41.9 percent, 37.4 percent, 9.4 percent, and 11.3 percent,*[* ***http://www.international-financial-institutions-international-monetary–fund-imf/]***

What SDR used for Today?

However, only a few years later, the Bretton Wood system collapsed and the major currencies shifted to a floating exchange rate regime. In addition, the growth in international capital markets facilitated borrowing by creditworthy governments. Both of these developments lessened the need for SDRs. Today, the SDR has only limited use as a reserve asset, and its main function is to serve as the unit of account of the IMF and some other international organizations. The SDRs is neither a currency, nor a claim on the IMF. Rather, it is a potential claim on the freely usable currencies of IMF members, ***Smriti Chand, 2011.*** As the monetary authorities in the major industrial countries normally sterilize the impact of any reserve accumulation, it is reasonable to say that a modest SDR allocation would not lead to any inflationary pressure, especially when it consider the quantitative magnitudes involved, ***M.S Ahluwalia, 1997.***

SDR Valuation

The value of the SDR was initially defined as equivalent to 0.888671 grams of fine gold—which, at the time, was also equivalent to one U.S. dollar. After the collapse of the Bretton Woods system in 1973, the SDR was redefined as a basket of currencies. On April 2007, SDR 1 = US$1.51222. Currently, the SDR basket consists of the U.S. dollar, euro, Japanese yen, and pound sterling. Effective October 1, 2016, the basket will be expanded to include the Chinese renminbi (RMB), ***imf, 2016.*** The U.S. dollar-value of SDR is determined daily and calculated as the sum of specific amounts of each basket currency valued in U.S. dollars, on the basis of exchange rates quoted at noon each day in the London market.

A new weighting formula was adopted in the 2015 review. It assigns equal shares to the currency issuer's exports and a composite financial indicator. The financial indicator comprises, in equal shares, official reserves denominated in the member's (or monetary union's) currency that are held by other monetary authorities that are not issuers of the relevant currency, foreign exchange turnover in the currency, and the sum of outstanding international bank liabilities and international debt securities denominated in the currency.

The respective weights of the U.S. dollar, euro, Chinese renminbi, Japanese yen, and pound sterling are 41.73 percent, 30.93 percent, 10.92 percent, 8.33 percent, and 8.09 percent. These weights will be used to determine the amounts of each of the five currencies to be included in the new SDR valuation basket with effect on October 1, 2016. The next review is currently scheduled to take place by September 30, 2021, ***imf, 2016.***

End Notes

Though international reserve includes official holdings of gold, foreign exchange, SDRs and reserve position in the IMF, but it does not include private holdings of gold, private holdings of foreign exchange and long-term international financing. Thus, international liquidity encompasses the international reserves and the facilities for international borrowings for financing the balance of payments deficit of the nation. It is need for all economies of the world, where many countries suffering from inadequate reserves almost two thirds of developing countries and three fourths of transition countries have inadequate reserves. The IMF has also realized that the conditionalities earlier imposed to sanction assistance, do not work anymore. The Fund realized that the dozens of conditions made it difficult for the recipient countries to focus on priorities. There is a thinking that the conditionalities, as criteria for lending, to be replaced by selectively –giving aid to the countries with a proven track record, allowing them to choose for themselves their own development strategies. The evidence is that aid given selectively can have significant impact both in promoting growth and reducing poverty, ***Aswathappa, 2012***. Also, recently, attention has been focused on debt forgiveness as without that many of the developing countries would not simply grow. High proportions of their incomes from exports go to repaying loans to the developed countries. Hence there is need for *debt forgiveness*.

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