Reconceptualising SDRs as a tool for development finance

Briefing

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The objective of this briefing is to examine the shortcomings of the current SDRs allocation system and develop a set of potential pathways to reform and reconceptualise SDRs as a key tool for development finance.

This briefing explores ways to reform the use of SDRs and adhere to their original design by considering general allocations periodically, using clearly defined criteria, and decoupling SDRs from quotas, to ensure their targeted, needs-based and equitable distribution.

Short-term, the IMF should revise its existing tools and rechanneling mechanisms to diminish barriers of access to financing, increase the level of financing to countries in need and ensure the use of SDRs is more timely and efficient.

As countries continue to struggle with the uneven recovery from the Covid-19 pandemic, the unequitable spill-overs from the war in Ukraine, rising inequality and the urgency to respond to the climate crisis, the global economy is experiencing a slow recovery, with growing divergences among economic sectors and regions. These challenges are exacerbated by the worsening debt crisis, with 60 per cent of low-income countries (LICs) already at high risk of or in debt distress. Moreover, the external financing needs to address climate change will demand an estimated $4 trillion annually by 2030. The need for international development finance is acute, but tensions between coordinated international action and growing geopolitical fragmentation are further deepening the fragility of the global financial system.

From a global perspective, the current financial system based on a currency hierarchy generates inflationary and recessionary biases in boom and bust cycles. As a protective measure against these cycles, low- and middle-income countries (LMICs) tend to build foreign exchange reserves by investing in assets issued by high income countries, effectively lending to rich countries at a low interest rate. At the same time, when LMICs need liquidity to address balance of payment issues, they borrow at a cost three times higher than their developed counterparts due to economic volatility and perceived high risk of default. Such macroeconomic inequities are associated with the lack of a "collective insurance" against global payment crises.

Special Drawing Rights (SDRs) are a reserve asset created by the International Monetary Fund (IMF) precisely as a tool to supplement its member countries' official reserves to foster financial stability and manage global financial crises. The $650 billion SDRs general allocation issued in 2021 to address the Covid-19 pandemic - only the 4th of its kind - showed the power of this instrument by providing rapid, unconditional liquidity, supplementing reserves, restoring market confidence and maintaining lower borrowing costs at a crucial time, thus enhancing global financial stability. Long-term, regular SDRs allocations have the potential to transform the global financial architecture as they involve less distortion of the global economic system because when they are used, they do not disappear but move around the system as they cannot be extinguished, except via cancellation. In contrast, foreign currency reserves disappear from the system once spent on goods and services or to service debt. Such a system in which reserves are exchanged instead of borrowed reduces systemic risks, dependencies and inequities within the financial architecture and provides key counter-cyclical sources of finance.

Despite their countercyclical impact, SDRs are hindered by being allocated according to the quota shares held by each member country of the IMF. Quotas are calculated using a formula based on a country's GDP, openness to trade and

What are Special Drawing Rights?

- *SDRs are an international reserve asset created by the International Monetary Fund that can be used by countries as a medium of exchange. Their value rests on a promise by all members of the IMF that, when a country needs so-called hard currency, it can exchange its SDRs for it. The amount of hard currency is provided on a voluntary basis by another member of the IMF, which will take it out of its reserves.*
- *The value of SDRs is based on a basket of five currencies—the US dollar, the euro, the Japanese yen, the British pound sterling and, from 2016, the Chinese renminbi. This value is set daily by the IMF on the basis of these five currencies and their daily market exchange rates.*
- *SDRs work as an automatic line of credit available to all countries regardless of their level of income. They generate little debt as countries are obligated to repay only the interest on allocated SDRs they utilise, not the initial size of the loan (principal).*
- *SDRs are one of the most advantageous, secure and dependable ways to strengthen a country's reserves. Compared to loans or grants that may come with conditions attached and geopolitical implications or high interest rates, SDRs allocations come at a low cost and are conditionality free, enabling countries to use their portion of the allocation for budgetary purposes, to reduce their public debt, bolster reserves or to prevent capital flight.*

capacity to deal with financial crises, giving rich countries a disproportionate influence in the Fund's decision-making. Allocations also must be agreed - per the IMF's Articles of Agreement - by an 85 per cent majority of IMF shareholders. As a result, SDRs have always been subject to political interests as is evidenced by their limited use historically, remaining highly dependent on political convergence and alignment in the international space.

Civil society organisations (CSOs) and the United Nations Conference on Trade and Development (UNCTAD) initially called for an SDR allocation of $3 trillion in 2021 to address the scale of the pandemic. Although the 2021 allocation was ultimately a fraction of this, support for broadening the use of SDRs is growing. Through the Bridgetown Initiative, in 2022 Barbados' Prime Minister Mia Mottley called for a new SDR general allocation to support climate action alongside pandemic recovery. Similarly, UNCTAD recommended a new issuance of SDRs to help alleviate the heavy debt burdens that hinder development. "The high cost of debt and increasing risks of debt distress demand decisive action to make at least $500 billion dollars available annually to developing countries and convert short term lending into long term debt at lower interest rates," stressed UN Secretary General António Guterres in February 2023.

More recently, voices in favour of reform are proposing concrete options to transform the use of SDRs. In May 2023, African Ministers called for a review of the SDRs rechannelling mechanisms and their reserve asset characteristic to align with the wide-ranging and unconditional contemporary use of reserve assets. The ministers emphasised "the need for SDR allocation[s] decisions to be made in a rule-based analytical manner to reduce the discretionary and political nature of the allocation process," and to ensure that SDRs are directed to countries that require them most. Similarly, the UN's High-Level Advisory Board on Effective Multilateralism supported amending the IMF's Articles of Agreement to permit "selective SDRs allocation" in order to facilitate a more targeted and effective distribution that prioritises the most vulnerable countries over the world's largest economies. Additionally, SDRs reform is part of the UNSG's agenda for international financial architecture reform. The UN Secretary General's July report on the International financial system and development highlighted that "The development of a mechanism that allows for a more automated process for issuing special drawing rights, either in a countercyclical manner or in response to shocks, could help to avoid protracted political negotiations and enhance the timeliness of issuances during a crisis. It took 11 months for the Board of Governors of IMF to agree on a new special drawing rights issuance following the onset of the 2008 global financial crisis,

and 17 months following the COVID-19 outbreak. In addition, allocating special drawing rights on the basis of the needs and vulnerabilities of countries, rather than IMF quotas, could allow for better targeting of special drawing right issuance towards countries that truly require liquidity. This could be done either directly in the allocation of special drawing rights or through an ex ante rechannelling agreement to rechannel special drawing rights at issuance."

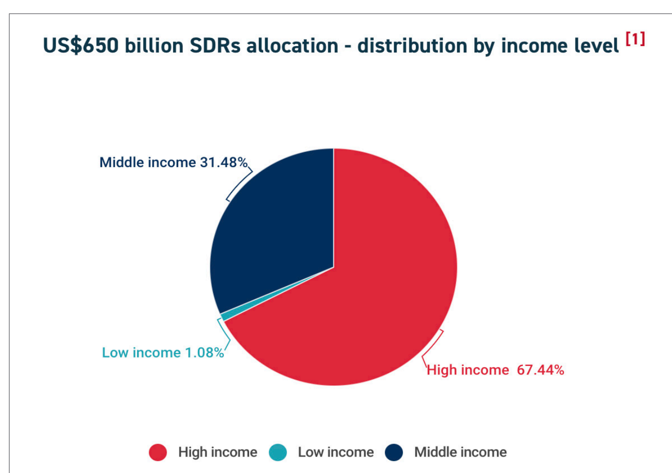
Momentum for a comprehensive SDRs reform is growing, requiring a close examination of the shortcomings of the current SDR allocation system and developing a set of potential pathways to reform, in order to reconceptulaise SDRs as a key tool for development finance.

The good, bad & ugly of the 2021 SDR allocation

In August 2021, 18 months after the start of the Covid-19 pandemic, the IMF issued a new allocation of $650 billion worth of SDRs to help member countries deal with the crisis and mitigate the economic effects of the pandemic. The allocation was historic in terms of size as it exceeded the IMF's total emergency funding granted to low-income countries during the Covid-19 crisis. Evidence shows that most of the allocation has been used to increase reserves, although 40 per cent of emerging economies and more than 60 per cent of low-income countries used SDRs to service debt held with the IMF, to bolster foreign reserves, cover social and health spending, and support pandemic response and recovery.

From the beginning however, the allocation had several important shortcomings:

- The timing and the size of the allocation were determined by the US, rather than global needs. The allocation only became feasible following the 2020 US election, as the Trump administration used its *de facto* veto power within the IMF to prevent it following the outbreak of the pandemic. The allocation ultimately took place a year later than initially called for by the UN and civil society, and remained dependent on US political dynamics.
- Rather than meeting the actual financing needs of $2.5 trillion as estimated by the UN to address the crisis, the actual size of the allocation was determined by what was politically feasible within the US, namely the maximum amount that could be allocated without the approval of the US congress, corresponding to just below 100 per cent of the US's IMF quota.
- Because the allocation of SDRs to individual members in a general allocation is determined by the IMF quota system, SDRs were unequally distributed based on the relative size of countries' economies instead of financing needs. Thus countries that needed the most financial support received the lowest SDRs allocation - with just 1.8 per cent going to LICs and 31.5 per cent going to middle-income countries (MICs) ($231.4 billion overall) with the rest being allocated to developed economies (67.4 per cent or $420 billion). The discrepancy between the SDR allocation and the financing needs of LMICs is further visible in the use of SDRs, with low- and middle-income countries having a median utilisation rate of SDRs of 42 per cent. On the other hand, advanced economies have barely used their SDRs - a rate of only 5.9 per cent, due to their greater access to reserve currencies and greater fiscal space to respond to shocks such as the Covid-19 pandemic.



Source: "The 3 trillion dollar question: What difference will the IMF's new SDRs allocation make to the world's poorest?" Eurodad 2021.

As a result, the Fund's greatest liquidity injection into the global financial system fell short of providing a genuine safety net to its developing country members in response to the largely exogenous economic shock caused by the pandemic. The IMF has been trying to correct these drawbacks by rechanneling SDRs from better off countries in three different ways: By boosting the resources of the IMF's Poverty Reduction and Growth Trust (PRGT); creating a new Resilience and Sustainability Trust (RST) designed to help countries address future balance of payments issues stemming from climate change; and exploring the possibility of on-lending SDRs to multilateral development banks (MDBs).

Reallocation of SDRs through the Poverty Reduction and Growth Trust

The PRGT is an IMF trust that provides concessional support to LICs that are deemed to be in debt distress. PRGT-eligible countries currently pay no interest on borrowed funds. The interest is financed through bilateral contributions from members and the Fund's own resources. Before the pandemic, the PRGT's available loan resources stood at under SDR 12 billion. The borrowing surge resulting from the economic crisis exacerbated by Covid-19 increased PRGT's uncommitted loan resources to SDR 20 billion. The demand for the PRGT is anticipated to remain high post pandemic, amounting to a shortfall of about 12.5 billion SDRs until 2024.

In order to increase funding via the PRGT it's necessary to increase the subsidy reserve account constituted from bilateral contributions from donor countries and IMF's own resources that covers the SDRs interest rate payments on behalf of borrowing countries. However, the main constraint here is the subsequent sharp rise in these interest rates (from 0.5 per cent to 3.5 per cent, reflecting interest rate rises of SDR-linked currencies) as well as the higher lending and difficulty in fundraising from IMF shareholders as resources will have to be in the form of grants or earned income, not loans.

Rechanneling of SDRs through the Resilience and Sustainability Trust (RST)

The purpose of the RST is to address potential future balance of payment issues stemming from climate change impacts in LMICs. It was created following the pandemic in an effort to correct the inequitable SDR allocation of $650 billion - despite being critiqued by CSOs for going against the principles for equitable rechanneling (see *Observer* Spring 2022). While advanced countries could in theory redistribute $393 billion based on their low SDRs utilisation rate, the capital pledged for the RST is a mere $40 billion. Three years since the start of the pandemic, only seven countries have benefited from RST, with around 40 countries expressing interest - a reflection of the large number of countries requiring financial support in the face of continued spill-over effects from 2022's inflationary dynamics in the Global South. As a result, the IMF Managing Director Kristalina Georgieva announced during the Paris Summit in June the ambition to increase the capital of the RST by 50 per cent to adequately respond to countries' financing needs. However, given that countries need to have another IMF lending programme to access the RST, the programme excludes about 70 per cent of LMICs - with only 26 out of the 142 potentially eligible countries currently able to access it.

To exhaust the additional stated pledge, the Fund would have to negotiate at least 16 new upper credit tranche (UTC) quality policies in order to make more countries eligible for the RST. This means that in order for countries to access financing, they must first negotiate a wider set of macroeconomic conditionalities with the Fund, which are typically based on fiscal consolidation - i.e. austerity measures – limiting their fiscal and policy space to address their vulnerability to climate in the first place and likely leading to other negative human rights, social and political consequences (see *Observer* Summer 2019). There are also significant questions about whether the green conditionality linked to RST programmes is fit for purpose, as in the first five RST-related programmes, this heavily promoted the use of public-private partnerships for climate projects, which the Fund's own research has shown can pose significant contingent liabilities.

Rechanneling SDRs through multilateral development banks (MDBs) - so far, a false dawn

Multilateral development banks with their "prescribed holders" status,[1] could potentially play a key part in reallocating SDRs to countries that need them most. SDRs could be 'on-lent' to MDBs which would in turn lend them to countries in need of investment in specific areas, such as vaccines, climate mitigation/adaptation, gender equality, agriculture, infrastructure, etc. However, rechannelling through MDBs is yet to materialise, as it depends on national regulations, cooperation from relevant central banks, and, at times, validation from ministries and parliaments. Thus far, the African Development Bank (AfDB) is the only MDB to pursue this avenue by developing a hybrid capital mechanism to allow the lending of rechanneled SDRs in order to increase capital while protecting the reserve asset characteristic of SDRs through a "liquidity support agreement". Here, 25 per cent of SDRs are committed for shareholders to draw down in the event that they face balance of payments problems and need of access to liquidity. However, this facility is yet to become operational: To date, only the UK and Japan have supported AfDB's proposal for SDRs rechanneling, and support from at least five donor countries is needed for the initiative's implementation.

1 Prescribed holders are official entities that can hold SDRs. They are approved by the IMF Executive Board with a majority of 85% of the total voting power.

Pathways to SDRs reform with regular, needs-based SDR allocations

Despite aiming to correct the shortcomings of the 2021 SDR allocation, these re-channelling mechanisms create additional negative externalities by imposing barriers of access and attaching policy conditions, including IMF-mandated fiscal consolidation. Moreover, these mechanisms do not conform to SDRs' original characteristics, instead transforming them into debt. In the absence of proactive debt restructurings, these loans are primarily used to bail out previous reckless lenders, while austerity is pushed on the borrowing country. The real beneficiaries are banks and hedge funds from rich countries whie citizens remain impoverished.

In order to fully unlock the potential of SDRs, not only in addressing systemic crises, but in advancing the Sustainable Development Goals and tackling the climate crisis, SDRs should be reformed, looking both at the criteria triggering allocation, and establishing a fair and need-based distribution. These areas should subject SDR allocations to greater automaticity, help remove political delays and restrict geopolitical interests as well as ensure allocations go to countries that need them most.

Criteria triggering SDR allocations

Uncertainties around the criteria for SDR allocations, namely what constitutes "global need" and "unexpected major development" are amongst the main obstacles in the slow and arbitrary nature of SDR allocations. To correct this, the IMF could clarify and modernise these concepts. They could be further concretised in terms of *force majeure shocks*, *global recession allocations* and *reversals of global capital flows*.

Declarations of pandemics, famines, natural disasters and other crises could be in the category of *force majeure shocks* and automatically trigger SDR allocations. These declarations and impact assessments can be made by relevant UN bodies such as the World Health Organization, the World Food Programme and/or the UN Environmental Programme.

Similarly, when *global economic recessions* occur, an SDR allocation would help mitigate the short- and long-term impacts of global downturns, thus providing a needed automatic counter-cyclical, non-debt response. Although establishing the existence of a recession quickly is rather difficult, a global recession allocation could be triggered through the IMF's post-factum identification of two consecutive quarters of negative global GDP growth or in the event that 3 out of the 5 SDR currency members enact stimulus packages.

Likewise, when the world's major economies are implementing tight monetary measures, they can erode the macroeconomic stability of LMICs producing large and sudden capital outflows and creating a systemic risk to their foreign-exchange reserves. In such cases, a *capital flow reversal allocation* could be triggered when the central banks of 3 out of the 5 SDR currencies undertake an average increase of 100 bps or more over a 12 month period.

Fair and needs-based distribution

Currently SDRs allocations are distributed based on the IMF's quota system, which determines a member country's voting rights, financial contributions and access to financing - i.e. SDRs/quota share. This governance structure concentrates the formal decision-making power into the hands of a few wealthy countries, notably the US and the EU, which hold 16.5 and 29.4 per cent of the voting share, respectively. These advanced economies have the power to determine the IMF's frameworks for policy advice and conditions attached to IMF lending, whereas LMICs, which are most likely to borrow from the IMF, have limited influence on the IMF's decisions.

While IMF quotas are designed to be revised every five years to account for changes in the global economy, in reality very few revisions resulted in actual quota changes, the last one being agreed in 2010 (and only made effective in 2016). The upcoming 16th Review of Quotas due to take place by December 2023 is unlikely to yield substantial reforms due to geopolitical tensions exacerbated by Russia's invasion of Ukraine and US - China dynamics.

The breakdown of multilateralism, on one hand, and the scale of the polycrisis, on the other, should serve as an incentive for the IMF and its shareholders to delink access to resources from quotas and allocate SDRs via a needs-based process through a multi-vulnerability index or "beyond gross domestic product (GDP)" indicators. Such a reform would eliminate the need for reallocation mechanisms that come with severe limitations (as discussed above), and eradicate the negative externalities derived from them.

In the absence of the political climate to achieve a quota reform that would more accurately reflect the changes in the global economy, decoupling SDRs from quotas and clarifying the criteria to trigger an SDR allocation should become more attractive for the biggest IMF shareholders, as it would send a strong signal they are willing to respond to the needs of the global community.

Obstacles against reform? Unpacking inertia to regular allocations

The global uneven recovery post Covid-19 led to a disproportionate need for liquidity in the Global South, while countries in the Global North consider the "long-term global need" for financing having dissipated. Despite the growing debt crisis in the Global South, advanced economies have put this argument at the forefront of their opposition against calls for a new allocation of SDRs. This argument is based on the idea that today countries can obtain unconditional credit from the markets and if they cannot borrow from markets, they are not creditworthy, and therefore, they should not have access to unconditional liquidity supplied by SDRs.

Overall, SDRs' characteristic as an unconditional reserve asset - its most favourable attribute - is also used as a counter-argument to regular allocations on the grounds that it can enable countries to pursue reckless economic policies. This idea represents the ideological foundation of IMF's lending - countries borrowing from the IMF must satisfy, or pledge to satisfy, conditions on their economic policies in the name of economic growth and stability. The flaw in this argument however, is the fact that economic problems of countries in the Global South don't necessarily come from reckless economic policies, but rather from currency hierarchies (see *Observer* Autumn 2022), and commodity dependence of LMICs which have constrained economic transformation in the Global South. Moreover, considering that using SDRs is not borrowing from the IMF, if the IMF is unable to place conditions on member countries' use of their own reserves acquired either by borrowing or by generating current account or capital account surpluses, why should it have the power to place conditions on a member's use of its SDR holdings?

Another argument that has been turned on its head by advanced economies, is the fact that SDRs allocations based on quotas lead to maldistribution amongst countries. Using this claim, opponents of the 2021 SDR allocation argued that the allocation would go to countries that do not need additional international reserves and only a small portion of the allocation would go to, and be used by, LICs. At the same time, they are not mobilising to reform and decouple SDRs from quotas, proving that this is an artificial argument disguising the aversion to providing financial support to geopolitical adversaries such as Russia, China or Venezuela.

Lastly, another key underlying argument standing in the way of a regular SDRs allocation is the idea that SDRs add to global inflation, by adding to central bank liabilities and monetary aggregates or by stimulating global aggregate demand. This argument however is flawed because SDRs allocations add to both the assets and liabilities of central banks, they do not increase the reserves that banks hold at the central bank. The Fund's biggest shareholders have so far resisted a second SDR general allocation despite a new IMF report showing that the 2021 allocation was not a significant contributor to increased global inflation because it represented less than 0.5 per cent of total global broad money in 2021, and only a proportion of 5 per cent of the total allocation was exchanged into freely usable currencies. Consequently, a new allocation - in line with longstanding civil society demands, accompanied by reforms correcting its SDR reallocation facilities – remains a prerogative for struggling LMICs facing recession and an increase in poverty.

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