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SCOTT LEE
ELAN KUGELMASS

TOPIC 2: SPECIAL DRAWING RIGHTS

Introduction

Welcome to the G20 summit in Washington. World leaders and their finance deputies are gathered here to ascertain the extent of a risk to the global financial system, and if and how it should be fixed. Amid unprecedented strain and turmoil in capital and foreign exchange (Forex) markets, several nations have questioned the reliability of the dollar as the world's predominant reserve currency. Others worry about letting the Federal Reserve and the US Treasury have such a large role in global commerce and exchange. As a delegate to the G20, you are here to represent the short- and long-term interests of your sending nation. As you prepare your position paper and ready yourself for the heated debate of the conference, you may wish to read this topic paper as an introduction to international exchange.

The International Balance of Payments and the Current Account

Before this paper delves into the details of Special Drawing Rights (do not worry, this is defined later), it is important to explain how different product markets in different countries interact through their respective currencies. Say that an American wishes to buy a gavel for their local MUN conference. The gavel costs 10 US dollars, commonly written as \$10. The American might opt to buy it from "Gavels R US," a national gavel franchise. The consumer might go to a website, enter some credit card information

and complete the transaction. \$10 is credited to the gavel store, \$10 is checked against the credit of the consumer, and the banking system eventually makes sure that all parties concerned end up with the correct amount of money in their accounts.

However, perhaps the American chooses to buy the gavel from "Super China Gavels, Inc." a Chinese company. SCG agrees to throw in free expedited shipping, which persuades the consumer to use their service. Now, the American consumer wishes to pay \$10 to SCG as part of the transaction. However, SCG is not interested in US currency, as all of their expenses are in



<http://visibility911.com/ford/wp-content/uploads/2009/03/xx.jpg>

Renminbi, the national currency of the People's Republic of China. Their shareholders wish to collect dividends denominated in Yuan (¥), the principle unit of the aforementioned currency. (To clarify: the name of the Chinese currency is the Renminbi, while the basic unit is 1 Yuan. This may be confusing, since for US currency these terms are not distinguishable. SCG purchases raw materials, buys new equipment, pays its workers and invest using

Renminbi. Now, how will this impasse be resolved? Essentially, after the credit card dust settles, SCG's bank is left holding \$10 which it does not want. The Chinese bank will try to turn its dollars into Renminbi by selling them on the *foreign exchange market* for yuan. Who might want to buy dollars and buy yuan? Theoretically, any bank or other financial institution might want to make this trade, but assume that a US bank is willing, perhaps to get rid of the Renminbi that its client acquired from a Chinese

consumer. The Chinese and American banks have just participated in the *balance of payments* process. The balance of payments is simply the result of the international market for currencies. At the hypothetical 'end of the day,' all parties in the market must be able to obtain the currencies they desire.

In this investigation of the international payments system, it will be useful to refer to the participants in the market as countries, instead of individual buyers and sellers, as this will simplify the discussion without much loss of generality or application. Forex functions like any other market, where there is a certain demand for a good and a certain supply of a good. In this case, the good is simply a currency. As long as the number of dollars (or any other unit of currency) up for sale is the same as the number demanded, the *market clears*. However, if the quantity demanded or quantity supplied change, a deficit or surplus of dollars will emerge on the market. When the accounting is done, this deficit or surplus in trade and transfers is called the *current account*. Together with the capital account, which you are free to research but will not be discussed here, the current account constitutes the balance of payments. Through your own experience, and perhaps in business or economics class, you know that the demand or supply shift (and thus the prices shift) to bring the market back to equilibrium. This is essentially the same in Forex. The quantities demanded or supplied may change because of the emergence of absolute and/or comparative advantages in one country, a change in transfer payments between governments, shifting consumer choice, or a variety of other reasons. However, in Forex, unlike product markets, there are 4, and only 4, *unique ways of balancing payments*.

Governments may try to cover the gap by making their reserves of foreign currencies available to the market, eliminating the glut of their own currency and supporting its price. Conversely, they may begin buying foreign currencies with their own currency. Governments can carry out this market operation by buying or selling gold, borrowing or lending various currencies, or using a host of other tools. The extended use of this technique threatens to exhaust foreign currency or gold reserves, and is therefore not suitable for long-term use. As an example, imagine that Turkey buys more from Mexico than Mexico cares to buy from Turkey. There is a surplus of lira, Turkish currency, on the foreign exchange market. There are not enough pesos 'chasing' lira. Therefore, the Turkish government begins buying lira on the open market using the pesos it happens to have.

Instead of government intervention, domestic prices may move in either of the two countries to offset the payments disparity. Under the gold-standard (see Topic Paper 1), the flow of gold triggered in mechanism 1, would cause the creation or destruction of money, which is the definition of inflation or deflation and would shift the prices in country with the change in money stock. The prices would necessarily move far enough so that the relative prices in two countries would yield a favorable balance of trade and therefore a cleared Forex market. Under the modern monetary-authority system, where institutions like the Federal Reserve or the European Central Bank, have the sole power to create or destroy money, this mechanism would be unlikely to take place, since it necessitates a deflation or inflation, which are not policy goals of central banks. Using the example introduced above, under the gold standard, gold would flow from Turkey to Mexico, tightening the supply of lira in Turkey and increasing the

supply of money in Mexico, thereby lowering prices in Turkey and raising prices in Mexico. At some point, Turkish products are attractive enough to both Turkish and Mexican consumers so that the current account is zero.

The third mechanism is similar to the second, except that the shifts in quantities demanded/supplied and the shifts in supply/demand occur in the forex markets, instead of the product market as a result of monetary contraction or expansion. As a

result of a surplus or deficit of a certain currency, exchange rates shift to compensate. Should there be too many dollars for a given number of

pounds sterling, forex traders selling pounds would realize their increased buying power and bid the 'price' of a dollar down, denominated in pounds. This mechanism is now the most commonly used method in the balance of payments system. After the end of the vestiges of the gold-standard, Nixon's unilateral dismantling of the Bretton Woods system, mechanism two was no longer viable and the majority of the world's countries elected to *float* their currencies. Returning to the previously introduced example, imagine that this mechanism was used to resolve the excess of lira. The number of lira purchasable by each peso would go up, executing a *de facto* devaluation of the lira—the lira has less *purchasing power* than peso. If this seems confusing, make up some random numbers

for prices of a product, and watch what happens when the exchange rate is changed.

The fourth and final mechanism is that of government controls and coercion. Subsidies, tariffs, penalties, embargoes, restrictions and other legislative constructions could be used to force a balance in payments. However, this method does not conform to the standards of freedom and democracy expected in the US, and thus has seen little use and even less support.

GOLD PRICE MOVEMENTS IN VARIOUS CURRENCIES				
Gold price in various currencies	2007	2008	2009 (YTD: Sep 15, 2009)	July 8, 2009 - Sep 15, 2009
Gold in US dollar	30.9%	1.0%	14.4%	10.7%
Gold in euro	18.5%	5.7%	9.2%	4.8%
Gold in British pound	29.2%	37.8%	0.8%	7.8%
Gold in Swiss franc	21.8%	-4.0%	10.8%	5.0%
Gold in yen	22.7%	-18.5%	14.8%	8.7%
Gold in Aus Dollar	17.6%	29.2%	-7.7%	1.2%
Gold in Can Dollar	12.1%	25.7%	0.3%	1.8%
Gold in rand	27.9%	42.9%	-9.5%	-1.3%
Gold in renminbi	22.5%	-5.4%	14.6%	10.7%
Gold in rupee	16.8%	24.2%	14.1%	9.9%
Gold in dinar	23.8%	2.0%	18.7%	10.2%

<http://www.investmentpostcards.com/wp-content/uploads/2009/09/gold-price-movements-in-various-currencies.jpg>

Foreign Reserves

The concept of official foreign reserves by national monetary authorities came to prominence as a result of

the Bretton Woods system. Under that arrangement, the US dollar served as the reserve currency for the entire world, and was convertible into gold at the Federal Reserve. Since then, foreign reserves have diversified to include a host of currencies, most notably the euro, the yen, the pound sterling and the US dollar. Reserves play varying roles under each currency regime, only a few of will be mentioned here.

A 'dirty float' is a combination of mechanisms one and three. The monetary authority purchases or sells the domestic currency to guide its exchange rate. Often, the goal is to maintain a certain band or artificially peg it to another currency. China has been accused of intentionally amassing large reserves of dollars to weaken its own domestic currency and increase the buying

power of Americans with respect to Chinese products.

Official reserves can act as a figurative insurance policy for debt or confidence crises. The domestic currency can be temporarily supported until the markets settle. It is suggested that committee participants read about the Mexican peso crisis and the Russian ruble crisis to understand how these representative crisis played out and what some experts think may have reduced the damage.

Central banks use reserves for a variety of different reasons. This paper will is not the appropriate medium for an in depth discussion of foreign currency reserves, though it should be noted that few monetary systems operate under the simplified conditions expressed here. Each country's domestic demand, production and productivity, imports and exports, relative prices of goods and services, etc., will necessitate different tools and policies. You are encouraged to research the techniques of your country's central bank or monetary authority.

Special Drawing Rights

Special Drawing Rights are specialized financial vehicles created by the IMF to act as a basket of currencies. Each SDR contains a fraction of a predominant reserve currency. Originally, the SDR was invented as a way to simplify the financial payments system under the Bretton Woods regime, so that large shipments of gold would become rarer, with central banks opting to hold a *claim* against the constituent currencies. Today, the SDR has become a unit of account like any other, except that its value is a function of the value of the dollar, pound, yen and euro.

Whom might increased SDR usage benefit? This question is much more complicated than simply: Who trades with the US and who does not? For example: Say County A has huge holdings of US-denominated securities and is concerned about a possible loss of value of the dollar. That country might push for swift conversion to SDR-'denominated' accounting. On the other hand, County B conducts the majority of its trade with the US, and has in fact dollarised much of its economy. It has no interest in marginalizing its *de-facto* currency or potentially weakening the US.

The purpose of this conference topic is to determine the role the SDR will have in the reconstructed international financial system. Some nations have expressed concern over the effective power of the monetary authorities of the major reserve currencies (most notably the dollar) on the holdings of various central banks and nation investment funds (a.k.a. Sovereign Wealth Funds). Holdings of foreign government bonds are also affected by relative currency strengths, because their real, purchasing power-controlled principal and interest return is denominated in the national currency. Others have taken issue with the makeup of the basket. Defenders of the status quo sometimes point to the IMF's supra-national status as a warning against surrendering the reserve system. Still, it seems that the current financial crisis has worked well for those advocating increased SDR creation and funding. In April 2009, the G-20 pledged to increase the total value of all SDRs by nearly 780%, with the explicit goal of bolstering the reserves of various IMF member nations. You, the representative of your nation to the IMF, must decide whether to approve this plan or argue for a different course of action.

Questions for Your Consideration

To guide you in the creation of your position paper, here are some questions for thought and consideration:

- What are your trade relationships with various countries, especially the major reserve currency nations?
- What is the current status of your foreign reserve?
- How stable is your currency? How is its value currently determined?
- Do you have large stocks of bullion, or proven supplies of precious metals?
- Do you have a national investment program? What are its primary goals and assets?

Be sure to include any other aspects you feel are appropriate in your paper. Remember, you are a representative of your government and your people, and your response must be in line with their stated policy goals.

Sources

<http://www.imf.org/external/index.htm>

<http://www.federalreserve.gov/>

<https://www.cia.gov/library/publications/the-world-factbook/>

<http://research.stlouisfed.org/fred2/>

<http://www.bea.gov/>

An anti-SDR paper:

http://www.cato.org/pub_display.php?pub_id=10331

In support of SDR:

<http://www.jstor.org/pss/2647014>

Any other website with international data is also useful. Be careful when perusing the

websites of foreign governments, as there may be false or intentionally misleading information. However, you might choose to use that to your advantage. Wikipedia is always a good source for basic information and further references, but is not an acceptable basis for your paper. Delegates who cut-and-paste from Wikipedia will face consequences.

Good luck!

