Commodity Discovery Fund

# IMF's 'Substitution Fund' to kick-start SDR as new global currency?

**After seven years of Chinese pressure, a plan allowing investors to exchange their U.S. Treasury holdings for SDRs through a 'substitution fund' is being discussed**

The Big Reset (2013) fully explains the need for a major reform of the world's financial system. At that time of publication, most people still had no clue what form the unfolding financial endgame would take. A few years further on, and as interest rates have reached a level not seen in 500 years, many are now starting to agree major monetary changes are needed urgently.

Two major problems need to be addressed. First we will need to find a new anchor for the world's monetary system, and secondly, worldwide debt restructurings, comparable to debt jubilees in ancient times, have to be arranged. Debt jubilees are still a step too far in the current global mental state, hence full focus is on the structuring of a new anchor.

Since the outbreak of the financial crisis, the Chinese have pressured the U.S. to change the current dollar-based monetary system. The Chinese, ever more in the driving seat of global finance, have made it very clear that the Special Drawing Rights (SDR or IMF-money) of the IMF is the preferred future international world reserve currency. A great example of China's frustration over U.S. monetary policies can be found in comments distributed by the Chinese official state press agency Xinhua a few years ago;

> *'Politicians in Washington have done nothing substantial but postponing once again the final bankruptcy of global confidence in the U.S. financial system'*

These words echoed complaints about the dollar from Zhou Xiaochuan, the most powerful Chinese central banker and governor of the People's Bank of China (PBoC), shortly after the fall of Lehman Brothers. He claimed the dollar has led to increasingly frequent global financial crises since the collapse in 1971 of the Bretton Woods system, when president Nixon cancelled the gold backing of the greenback. In an article published on the PBoC's website, in 2009, he called for 'a sweeping overhaul of the global monetary system' and proposed for the dollar to be replaced by the IMF's Special Drawing Right (SDR).[1]

The SDR, an international reserve currency (asset) created by the International Monetary Fund in the late 1960s, could serve 'as the light in the tunnel for the reform of the international monetary system', he believes.

1 http://www.pbc.gov.cn/publish/english/956/2009/20091229104425550619706/2009 1229104425550619706_.html

*'A new global financial order' has been subject of high-level discussions for the past few years*

Now some seven years later, the preparations for such an overhaul by using SDRs, seems to be well underway. The Chinese leadership has been speeding up the internationalization of the Chinese Renminbi so it can officially be added to the SDR by October 1st 2016. Currently, the SDR is a currency basket of the four most important currencies, the dollar, euro, pound and yen. Once the renminbi is added as a fifth currency, the SDR will be ready to be used as a truly world currency.

Wall Street insider James Rickards was the first to explain the importance of SDRs in his books:

> *'The brilliance of the SDR solution is that it solves Triffin's dilemma. Recall that the paradox is that the reserve-currency issuer has to run trade deficits, but if you run deficits long enough, you go broke. But SDRs are issued by the IMF. The IMF is not a country and does not have a trade deficit. In theory, the IMF can print SDRs forever and never go broke. The SDRs just go round and round among the IMF members in a closed circuit. Individuals won't have SDRs. Only countries will have them in their reserves. These countries have no desire to break the new SDR system, because they're all in it together. The United States is no longer the boss. Instead, you have the "Five Families" consisting of China, Japan, the United States, Europe and Russia operating through the IMF. The only losers are the citizens of the IMF member countries—people like you and me—who will suffer local-currency inflation. I'm preparing with gold and hard assets, but most people will be caught unaware, like the Greeks who lined up at empty ATMs in June 2015. This SDR system is so little understood that people won't know where the inflation is coming from. Elected officials will blame the IMF, but the IMF is unaccountable. That's the beauty of SDRs—Triffin's dilemma is solved, debt problems are inflated away and no one is accountable. That's the global elite plan in a nutshell.'*[2]

We know that the structure of 'a new global financial order' has been subject of high-level discussions for the past few years, and that the role of China in these is prominent.[3] Participants from the UN, World Bank and IMF talked about 'the new framework for the global financial and economic system' for three days in late 2014, during the prestigious Chinese International Finance Forum (IFF). Jean-Claude Trichet, the former president of the ECB, also a co-chairman of the IFF, told the forum via a video link:

> *'New rules have been discussed, not only inside advanced economies, but with all emerging economies, including the most important emerging economy, namely, China.'*

2 From The Big Drop by James Rickards
3 http://www.ifforum.org/en/index.php?m=content&c=index&a=lists&catid=31

*The last monetary reset of the 'global financial order' was executed in 1944*

This news was later confirmed by a high-ranking executive of China's largest bank (ICBC) who remarked:

> *'With the status of the U.S. dollar as the international reserve currency being shaky, a new global currency setup is being conceived.'*

The last monetary reset of the 'global financial order' was executed in 1944, at the end of World War II, when the U.S. invited 44 countries to the Bretton Woods conference. The U.S. proposed a new monetary system centered on the U.S. dollar, which would be backed by gold. The U.S. convinced the European countries with the American promise that paper dollars could always be exchanged for gold. This promise was the only reason the Europeans accepted the American plan.

However, when the U.S. started to print large amounts of dollars in the 1960s to finance the Vietnam war, more and more countries became nervous about the future value of the dollar and started to exchange surplus dollars for gold. In just a few years, the U.S. lost half of their 20,000 tonnes gold reserves. This was a drain to the U.S., and in the summer of 1971, President Nixon therefore refused to exchange an extra few hundreds of millions of dollars of the Bank of England for gold. He decided to 'close the gold window'. In a nationwide television address he announced:

> *'I have directed to suspend, temporarily, the convertibility of the American dollar into gold [..] in full cooperation with the IMF and those who trade with us we will press for the necessary reforms for a urgently needed new international monetary system'.*

This decision is seen as a U.S. default, since it not longer could fulfill its 1944 obligations. In the years after this 'Nixon shock', a number of ideas about reforms for the international monetary system were being discussed. The issue with SDRs as a true reserve currency thus far had been its lack of liquidity. There were simply not enough SDRs in circulation for it to play a major role in international monetary finance. To cope with countries that wanted to get rid of large dollar positions, a 'Substitution Fund', run by the IMF, was proposed. This fund could facilitate a direct exchange of dollars for SDRs. The liquidity issue would be resolved with one stroke of the pen, as an SDR would be created for every dollar that was exchanged. But this concept never materialized because the dollar crisis waned after Paul Volcker introduced a shock therapy with interest rates exceeding 10%. Volcker's drastic measures worked, so the U.S. no longer had an interest to promote the SDR.

The substitution fund was little more than a thought experiment, until the Chinese brought about its revival earlier this year. In the May 2016 edition of International Monetary Review, China's most prominent international monetary magazine, an article titled 'Revive the IMF's SDR Substitution Fund' was published. It explained in detail how a transition from a dollar-centered system towards an IMF-SDR system was planned as early as the early 1970s:[4]

4 http://www.imi.org.cn/en/?p=627

## *An SDR Substitution Fund could well be the best approach to kick-start the SDR*

> *'In 1972, at the IMF Annual Meetings, then U.S. Treasury Secretary George Shultz offered the international community a bold plan to reform the international monetary system and end the special role of the dollar as a reserve currency. The U.S. proposal came after a complete disruption of the then existing monetary order and as key countries growing mistrust in the U.S. administration's willingness to make necessary economic policy adjustments to ensure the stability of the dollar. Shultz presented the outlines of a plan including:*
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> *Substituting the dollar for the SDR to become the formal numeraire of the system, offering an exchange of existing reserve assets (dollars) into other reserve assets [...] In 1979 the IMF reconsidered a substitution account to exchange dollars for SDRs. The idea attracted considerable interest and consisted of an account administered by the IMF that accepts deposits on a voluntary basis of eligible dollar-denominated securities in exchange for an equivalent amount of SDR-denominated claims.'*

Now, almost 40 years after its introduction, an SDR Substitution Fund could well be the best approach to kick-start the SDR as a truly World Reserve Currency (WRC).

If only half of the almost 20 trillion outstanding U.S. treasuries would be exchanged through this Substitution Fund, almost 10 trillion of SDRs would be created instantly. The SDR would become one of the most liquid financials instruments almost immediately. A number of (academic) publications about this topic have been published recently. The most important one is working paper no. 444 by the BIS titled '*Reforming the international monetary system in the 1970s and 2000s: would an SDR substitution account have worked?*[5]

> *'One recently revived proposal would transform U.S. dollar official reserves into claims denominated in the IMF's key currency basket, Special Drawing Rights (SDRs) [...] a substitution account would have allowed central banks to diversify away from the dollar into the IMF's Special Drawing Right (SDR)'.*

'To diversify away from the dollar' is central banker speak for dropping the U.S. dollar as the anchor for the world's monetary system. A dollar panic has to be avoided at all cost, so the diversification has to be 'orderly' according to this study:

> *'The scope for supporting the orderly diversification of reserves via a mechanism allowing their conversion into SDR-denominated claims could be re-examined [...] The prospect of a destabilising rush out of the U.S. dollar led the Committee of Twenty (representing the executive directors of the IMF) to consider a substitution account in 1973-1974. The plan would allow official reserve holders to replace a portion of their foreign exchange reserves with SDRs, issued by a special account overseen by the IMF. By February 1973, the U.S. Treasury was prepared to envisage a one-time conversion of some existing U.S. dollar reserves into SDRs, replacing*

5 http://www.bis.org/publ/work444.pdf

*'The dollar's last days?', also elaborates on the idea of a dollar-SDR Substitution Fund*

*liabilities to national creditors with a liability to an IMF-based substitution account [...] Lurking behind these issues was the European desire to require the U.S. Treasury to amortise the dollar assets in the fund over time by exchanging them for SDRs. Europeans saw such settlement of dollar obligations in a medium not created by the United States as making the International Monetary System more symmetric and as exerting collective control over international liquidity.'*

Another publication, from 2009, written by Onno Wijnholds, a former Dutch Executive Director of the IMF and titled '*The dollar's last days?*', also elaborates on the idea of a dollar-SDR Substitution Fund: [6]

*'a substitution account to absorb unwanted U.S. dollar reserves and increase the role of the SDR have attracted International Monetary System reformers for over 30 years. In the 1970s, part of the appeal of such schemes was to develop a mechanism that might ultimately require the United States to redeem its liabilities in SDR, or at the very least would create an SDR-denominated reserve asset that could rival the dollar.'*

This idea by Wijnholds was also discussed in a OECD publication that same year: [7]

*'The approach attracting most attention is a new global reserve system based on an extended version of the International Monetary Fund's Special Drawing Rights (SDR) , an international reserve asset set up in 1969 to supplement member countries official reserves. Building on the SDR, the main global reserve currency would be represented by an extended basket of significant currencies and commodities. The UN-appointed Stiglitz Commission on reforming the international monetary and financial system has suggested a gradual move from the U.S. dollar to the SDR. Moreover, following the G20 Summit in London earlier in the year, the IMF plans to distribute to its members $250 billion in SDRs. But as this will increase the share of SDRs in total international reserves to no more than 4%, some extra steps will be needed. To make the SDR the principal reserve asset via allocation, close to $3 trillion in SDRs would have to be created. One expert, Onno Wijnholds, has suggested a so-called SDR substitution account. This would permit countries who feel their official dollar holdings are uncomfortably large to convert dollars into SDRs. Because conversion would occur outside the market, it would not put downward pressure on the dollar. This suggestion, however, carries exchange risks because the SDR substitution account is likely to hold mostly dollars. Another step to enhance the SDR would be to make its currency composition more neutral to global cycles and more representative of the shift in economic power witnessed over the last two decades. This implies an increase in the commodity content and the inclusion of major emerging-market currencies.'*

6 http://www.project-syndicate.org/commentary/the-dollar-s-last-days
7 http://www.oecdobserver.org/news/archivestory.php/aid/3075/Towards_a_new_reserve_currency_system_.html#sthash.FEz-jErwq.dpuf

## *China's current G20 leadership could well be used to 'launch major reforms of the global monetary system'*

So there you go, to include a commodity like gold into the SDR as a sixth currency component could help to make the SDR, *'more neutral to global cycles and more representative of the shift in economic power witnessed over the last two decades'.*

The idea of adding gold to the SDR was also studied by professor Catherine Schenk in 2011. According to her study to '*re-introduce a role for gold in the international monetary system'* it would '*provide a counterweight to the impact of the depreciation/appreciation of the U.S.$*', and could '*reduce vulnerability to the USD exchange rate*'. [8]

Professor Robert Mundell, a special advisor to the Chinese government, is also in favor of bringing gold back in to the monetary system:[9]

> *'There could be a kind of Bretton Woods type of gold standard where the price of gold was fixed for central banks and they could use gold as an asset to trade within central banks. The great advantage of that was that gold is nobody's liability and it can't be printed. So it has a strength and confidence that people trust. So if you had not just the U.S. but the U.S. and the EU (area) tied together to each other and to gold, gold might be the intermediary and then with the other important currencies like the yen and Chinese Yuan and British pound all tied together as a kind of new SDR that could be one way the world could move forward on a better monetary system.'*

So plans for substituting dollars for SDRs and linking SDRs to gold have clearly been around for quite some time. But when can we expect the SDR to become more openly promoted? José Antonio Ocampo, former minister of Finance of Colombia, recently published an interesting article in which he explains China's current G20 leadership could well be used to '*launch major reforms of the global monetary system'* and to reconsider the *'dollar's outsize role':* [10]

> *'China's G20 leadership could be the impetus the group needs to initiate this shift [...] (it) represents an important opportunity to improve macroeconomic cooperation and launch major reforms of the global monetary system [...] Such reform must include a reconsideration of the U.S. dollar's outsize role in shaping the international monetary system. In an increasingly multipolar world, would it not be more appropriate to build a multicurrency system and make greater use of the only global currency that has ever been created: the IMF's Special Drawing Rights (SDRs)? Establishing the SDR as the leading global reserve currency would have far-reaching benefits. It would allow all countries – not just major economic powers – to enjoy "seigniorage," or the profits brought by money creation.'*

8 https://www.chathamhouse.org/sites/files/chathamhouse/field/field_document/0212gt_schenk1.pdf
9 http://www.forbes.com/sites/ralphbenko/2011/06/13/the-emerging-new-monetarism-gold-convertibility-to-save-the-euro/#5bbac336e659
10 https://www.project-syndicate.org/commentary/g20-summit-global-monetary-reform-by-jose-antonio-ocampo-2016-07

*'a general allocation of Special Drawing Rights (SDR)' could be 'a source of global liquidity'*

Ocampo's analysis should be given extra weight since he is also the author of an important paper published in 2010 titled '*Building an SDR-Based Global Reserve System*':[11]

> *'The second and better path would be to fulfill the aspiration of transforming the Special Drawing Right (SDR) into the dominant global reserve asset, as well as the instrument for funding IMF emergency financing during crisis. This reform can be complemented with other features: enhancing the use of SDRs, launching a substitution account, and creating regional reserve pools. And, of course, it has to be matched by a more ambitious reform of IMF quotas and governance. The renewed interest in this instrument of international cooperation shown by the G-20 in 2009 makes this reform agenda a viable one.'*

The IMF now shares these ideas. At the end of June 2016, president Christine Lagarde wrote a special note to the Board of Governors of the IMF, in which she advised:

> *'a general allocation of Special Drawing Rights (SDR)' could be 'a source of global liquidity', during a 'reform of the international monetary system'.*[12]

In a following IMF-note, prepared to be presented to the most important IMF body, the G20 board,[13] we find more details of this new SDR-system.[14] It is the first to describe how new SDR-money (M-SDRs) can be issued by commercial 'parties' as well, next to the official O-SDRs;

> *'Following the recent diagnostic of the international monetary system (IMS), the IMF will explore whether a broader role for the SDR could contribute to its smooth functioning [..] The note sketches some key issues bearing on the role of the SDR in each of three concepts:*
>
> – *The official SDR, or "O-SDR", the composite reserve asset issued by the IMF*
> – *SDR-denominated financial market instruments, or "M-SDRs," which could be both issued and held by any parties;*
> – *The SDR as a unit of account [...] for such uses as reporting economic statistics and financial statements, and pricing transactions—examples of the latter include Suez Canal fees and the Montreal Convention on damages, such as lost baggage, incurred by air carriers*

11 Ocampo, José Antonio., 2010, "Building an SDR-Based Global Reserve System," Journal of Globalization and Development 1, Article
12 http://www.imf.org/external/np/pp/eng/2016/062916.pdf
13 The membership of the G20 includes the heads of state and government, and finance ministers and central bank governors of the G7, 12 other key countries, and the European Union. China is the 2016 chair of the G20, to be followed by Germany in 2016.
14 http://www.imf.org/external/np/pp/eng/2016/072416.pdf

## *Commercial banks could be used to issue 'Market-SDRs'*

So, according to this idea commercial banks could be used to issue 'Market-SDRs', just like they now create money by providing new loans. Epoch Times was the first publication to understand the importance of this IMF note:

*'It echoes Ocampo's idea of private corporations issuing bonds in SDR and banks making loans in SDR, or a special version of it called M-SDR, presumably standing for "market" based instruments like bonds. The IMF experimented with these M-SDRs in the 1970s and 1980s when banks had SDR 5-7 billion in deposits and companies had issued SDR 563 million in bonds. A paltry amount, but the concept worked in practice. [...]*

*So after the G20 meeting on July 25, the deputy director of the People's Bank of China's (PBOC) International Office Zhou Juan immediately countered the concern about a lack of market demand. He said an international development organization like the Asian Infrastructure and Investment Bank (AIIB) could issue SDR bonds in China as late as August, according to Chinese newspaper Caixin. [...]*

*China insider David Marsh, the founder of finance think tank OMFIF (Official Monetary and Financial Institutions Forum) wrote on Marketwatch in late April about another benefit of launching the M-SDR in China, although he did talk about a wider range of applications rather than just the issuance by the development institution; 'Beijing's SDR capital market initiative will allow domestic Chinese investors to subscribe to domestic bond issues with a significant foreign currency component, a means of helping dampen capital outflows that have gained prominence in the last 18 months as a result of progressive capital liberalization.'*

*In other words: If Chinese investors can buy bonds or other debt instruments in SDR in China, they could circumvent the capital controls and hold a diversified portfolio of euros, dollars, yen, and pounds with a small amount of renminbi mixed in. And they don't have to go out of their way smuggling gold across the border to Hong Kong or buying up Italian soccer clubs. China lost $676 billion in capital in 2015 alone and foreign currency reserves are nearing the critical level of $2.7 trillion (now $3.2 trillion), the minimum the IMF thinks the country needs to run the economy. So it's safe to say the IMF had the same issue in mind when it wrote its paper, whose authors we don't know. In mid-July it stated:*
*'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.'*

## *China is building a platform to expand borrowing and trading in SDRs*

James Rickards called this IMF-note in a tweet, '*a cruise missile at the dollar*'. In a recent edition of his newsletter Strategic Intelligence he explained '*the elite plan*' to kick-start the SDR in more detail:

> *'What's the evidence that the elites are planning to start up the SDR printing press? Here's an excerpt from an article dated April 25, 2016, by Andrew Sheng, former chairman of the Hong Kong Securities and Futures Commission and a professor at Tsinghua University in Beijing. Sheng's co-author is Xiao Geng. The article is called "How to Finance Global Reflation":*
>
> *An incremental expansion of the SDR's role in the new global financial architecture, aimed at making the monetary policy transmission mechanism more effective, can be achieved without major disagreement. This is because, conceptually, an increase in SDRs is equivalent to an increase in the global central bank balance sheet (quantitative easing) [...] Central banks would expand their balance sheets by investing through the IMF in the form of increased SDRs [...] Consider a scenario in which member central banks increase their SDR allocation in the IMF by, say, $1 trillion. A five-times leverage would enable the IMF to increase either lending to member countries or investments in infrastructure via multilateral development banks by at least $5 trillion. Moreover, multilateral development banks could leverage their equity by borrowing in capital markets...'*
>
> *This work on SDRs is not merely theoretical. China is building a platform to expand borrowing and trading in SDRs. It will be launched this summer. This is only the second platform of its type in the world. The only existing SDR trading platform today is inside the IMF itself.'*

China indeed seems to be planning the creation of a market for SDR-denominated bonds. The government-linked China Development Bank will issue $300 - $800 million SDR denominated notes later in 2016, the first float of SDR-denominated bonds by an individual financial institution. Japan's three megabanks recently also expressed interest in selling SDR bonds, while other major Chinese banks are planning SDR bond offerings as well. The Chinese government has already said it would open trading of these instruments on the interbank market.

All this clearly points to coming changes for the world's financial system. China's G20 presidency will present the perfect timing to make them public. In a statement on the official G20 website Chinese central bank Governor Zhou Xiaochuan calls for a:[15]

> *'broader role of the Special Drawing Rights (SDR) to jointly shape a more stable and orderly international monetary and financial environment.'*

15 http://www.g20.org/English/China2016/FinanceMeetings/201603/t20160321_2205.html

## *President Xi Jinping hopes to cite a successful SDR bond float*

According to news reports: [16]

> *'President Xi Jinping hopes to cite a successful SDR bond float as progress toward the yuan's internationalization when G-20 leaders meet September 4th in Hangzhou, China.'*

I would like to end with an interesting side note. One of China's most senior central bankers, Mr. Min ZHU, who was one of the IMF's Deputy Managing Directors since 2011 left the IMF at the end of July. Prior to joining the Fund in 2010, Min served as Deputy Governor of the People's Bank of China. I expect him to return to the PBoC to become the next Governor of the People's Bank of China. Christine Lagarde seems to be aware of this new position by stating:

> *'I will miss Min dearly, both as a friend and a loyal and trusted advisor [...] and wish him the very best in the next exciting chapter of his life.'*

Willem Middelkoop is the founder of the Commodity Discovery Fund and author of The Big Reset, first published in 2013. In 2007 his first book was published in the Netherlands, titled Als de dollar valt (When the dollar falls).



16 http://asia.nikkei.com/Politics-Economy/Economy/SDR-bonds-are-China-s-next-step-to-take-yuan-global