FONDATION POUR LES ÉTUDES ET RECHERCHES SUR LE DÉVELOPPEMENT INTERNATIONAL

Questions raised by the SDR channeling

Bruno Cabrillac, Deputy Director General of Statistics, Studies and International Relations at Banque de France, Senior Fellow FERDI.

The decision to allocate SDRs up to 455 billion (i.e. approximately USD 650 billion), taken by the G20 and which should be validated by the IMF's Executive Board before the end of the summer, entails a more than threefold increase in the stock of public SDRs. Until now, a very large part of these SDRs has remained immobilized in the balance sheets of the central banks of the major economies. The new dimension that this instrument is taking on has initiated a reflection on how to make this injection of international liquidity more effective by redirecting it to the countries that need it. This reflection is also taking place in a context where the public finances of the main official development assistance donor countries are under pressure due to the consequences of the health crisis.

policy brief 221
July 2021
note brève

LA FERDI EST UNE FONDATION RECONNUE D'UTILITÉ PUBLIQUE.
ELLE MET EN ŒUVRE AVEC L'IDDRI L'INITIATIVE POUR LE DÉVELOPPEMENT ET LA GOUVERNANCE MONDIALE (IDGM).
ELLE COORDONNE LE LABEX IDGM+ QUI L'ASSOCIE AU CERDI ET À L'IDDRI. CETTE PUBLICATION A BÉNÉFICIÉ D'UNE AIDE DE L'ÉTAT FRANÇAIS
GÉRÉE PAR L'ANR AU TITRE DU PROGRAMME « INVESTISSEMENTS D'AVENIR » PORTANT LA RÉFÉRENCE « ANR-10-LABX-14-01 »

The nature of SDRs and their conditions of use impose strong constraints on this channeling. The use of multilateral channels makes it possible both to remove these constraints and to resolve some of the coordination problems that would arise from bilateral reallocations. The IMF channel, through the Poverty Reduction and Growth Facility (PRGF) Trust Fund, which has already been experimented with for SDR channeling, is a solution within reach. It has the advantage of focusing on low-income countries, but the disadvantage of not taking into account the needs and vulnerability of countries, as financing remains allocated according to quotas, even if access limits have been significantly raised. Channeling SDRs through this channel can significantly increase the IMF's financing capacity for LICs. This could be an opportunity to rethink IMF assistance to poor and fragile countries, not by relaxing the existing framework, but by reforming it completely, while not changing the IMF Articles of Agreement, with the IMF assuming a central role in LICs global resilience.

What is the purpose of an SDR allocation?

The purpose of an SDR allocation is to strengthen the foreign exchange reserves of countries vulnerable to a balance of payments crisis of global origin.[1] The appropriateness and size of the global SDR allocation is therefore determined by the residual foreign exchange needs of vulnerable countries in the event of a global shock. Vulnerable countries can be developing countries as well as advanced countries, but international currency issuing countries are logically not concerned. It is on this basis that the 2009 allocation (183 billion SDRs, including 21.5 billion special allocation) and the 2021 allocation (455 billion SDRs) have been calibrated. The IMF estimates that the needs are now between 800 and 1400 billion SDRs and that the allocation would cover between 30% and 60% of these needs.

How SDRs are allocated?

SDRs are allocated according to the contributions of member countries to the IMF, the quotas, in the very logic of the IMF's operation, which is that the financing rights are proportional to the contributions. The new SDR allocation thus corresponds to 95% of each country's quota. These contributions are largely determined by a formula that takes into account the size of economies (GDP), their openness, the level of reserves and the volatility of capital flows. They therefore take little account (through the volatility of capital flows) of additional reserve needs. The countries issuing international currencies thus receive more than 60%, the countries issuing the 5 currencies of the SDR basket more than 50% and the G7 more than 40%.

Why reallocate part of the SDRs?

There is a contradiction between the objective of an SDR allocation (to provide reserve assets to countries that need them) and its distribution rule (which is not determined by needs).

This contradiction has two consequences:

- The new SDR allocation may have been oversized, considering that a large share would remain unused and that needs were essentially being met through a direct allocation; this is the view of some IMF member countries that already consider the level of international liquidity to be sufficient or even excessive
- The transfer of SDRs to countries that need them, which was already tested after the 2009 allocation, is envisaged on a larger scale for the 2021 allocation, so as to maximize the effect of this allocation: this is the view expressed by the

1. AoA (Art. XVIII, Section 1(a)): "In all its decisions with respect to the allocation and cancellation of special drawing rights the Fund shall seek to meet the long-term global need, as and when it arises, to supplement existing reserve assets in such manner as will promote the attainment of its purposes and will avoid economic stagnation and deflation as well as excess demand and inflation in the world."

G7 Heads of State and Government in June 2021.[2]

What amount are we talking about?

The entire stock of SDRs, with the exception of about 10 billion SDRs already loaned to the PRGT (Poverty Reduction and Growth Trust) or in rare bilateral operations, i.e. about 650 billion, is potentially concerned. However, countries vulnerable to balance of payments shocks (low-income countries and fragile middle-income countries) hold about one-third of SDRs, so the outstanding amount concerned is at most SDR 430 billion. It should be noted that at this stage, the G7 countries have committed to a figure of USD 100 billion[3], which it is not entirely clear concerns only the G7 and the reallocation, i.e. 70 billion SDRs out of a potential 260, and the United States has committed to a reallocation of 22 billion out of a potential 115.

This amount must be compared with: ODA flows (140 billion SDRs for DAC countries, including 40 billion SDRs for fragile contexts), global foreign exchange reserves (around 10,000 billion SDRs), and gross capital flows to emerging and developing countries, of which it represents only a small fraction. Three lessons can be drawn from these comparisons: i) the channeling of SDRs can change the situation if it is targeted on LICs (low-income countries) or a fortiori on fragile contexts, although it may exceed their absorption capacity; ii) the extension of the scope of the channeling to vulnerable MICs (middle-income countries) naturally reduces its relative scope; iii) the extension to all MICs (excluding China) would transform it into a back-up resource.

2. https://www.g7uk.org/wp-content/uploads/2021/06/Carbis-Bay-G7-Summit-Communique-PDF-430KB-25-pages-3-1.pdf
3. "We are resolved to deepen our current partnership to a new deal with Africa, including by magnifying support from the International Monetary Fund for countries most in need to support our aim to reach a total global ambition of $100 billion."

Nature of the SDR and conditions of use

The SDR is both a debt security and a debt instrument registered in the books of the IMF (but neither a debt security nor a security for claims on the IMF), bearing an identical interest rate determined by regulation on the basis of the short-term market rates of the five currencies that make up the SDR basket. In practice, this characteristic limits the use of SDR channeling to lending operations. Indeed, the use of SDRs to finance grants does not offer decisive advantages in financial terms for donors' Governments, insofar as many of them are financed at rates lower than those of the SDR. Financing a grant in SDRs would also entail an interest rate and exchange rate risk, and even a liquidity risk in case of cancellation of the SDR allocation.

The SDR is also a payment instrument that is traded among a small number of «prescribed holders»: IMF member states participating in the SDR and international financial institutions (15 prescribed holders in addition to member states). Beyond this circle, SDRs must be converted at the prescribed holders. The SDR is in effect a claim on the recognized «freely usable» currencies of IMF member states (which go beyond the five currencies that make up the basket). Many prescribed holders have signed voluntary exchange agreements (VEAs) to guarantee this conversion, but the ceilings of these VEAs need to be scaled up. Incidentally, a consequence of the reallocation of SDRs will be a positive and growing net SDR position of the countries, which will buy back some of the reallocated SDRs.

The SDR is also designed to be a reserve asset, fully fungible with other foreign exchange reserves. The notion of reserve assets is defined by the IMF in its 6th Balance of Payments Manual and implies that the SDR-denominated claim has limited credit and liquidity risk. Many countries that would like to lend their SDRs will only do so if they are sure that these SDRs will be able to keep the status of reserve assets, either because these SDRs are housed in the balance sheet of their central bank and the loss of this status could lead to direct monetary financing of the State[4], or because domestic legal provisions oblige them to do so.

Setting up channels for SDRs

The decision to use SDRs is a sovereign and voluntary decision of the holder. However, the establishment of multilateral channels for SDRs has two advantages: on the one hand, it allows for a certain multilateral coordination of the use of financing instruments that have their own characteristics, and on the other hand, it can guarantee the maintenance of the status of SDRs as reserve assets.

The first and most obvious channel is the IMF itself. Since 2010, several countries, including France, have voluntarily lent SDRs to the PRGF Trust Fund, which finances the facilities granted to LICs. This has allowed the claims to retain their status as reserve assets, thanks in part to prudential provisions that require the Trust Fund to maintain a minimum level of liquidity and in part to the IMF's status as a preferred creditor. The IMF is considering the creation of new trust funds with similar characteristics, broader geographic coverage (including MICs), and or specific usages (health, climate…). Using the IMF channel has two other advantages: on the one hand, the use of SDRs remains in line with the logic that prevailed at its creation, i.e., the prevention and treatment of balance of payments crises; on the other hand, the SDR conversion channels would remain the well-trodden paths of the IMF.

The second possible channel is that of other relevant multilateral «prescribed holders», i.e. the multilateral development banks. Arrangements that would allow this channel to retain many of the advantages of the IMF channel still need to be explored. But, in any case, the logic of this financing will be different and will naturally correspond to the corporate purpose of the multilateral development banks (sustainable development, MDGs). Another issue is the cost of the resource, which is higher for the SDR than that currently available to the World Bank and even certain regional banks, and which entails an interest rate risk since the SDR is variable.

Finally, a third channel is that of multilateral ad hoc funds; the field of possibilities is very vast, but the constraints linked to the nature of the SDR are strong and we are still in an exploratory phase on this channel.

To whom should SDRs be reallocated?

A first issue is the geographical coverage of the reallocation. The first circle is naturally that of LICs. Given the amounts involved, however, the reallocation of SDRs could quickly saturate the absorption capacity of LICs, insofar as these are borrowing resources at market rates. Of course, subsidy mechanisms could reduce interest rates, but the financing of these subsidies may be a first constraint, as seen in the case of the PRGF, where the replenishment of the subsidy fund constrains the increase in financing capacity. In addition, a significant portion of LICs are already critically leveraged, with a significant portion of debt owed to preferred creditors, which limits the potential for additional debt. Under these conditions, LICs can absorb at most 15 percent of the reallocation potential. The IMF's proposal to create an alternative SDR reallocation vehicle with a geographic scope that would extend to vulnerable MICs is in this context.

The calibration of the reallocation for each country is another key issue. The channels used

4. The loss of the status of reserves assets would imply that an asset of the central bank would be a claim directly generated by fiscal policy (international cooperation).

imply a type of reallocation largely based on the size of the economy (for the IMF) or on performance (for the multilateral development banks), more than on intrinsic vulnerability or vulnerability linked to particular challenges (climate change, pandemic...). The problem of reallocating SDRs must lead us to question the relevance of these allocation methods, which lack the flexibility to better respond to a logic of needs.

What are SDRs for?

A first option is to allocate these SDRs to global budget support. This is the natural option if the channeling of SDRs is done through the IMF and one of the possible options through multilateral development banks (MDBs) which also provide global budget support. The MDB channel also opens up the possibility of targeted support: program aid, project aid, etc., which are part of their know-how. A third option, within the framework of specialized ad hoc funds, is a targeted cross-cutting use (health, climate...) possibly attached to the management of a global public good (a good start to the financing of such funds?).

Finally, a fourth option, also compatible with specialized funds, would be to allocate these funds to mechanisms for leveraging private financing (for example, to facilitate the access of border countries to international markets). These options can, to some extent, be combined, at the risk, however, of weakening the impact of the channeling of SDRs and reducing their additionality.

A second issue is the maturity of the financing achieved through this reallocation. In a context of a relatively flat yield curve, the relative interest in using SDRs is greater for very high maturities that may, for some, not be compatible with the quasi-monetary nature of SDRs.

Finally, there is the issue of conditionality. SDRs are by nature unconditionally allocated. Reallocation is a priori conditional, to limit moral hazard, ensure external debt sustainability and avoid arbitrage with other conditional financing. In the case of the use of the IMF channel (and to a lesser extent the MDB channel), the conditionality is that of the development programs/strategies to which the reallocation is linked.

Created in 2003 , the **Fondation pour les études et recherches sur le développement international** aims to promote a fuller understanding of international economic development and the factors that influence it.

Contact
www.ferdi.fr
contact@ferdi.fr
+33 (0)4 73 17 75 30

n° ISSN : 2275-5055

policy brief
221
July
2021
note brève