The Scoop on Reserve Currencies

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You've heard that the IMF is considering printing hundreds of billions of dollars worth of its own currency. – called "Special Drawing Rights" or SDRs. Currently, the SDR is pegged to four currencies: the dollar, yen, euro and sterling.

You've heard that China's central bank proposed making SDRs the world's reserve currency.

You've likely heard that Tim Geithner has said that he supports the IMF's proposal to issue large amounts of SDRs (and that some people say that Geithner also supports making SDR the world's reserve currency).

You may even have heard that Russia also backs making the SDR the world's reserve currency, and that Russia wants the SDR to be pegged to a basket of yuans, rubles and gold.

But you probably have not heard that:

> China's government has floated a variant of this idea, suggesting a currency based on 30 commodities along the lines of the "Bancor" proposed by John Maynard Keynes in 1944.

Indeed, the head of the China's central bank wrote recently:

> Though the super-sovereign reserve currency has long since been proposed, yet no substantive progress has been achieved to date. Back in the 1940s, Keynes had already proposed to introduce an international currency unit named "Bancor", based on the value of 30 representative commodities. Unfortunately, the proposal was not accepted. The collapse of the Bretton Woods system, which was based on the White approach, indicates that the Keynesian approach may have been more farsighted. The IMF also created the SDR in 1969, when the defects of the Bretton Woods system initially emerged, to mitigate the inherent risks sovereign reserve currencies caused. Yet, the role of the SDR has not been put into full play due to limitations on its allocation and the scope of its uses. However, it serves as the light in the tunnel for the reform of the international monetary system.

Keynes proposed that the Bancor was to be fixed in terms of 30 commodities, of which one would be gold. The arguments for currency fixed on a basket of commodities was that it would stabilize the average prices of commodities, and with them the international medium of exchange and a store of value.

As China's central banker said, the goal would be to create a reserve currency "that is disconnected from individual nations and is able to remain stable in the long run, thus removing the inherent deficiencies caused by using credit-based national currencies".

But Keynes' Bancor proposal did not only entail pegging SDR's to a basket of currencies:

> He proposed a global bank, which he called the International Clearing Union. The bank would issue its own currency – the bancor – which was exchangeable with national currencies at fixed rates of exchange. The bancor would become the unit of account between nations, which means it would be used to measure a country's trade deficit or trade surplus.
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> Every country would have an overdraft facility in its bancor account at the International Clearing Union, equivalent to half the average value of its trade over a five-year period. To make the system work, the members of the union would need a powerful incentive to clear their bancor accounts by the end of the year: to end up with neither a trade deficit nor a trade surplus. But what would the incentive be?
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> Keynes proposed that any country racking up a large trade deficit (equating to more than half of its bancor overdraft allowance) would be charged interest on its account. It would also be obliged to reduce the value of its currency and to prevent the export of capital. But – and this was the key to his system – he insisted that the nations with a trade surplus would be subject to similar pressures. Any country with a bancor credit balance that was more than half the size of its overdraft facility would be charged interest, at a rate of 10%. It would also be obliged to increase the value of its currency and to permit the export of capital. If, by the end of the year, its credit balance exceeded the total value of its permitted overdraft, the surplus would be confiscated. The nations with a surplus would have a powerful incentive to get rid of it. In doing so, they would automatically clear other nations' deficits.

Given that it is impossible to predict whether the IMF will actually issue large amounts of SDRs , whether SDR's will become the world's reserver currency, or even the basket upon which SDRs will be pegged in the future, the investor cannot confidently purchase items in a hypothetical basket in advance in order to profit from a potential boom in SDRs.

Moreover, given that the World Bank has just come out in support of the continuation of the dollar as the world's reserve currency, the political fight over reserve currency issues has just begun.