Tip of the iceberg: How the call for SDRs reveals the urgency for deeper reforms of the global reserve system to address systemic inequalities

At issue

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A substantial new allocation of the IMF's Special Drawing Rights is urgently required to respond to the needs of the most vulnerable countries in this period of health, social and economic crises. While this is perhaps the most consequential issue in terms of the international financial response to the pandemic, the opportunity cannot be missed to raise deeper questions about how our international monetary architecture is failing us and what alternatives must be considered.

Over the last year, the Covid-19 pandemic has not only revealed the true depth and scale of structural global inequalities but has also exacerbated a dire need for liquidity across most of the Global South. Countries face stalled economic activity, sharp drops in revenue and increased costs of shoring up domestic economies amidst a rise in unemployment and business closures, while they must also respond to the public health emergency. Fiscal needs are urgent. In response, a wide range of civil society organisations (CSOs), academics and governments started calling for a new issuance of the IMF's Special Drawing Rights (SDRs) in March last year. SDRs are an international reserve currency maintained by the IMF that can be exchanged by governments for cash, based on a basket of five currencies (the US dollar, the Euro, the Chinese renminbi, the Japanese yen and the British pound) (see Background, *Special Drawing Rights*). Unlike other IMF instruments, SDRs are a non-conditional, non-debt creating resource. It is, in effect, a liquidity booster. Yet, no new allocation was made in 2020 because US Treasury Secretary, Steve Mnuchin, blocked the initiative, reportedly over geopolitical concerns (see *Dispatch* Spring 2020).

After a new US administration was voted into office in November, calls for an SDR allocation regained strength. In January at the World Economic Forum, UN Secretary General António Guterres called for SDRs to form part of a worldwide fiscal relief campaign, "so that no one is forced to choose between providing basic services for their people or servicing their debts."

Ahead of a Group of 20 (G20) finance ministers' meeting in February, more than 200 civil society organisations from around the world called for a $3 trillion allocation of SDRs in an open letter. Because SDRs are allocated across countries according to the IMF's quota formula, which is mostly based on the size and openness of economies, around 60-70 per cent of a new allocation would go to rich countries and large emerging market economies, who largely do not need them. In order for a new allocation to meet the needs of the world's most vulnerable countries in this period of health, social and economic crises, the overall allocation needs to be significant. A $3 trillion allocation would enable the countries that need it most to boost reserves and stabilise economies, helping to minimise other economic and social losses. The CSO letter stressed that developing countries need liquidity in order to free up funds urgently required for the pandemic response, including gender-responsive public health systems, universal social protection and comprehensive vaccine rollouts (see

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Observer Spring 2021). The letter also pointed out that SDRs would provide much-needed foreign exchange resources to countries whose capacity to earn them continues to be severely constrained in the short-to-medium term. SDRs do not add to countries' debt burdens, promote debt sustainability and do not represent a loss for anyone – only a gain. Importantly, they would provide a liquidity injection with economic stimulus benefits worldwide.

After their February meeting, the G20 issued a statement expressing their support for the IMF to formulate a proposal for a new SDR allocation. That means the ball is now in the court of IMF staff, who are expected to propose a figure for a potential SDR allocation during the IMF and World Bank Spring Meetings in April. While it seems the political reality of the moment dictates that any new allocation made is lower than $680 billion, because anything above that requires the approval of the US Congress which is considered unlikely to materialise, it is essential that the economic analysis underpinning the IMF's proposal be unbiased by such political considerations and be based solely on the *needs* of the world's most vulnerable countries.

While this potential new allocation, its size, and how rich countries' unused SDRs might be reallocated are crucial discussions – perhaps *the* most consequential in terms of the international financial response to the pandemic – it is also critical this opportunity is used to revisit deeper, systemic questions about how our international monetary architecture operates, how it is failing us, and how we got here.

The 'non-system' of global reserves

When the SDR was created in 1969, one of its main purposes was to allow rich countries other than the US to reduce their dependence on running a balance-of-payments surplus with the US, which they had to do to accumulate US dollars for foreign exchange reserves under the Bretton Woods System. In part to prevent that system from collapsing, the US agreed to introduce SDRs, but when it collapsed anyway in 1971, the SDR stuck around.

> **Reforming the current reserve architecture through counter-cyclical and regular allocations of some type of global reserve currency would create a more equitable and efficient reserve architecture.**

In negotiations that then took place between 1972 and 1974, IMF member states were unable to agree on a new international monetary system in a dedicated committee, known at the time as the Committee of Twenty. As a result, the system that evolved in an *ad-hoc* fashion instead has been termed to effectively be a 'non-system,' in that it is still based on the US dollar but is open in principle to competition from other reserve currencies. In other words, nation states are free to choose their exchange rate regime, as long as they avoid 'manipulating' their exchange rates - a term that has never been clearly defined.

This 'non-system' poses three central challenges and has long been critiqued for lacking an effective multilateral arrangement that averts the distortions created by the global reliance on the US dollar as the reigning reserve currency.

First, the *asymmetric adjustment problem* was highlighted by Keynes early on. It relates to the strong pressure that deficit countries face to reduce their balance of payment imbalances versus the weak pressure that surplus countries experience to do so. This generates a global recessionary effect during crises when global financing circuits dry up. Deficit countries are expected to adjust their ledgers while enduring the fallout of economic crises, while surplus countries are off the hook. This results in a spectre where surplus countries have the opportunity to recover from crises at a much faster pace and in more equitable ways than deficit countries can, as we see in the responses to the Covid-19 pandemic.

Second, an *inequity bias* is generated by the need for developing countries to 'self-insure' against the volatility in external financing flows through the accumulation of foreign exchange reserves. This generates an inequity because reserves are invested in safe industrial countries' assets, which creates a perverse reality where developing countries are actually systematically lending to rich countries at low- or zero-interest rates. Developing country reserves, on average, have increased from 5 per cent of GDP in 1990 to almost 30 per cent in 2018.

As developing countries accumulate reserves, global imbalances between surplus and deficit countries are worsened and a deflationary bias is created, in that dormant reserve holdings have a contractionary effect on the world economy. The large sums of financial resources frozen in reserves are essentially foregone development resources, which, if invested in social and economic development needs, could yield higher long-term returns and allow countries to escape their export-led growth dependence.

This precautionary move to self-insure by developing countries contributes to the generation of global imbalances, i.e. the third central problem of the current system: *the instability link*. Together with the inequity bias, this results in a dangerous combination of inequity and instability baked into the post-war design of the world reserve system.

Meanwhile, reserve accumulation is not a systemic or sustainable solution to prevent financial vulnerability and instability, or the threat of conditional loans from the IMF. Capital outflows, and in particular sudden and volatile exits, could be prevented by capital controls, but the IMF continues to maintain an overly restrictive approach to their use, as confirmed by the Fund's Independent Evaluation Office in September last year (see *Observer* Spring 2021). In the absence of both a normative acceptance of capital controls by international capital and financial markets, and in particular credit rating agencies, as well as the lacuna of a fully adequate global safety net, developing countries are left with little option but to accumulate reserves as a form of self-insurance.

The more general problem with a global reserve system that relies on a national currency, also known as the 'Triffin dilemma', is that the provision of international liquidity requires that the country supplying the reserve currency run balance-of-payments deficits, which could eventually erode the confidence in that currency. It also implies that the stability of the global reserve system may be inconsistent with the monetary policy objectives of the reserve-issuing country, i.e. that the world economy is effectively hostage to the monetary policy of the US Federal Reserve and US Treasury Department.

The urgency of a new global reserve system

Over the years, proposals to reform the global reserve system have stressed the need to address the systemic inequalities that characterise the international monetary system. In 2010, after a new issuance of SDRs was made in response to the global financial crisis (GFC), the United Nations Conference on Trade and Development called for abandoning the dollar as the single major reserve currency and moving to a system that permits the disbursement of international liquidity that could underpin the financing of investment in long-term sustainable development. Such annual, or regular, counter-cyclical issuances of a global reserve currency could serve to create a more stable, equitable and resilient global financial safety net, without an attendant risk of inflation, particularly if they are equivalent to the estimated additional demand for foreign reserves in times of economic crisis and recession. Another salient advantage of using a global reserve currency in such a counter-cyclical manner is that it would, in principle, facilitate the task of preventing excessive currency depreciations for countries in crisis. Over time, different proposals have been made for what the principal global reserve asset itself could look like, from Keynes' original Bancor concept to the more recently proposed International Currency Certificates. While originally proposed by some with the intent of becoming the principal global reserve asset, SDRs have in practice been designed as a residual reserve asset instead, with severe limitations to their use. A 2018 IMF report on SDRs revealed that using SDRs for such larger, pro-cyclical issuances was avoided in the 1970s because their unconditional nature "began to raise concerns that it could be used by members to avoid necessary policy adjustment."

In addition to those debates on currency, a broad range of proposals have been made on what type of international architecture would be required to govern such a global reserve asset. In his 2009 report to the UN General Assembly in the aftermath of the GFC, former vice president and chief economist of the World Bank, Joseph Stiglitz, recommended such a new reserve currency system could be established by broadening out existing SDR arrangements and therefore be maintained by the IMF. Critically however, Stiglitz pointed out that this could only work *if* the long-standing deficiencies in governance of non-representative institutions like the IMF are addressed, which had "impaired the ability of these institutions to take adequate actions to prevent and respond to the crisis." The report specifically recommended restoration of the weight of basic votes, which are equally distributed among all countries, and the introduction of double or multiple majority voting at the IMF and electing IMF and Bank leaders under an open, democratic process (see *Inside the Institutions*, IMF and World Bank decision-making and governance).

Eleven years on, the clock has run out. These critical reforms have not been implemented and the typically slow pace of IMF governance reforms even came to a complete halt in December 2019, as the US blocked the 15th regular review of IMF quotas (see *Observer* Winter 2019). Just a few months later, this failure in governance reform that continues to provide the US with an effective veto on major decisions on the IMF board, allowed a particularly insular US administration to hold the entire world hostage and block an SDR allocation in the midst of a global pandemic – painfully demonstrating the human costs of the failures of our international monetary architecture.

It is therefore high time to consider alternatives. One counterproposal is that of creating a new global reserve currency and a new institution to manage this, such as a 'Global Reserve Bank.' Under such a new agency, an SDR-like allocation methodology could be carried out more equitably, based on a combination of economic needs, size and consideration of global economic trends. Such an arrangement, according to Stiglitz, "should be designed to regulate the creation of global liquidity and maintain global macroeconomic stability" and make problems "related to the creation of excess liquidity by the reserve currency country less likely to occur." On a systemic level, a new global reserve system should put pressure on surplus countries to reduce their contribution to the insufficiency of global aggregate demand and productive financing.

Another method of implementing a reformed reserve system would be to assign regional economic formations (e.g. BRICS, ASEAN, SADC, Mercosur, etc.) to lead the process. Regional mechanisms can be based either on swap arrangements between central banks to exchange an agreed reserve currency or on a pooling of foreign reserves. While governments may hesitate to collectivise their reserves, establishing reserve pools allows for a counter-cyclical use of the funds as well as the issuance of a currency or reserve asset that could be used at the regional or global level.

While the specific contours of the institutional architecture, methodology and governance of a 'Global Reserve Bank' or regional formations may vary in detail, scope and ambition, the point is that reforming the current reserve architecture through counter-cyclical and regular allocations of some type of global reserve currency would create a more equitable and efficient reserve architecture by mitigating the three central challenges described above. By embodying characteristics such as being unconditional, predictable and needs-based, regular global reserve allocations would be akin to a global public good. Deficit countries could concentrate on better financing domestic development priorities rather than protecting themselves through reserves or balancing their payments, while the entire world could benefit from greater autonomy from US monetary policy. Dethroning the US dollar as the world's reserve currency ultimately represents a decolonial approach, one which creates a more stable, equitable and just international monetary system.

The pandemic has revealed the true depths of structural inequalities between Global North and South, as the North hoards vaccines and enacts generous fiscal stimulus, while many countries in the South spend more public resources repaying private creditors than they do on domestic health and economic resuscitation. The urgency of democratising multilateral economic and financial governance has never been clearer.

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