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How Might an SDR Allocation be Better Tailored to Support Low-Income Countries?

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Since COVID-19 emerged there have been numerous calls for an allocation of Special Drawing Rights (SDRs) as part of a broader effort to assist low-income countries (LICs) in dealing with the fallout from the pandemic. So far, these calls have been thwarted by political opposition from some of the IMF's shareholders, in part because SDR allocations are not well-targeted towards LICs or developing countries in general. In recent years there have also been calls for SDRs to be used as a vehicle to support specific objectives such as a Green Fund or support for health expenditures. This note considers how an SDR allocation might be better tailored to support LICs either directly or through a trust fund or similar arrangement.1 Before turning to consider possible allocation mechanisms and their pros and cons, both political and practical, we begin with some background on the SDR, how it has been used, and recent allocations.[2]

WHAT IS THE SDR?

The SDR is an international reserve asset created by the IMF is 1969, but it is not a currency. Rather the SDR's value as a reserve asset stems from the guarantee that SDRs can be exchanged for freely usable currencies. For more than 30 years the SDR market has functioned primarily through voluntary SDR trading arrangements facilitated by the IMF. However, if these voluntary arrangements are insufficient, the IMF can activate the so-called designation mechanism to require IMF members with strong external positions to purchase SDRs from those with weaker positions. As such the designation mechanism provides a backstop to guarantee the liquidity and reserve asset character of the SDR.

The SDR cannot be held by private entities or individuals. Only IMF members[3], the IMF's General Resources Account (GRA) and certain prescribed official entities may hold SDRs. As of end-2020,

1 This note does not consider options to enhance the role of the SDR that would require changes to the IMF's Articles of Agreement. As such the focus is on more immediate steps to facilitate an effective SDR allocation.

2 See Chapter 4 of "IMF Financial Operations" for a more detailed elaboration.

3 Strictly speaking, it is members of the SDR Department and not IMF members (who are members of the General Department) who can hold SDRs. But the membership of the two is now identical

there were 15 organizations (central banks, intergovernmental monetary institutions, and international development banks and funds) approved by the IMF as prescribed holders.[4]

The SDR's value is calculated daily from a basket of five currencies (US dollar, Euro, Chinese renminbi, Japanese yen and pound sterling) and the SDR interest rate is determined weekly as a weighted average of rates on three-month bonds for the same basket of currencies. However the SDR interest rate can never be negative; it is subject to a floor of five basis points (0.05 percent).

Under the IMF's Articles of Agreement its shareholders can, by an 85 percent majority vote, approve SDR allocations which create unconditional liquidity. Member countries do not have to meet any specific requirements to receive their share of an allocation; they have the right to use SDRs to obtain currencies from other participants; and there is no obligation on countries to maintain any particular level of SDR holdings.[5] The IMF and prescribed holders do not receive SDR allocations.

An SDR allocation provides each recipient country with a costless asset. The country earns the SDR interest rate on its holdings of SDRs and pays the SDR interest rate on its cumulative allocation. These two amounts net out as long as the country's holdings are equal to its allocation. Countries that use their SDRs (by exchanging them for currencies) will therefore hold fewer SDRs than their cumulative allocation and pay interest at the SDR interest rate on the difference. Conversely, countries holding more SDRs than their cumulative allocation will earn interest. The IMF's SDR Department maintains records of SDR transactions, holdings and allocations, and debits and credits interest to member countries according to the net balance of their holdings and allocations. Interest payments also typically accrue to both prescribed holders and the IMF's General Resources Account reflecting holdings accumulated through transactions.

The IMF's Executive Board has authorized, as allowed for the Articles of Agreement, a range of SDR transactions and operations that can be undertaken by IMF members and prescribed holders. These include loans, pledges, donations, swaps and forward operations. However, the vast bulk of SDR transactions consist of spot sales and purchases against freely usable currencies.

The SDR is widely used in transactions between IMF members and the General Resources Account.[6] The IMF generally offers SDRs as an alternative to currencies in lending operations and transactions with member countries. IMF holdings of SDRs also tend to increase after quota increases (such as the 14th Quota Review which became effective in 2016) as some countries typically chose to provide the portion of their quota contributions due in reserve assets in the form of SDRs. At the end 2020, the GRA held over SDR 22 billion or about 11 percent of the total stock of SDRs; prescribed holders accounted for held less than 1 percent of the total.

The SDR is also used in some of the IMF's concessional lending operations but the IMF's Poverty Reduction and Growth Trust (PRGT) is not a prescribed holder. The funds lent to LICs accessing the PRGF are provided under bilateral agreements with a number of member governments or their

4 African Development Bank, African Development Fund, Arab Monetary Fund, Asian Development Bank, Bank for International Settlements, Bank of Central African States, Central Bank of West African States, Eastern Caribbean Central Bank, European Central Bank, International Bank for Reconstruction and Development, International Development Association, International Fund for Agricultural Development, Islamic Development Bank, Latin American Reserve Fund, and Nordic Investment Bank

5 An earlier requirement that countries hold a certain proportion of their allocations (a so-called "reconstitution requirement") was abrogated in 1981.

6 The General Resources Account encompasses the non-concessional lending operations of the IMF which draw upon quota resources and well as IMF's public good operations carried out for the membership as a whole. It is distinct from the IMF's concessional lending operations in the Poverty Reduction and Growth Trust (PRGT) which can only be accessed by LICs.

central banks. A significant proportion of these agreements specify that the lender will provide SDRs.[7] However, the PRGT acts as a pass-through in on lending these resources and does not itself hold SDRs.[8] Lenders that have provided SDRs to the PRGT also typically then make use of standing arrangements with the IMF to replenish their SDR holdings. Thus, despite significant SDR loan contributions to the PRGT, their holdings of SDRs have tended to approximate to their allocations.

HOW DO ALLOCATIONS WORK?

General Allocations of SDRs must be distributed in proportion to IMF members' quotas. This requirement reflects the original motivation for creating the SDR, namely, to address concerns of a shortage of reserve assets that could hamper growth, as well as the principle embodied throughout the IMF's governance that quotas, which determine the size of each member's basic financial contribution to the IMF, should also be used in determining access to financial support to ensure uniformity of treatment among the membership.

The approval process for an allocation has a number of stages. The power to decide on an allocation cannot be devolved to the Executive Board. Approval of an allocation, as first proposed by the Managing Director and then supported by the Executive Board, requires an 85 percent majority of voting power by the Board of Governors. The Articles also stipulate that consideration of the need for General Allocations should follow a five-year cycle. However, there is flexibility to take decisions outside of this cycle in the event of "unexpected major developments."

There have been only three General Allocations. The first which took place in 1970-72 just after the SDR was created, totaled SDR 9.3 billion and the second in 1979-81 totaled SDR 12.1 billion, bringing total cumulative allocations to SDR 21.4 billion. The third General Allocation in August 2009, which was designed to help countries address the global financial crisis, totaled SDR 161.2 billion (100 percent of quotas at the time) or approximately $250 billion at prevailing exchange rates.

There has also been one Special Allocation that took place alongside the General Allocation in August 2009. This was designed specifically to address the inequity that countries joining the IMF after 1981 did not benefit from the first two General Allocations noted above. The total allocation of SDR 21.5 billion took into account the increase in the size of total IMF quotas since these earlier allocations and was distributed only to those who were not members in 1981, including the many that joined after the breakup of the Former Soviet Union.

Approval of this Special Allocation required an amendment to the Articles. The fourth amendment (Schedule M of the Articles) was initially proposed in 1997 but did not become effective until August 2009.[9] It was focused exclusively on this one-time adjustment for new members of the IMF and did not introduce any flexibility in the distribution of future General Allocations. To the contrary,

7 In 2020, the IMF reached new loan agreements with 9 members to bolster the loan resources of the PRGT that were being rapidly drawn down during the pandemic. Like all IMF transactions with members, the agreements are denominated in SDRs but more than three-quarters of the total amount of SDR 10.6 billion covered by these loan agreements is to be provided in the form of SDRs from 5 of the contributing countries.

8 The Bank for International Settlements conducts sales on behalf the PRGT so that loan resources provided in SDRs can be disbursed in currencies if requested by the borrower.

9 There have been only six amendments to the Articles. The ratification of even seemingly noncontentious amendments often requires months, if not years, given the need to obtain formal acceptances from three-fifths of the membership accounting for 85 percent of total voting power.

it serves to underline the *lack* of flexibility to move away from a quota-based distribution of General Allocations.

WHAT WOULD A GENERAL SDR ALLOCATION IMPLY FOR LICs?

For illustrative purposes, assume an allocation of 100 percent of quotas. At SDR 476 billion or $685 billion this would be close to mid-point of the range of $500-1000 billion that some have advocated. LICs (defined here as the 69 countries that are eligible to access the PRGT) would in total receive just under 3.2 percent of this allocation. At the other extreme, the G20 would receive 68 percent of the total while the US, EU members and the UK would together receive 48 percent. The bulk of the allocation would therefore accrue to countries that may not have a strong need.

However, the positive impact on LICs of even this poorly distributed allocation should not be understated. In part this reflects the fact that quotas for LICs tend to be higher relative to economic size than they are for larger IMF members. An allocation of 100 percent of quotas, or SDR 15.2 billion for LICs would be larger than the current stock of IMF lending under the PRGT of about SDR 12½ billion and about 2½ times the record pace of PRGT disbursements in 2020. The bulk of these disbursements were under the interest free Rapid Credit Facility in 2020, with countries typically receiving disbursements of 50 or 100 percent of their quotas. The 29 most vulnerable LICs that could benefit from emergency debt relief of up to a SDR 0.7 billion from the IMF during the pandemic would receive SDR 5.5 billion from the assumed SDR allocation.[10]

The pattern of current SDR holdings also shows that LICs have tended to convert more of their SDRs. As would be expected, countries facing very difficult external positions have generally used at least part of their allocations from 2009 to acquire freely usable currencies, while advanced economies have typically maintained holdings close to their allocations. However, the disparate pattern of holdings is also a reflection of central banks' choices in reserve management. There are, for example, a significant number of LICs facing very tight external constraints whose SDR holdings are higher than their allocations. (For some this choice may be linked to large debt repayments that are SDR-denominated).

However, countries do not have to convert SDRs to benefit from their allocations. Whatever the precise motivation for the observed pattern of SDR holdings since the 2009 allocation, it is illustrative of a more general point. The increase in a country's reserves from an SDR allocation is "fungible" providing a reserve cushion even if the allocation in not converted. To give a simple hypothetical example: if prior to an allocation a country has 3 months of reserve cover, an allocation of SDRs that bolsters reserve cover to 4 months would ease the external constraint by providing the flexibility to rundown *non*-SDR holdings while still retaining 3 months of fully liquid international reserve cover.

10 This debt relief under the IMF's Catastrophe Containment and Relief Trust (CCRT) could be extended to cover amounts due to the IMF/PRGT in the two years to April 2022 providing financing become available.

HOW COULD SDRs CREATED BY A GENERAL ALLOCATION BE BETTER TARGETED?

The lack of flexibility in the distribution coupled with the evident and urgent needs of LICs greatly complicates political decision making on the size of the allocation. While there is broad consensus on the need to assist LICs, support may be tempered or in some cases countered by concerns over the overall size of the allocation. The larger it is, the more it could benefit LICs but at the cost of providing significantly larger allocations to countries that do not need additional reserves. A larger allocation could also exacerbate the geopolitical concerns of some shareholders over reserve increases for particular countries.

Proposals to re-target or make better use of an allocation have included donating or lending SDRs or, in some cases, establishing an SDR-based fund that would either leverage or on-lend a pool of SDRs. There are pros and cons to each of these approaches. While donations and lending SDRs between individual IMF members and prescribed holders has been explicitly permitted by the IMF's Executive Board, other steps such as establishing a separate entity to pool SDRs would break new ground.

DONATING SDRs

A commitment to donate SDRs could help in the targeting and, by implication, the approval of an allocation. A "reallocation" of only a small share of an SDR allocation could sharply increase the benefits to LICs. In the example given earlier, donating under 4 percent of a total allocation to LICs would double the impact of the allocation on LICs. Similarly, a relatively small reallocation could allow LICs to benefit while avoiding the misgivings of some over the total size of the allocation. Since a smaller allocation would reduce the SDR amounts provided to all countries in proportion to their quota shares it may also help to lessen the political objections that some shareholders would have to providing SDRs to countries such as Iran and Venezuela. However, there is no scope in the Articles to prevent particular countries from participating in the allocation.[11]

If subsequent donations were to be key in developing a consensus on a possibly smaller allocation, some assurance of their equitable distribution would be desirable if not essential. The small size of the donations relative to the total allocation might suggest that voluntary action could suffice. However, a purely voluntary and uncoordinated approach could raise concerns over the timely and equitable delivery and receipt of expected donations to all LICs. In contrast, a commitment to donate to *all* LICs in proportion to their quota shares would have the advantage of following the established principles governing a General Allocation and avoiding a possibly intractable debate on alterative reallocation schemes.

The treatment of interest due on the donated SDRs would also need to be considered. Although permitted for more than 40 years, there have been few (if any?) donations of SDRs. In part this may reflect the unusual nature of a donation of SDRs. The original recipient of the SDR would, through the donation, reduce its holdings relative to its allocation and thereby incur an interest cost, while

11 After the allocation it would be important to ensure that voluntary trading arrangements are sufficient to cover future conversions of SDRs. In the absence of adequate voluntary trading arrangements, a formal designation plan could require countries to participate in politically difficult exchanges.

the country benefitting from the donation would earn interest for as long as it holds the SDRs. A gift that keeps on giving. At present the resulting interest costs to the donor would be minor but over time the SDR rate would, of course, reflect movements in its constituent market rates. There could also be some mechanism agreed between the donor and the recipient to share the interest cost or fully transfer this to the recipient.

A commitment to donate a proportion of the allocation to LICs would ideally include a common position on how interest costs are treated. By providing uniform treatment for all LICs, this approach would again follow a key feature of the allocation as well as a wider principle of IMF governance. Reaching a common position may be difficult given differences in domestic processes. A simple approach may therefore help in reaching a consensus. One possibility is that all donors accept the interest costs. This would avoid the administrative complexities of donors seeking to recoup fluctuating interest payments from multiple recipients. In the background there may need to be some domestic processes to determine which institution bears the interest cost of the donation. For example, in countries where the central bank rather than the finance ministry is the holder of SDRs, there may need to be a change of ownership of the SDRs so that the budget bears the interest cost of the donation. Alternatively, to avoid the complexity of budgeting for future interest payments, the commitment to donate could include prior understandings that the recipient LICs immediately convert their donated SDRs to freely usable currencies in transactions with the donors.[12] The donating country would thus restore its SDR allocation through an offsetting acquisition of SDRs, but at the possible cost of some interest foregone.

A decision on an allocation could effectively be conditional upon a prior commitment including an agreed mechanism to deliver the donations. The prior commitment could require pledges from part of the membership to donate a combined total of, say 5 to 10 percent of the allocation (depending on its overall size) to LICs. To provide greater transparency and assure timely delivery this could even include instructions to the SDR department to immediately transfer, as a donation, a set amount from the recipients' allocations, to be divided in proportion to quota shares among all LICs.

The approval process followed in a different context to allow "windfall" gold sales profits to be transferred to the PRGT may provide a possible model. In 2009-2010 the IMF sold almost 13 million ounces of gold to fund an endowment to provide more durable and reliable financing to support the IMF's administrative budget. However, profits from gold sales were stronger than anticipated. The Executive Board decided that the resulting windfalls should be used to support the PRGT. As there was no legal basis for a direct transfer of these profits to the PRGT, an indirect procedure was adopted. The Executive Board approved, by 70 percent majorities, two distributions of these profits to the membership. However, these approvals were not granted until more than 90 percent of the membership had agreed that their shares of the distribution would be placed in the PRGT subsidy accounts.

Although this approach envisages prior commitments to make donations, it need not require all to commit, thereby maintaining its voluntary character. To attain the desired level of donations a critical mass of support would be needed, but the relatively small size of the donations provides scope for some to opt out. The key issue is then whether other countries would be comfortable sharing more of the "burden" of donations in building a consensus. The process may also be more tractable if, for example, there were an expectation that the required donations would be forthcoming from only advanced economies but again, a consensus could emerge without all in this group agreeing to commit.

12 Multiple voluntary transactions involving LICs and donating countries could be set up prior to the allocation and related donations.

Similarly, there would be nothing to preclude donations outside this framework to support particular countries that are not classified as LICs.

LENDING IN SDRs

A number of countries already lend some of their SDRs to the PRGT. These resources are intermediated by the PRGT which, with the aid of separate subsidy resources, on-lends these funds to LICs. The SDR interest rate is paid on funds lent to the PRGT under bilateral agreements, thus offsetting the SDR interest that is payable by the contributing country whose SDR holdings fall relative its allocation by the amount of the loan. Although these SDR loans are an important source of funding for the PRGT, they have typically amounted to only about a quarter to a third of the contributing countries' existing SDR allocations, and only a handful of countries have provided SDR resources to the PRGT.[13]

The higher subsidy costs of a significant scaling up PRGT lending would also need to be addressed. LICs currently pay no interest on their borrowing from the PRGT, while loan contributors to the PRGT earn the SDR rate of interest and the resulting subsidy costs are covered by an endowment within the PRGT. Prior to the pandemic, it was assumed that broadly stable levels of lending would allow earnings from the endowment to cover subsidy cost thus supporting the IMF's concessional lending to LICs for decades to come. However, after the surge in lending in 2020, which doubled the stock of PRGT credit outstanding to about SDR 12½ billion, income from the endowment will not be sufficient to cover subsidy costs; some depletion of the endowment's principle will also be required. Under almost any scenario for a general allocation there would be ample SDRs to support a sharp increase in PRGT lending. For example, applying just 5 percent of an assumed allocation of SDR 476 billion to the PRGT would triple its current stock of lending to LICs. However, lending on this scale would sharply increase subsidy costs and thus the pace at which the endowment is depleted. Additional resources would ultimately be needed to replenish the endowment; see "Financing a Possible Expansion of the IMF's Support for LICs" (forthcoming). In addition, a sharp rise in lending would also entail a further decline the ratio of the PRGT's Reserve Account to credit outstanding, sharply reducing the assurance that these reserves provide to lenders.

A fresh injection of unencumbered resources—and not loans—would be needed to replenish the PRGT's endowment, including the Reserve Account. Over the medium term, these resources could in principle be generated through sales of a small part of the IMF's gold holdings (see the companion blog on the IMF's gold). But, in the meantime, substantial on-lending of SDRs via the PRGT would accelerate the decline in the endowment.

Lending SDRs outside the PRGT would entail reduced safeguards for lenders. The conditionality applied to PRGT lending and the PRGT's reserve account both provide assurances to lenders. In addition, lenders have the option of participating in an encashment regime to maintain the liquidity of their claims. For central banks providing loan resources this can allow loan contributions to be

13 A fund-raising exercise launched in 2015 resulted in 15 loan agreements for the PRGT of which 5 were for SDRs. 2018-19 Review of Facilities for Low-Income Countries---Reform Proposals: Review of The Financing of The Fund's Concessional Assistance and Debt Relief to Low-Income Member Countries https://www.imf.org/en/Publications/Policy-Papers/Issues/2019/06/06/2018-19-Review-of-Facilities-for-Low-Income-Countries-Reform-Proposals-Supplementary-46970
Similarly, 5 of the agreements reached in 2020 were SDR based.
https://www.imf.org/en/Publications/Policy-Papers/Issues/2020/10/20/2020-Borrowing-Agreements-With-The-National-Bank-Of-Belgium-Banco-Central-Do-Brasil-Banque-49832;

considered liquid assets carried at full face value. These attributes would not apply if countries were to lend their SDRs directly to LICs or through some simple pooling mechanism.

Countries could lend SDR without the safeguards provided by PRGT, but donations would be better. Such unconditional lending without these safeguards could be justified by the scale of the needs facing LICs. But in these circumstances, donations of SDRs would be more appropriate. They would provide flexibility without adding to the risk of debt distress that could be heighted by unconditional lending.[14]

SPECIAL PURPOSE FUNDS

While loans and donations aim to improve upon the effective distribution of international reserve assets created by an SDR allocation, special purpose funds would seek to leverage otherwise underused allocations. The basic approach as laid out in 2010 in a proposal for a Green Fund is for countries to capitalize a fund with at least part of their SDR allocations.15 This equity would then facilitate bond issuance for larger scale activities to tackle climate change. A similar approach could in principle be envisaged to establish a health fund as another public good, geared initially to addressing the global pandemic.

Although these ideas are not new, they have not been put to the test. While it may be reasonable to assume broad support for the objectives of a Green Fund or a health fund geared to the needs to LICs, there are both legal and political questions as to whether it is appropriate or feasible to use the SDR as vehicle for establishing such a fund. These issues are discussed below, looking at some of the steps that would be required.

The fund would need to be approved as a prescribed holder for it to receive SDRs as capital. As noted earlier, only 15 entities are currently approved as prescribed holders, the last being the ECB in 2000. The Articles allow the Executive Board to prescribe as holders "institutions that perform functions of a central for more than one member or *other entities.*" However, "the terms and conditions on which they are permitted to hold SDRs… shall be consistent with the provisions of [the Articles] and the effective functioning of the SDR department." There may be some doubt as to whether this language would support approval of such as fund as a holder. While a legal clarification would be important, the potential for different interpretations is particularly important here because approval for a prescribed holder requires an 85 percent majority vote.

There would need to be a strong consensus that placing SDRs in the fund, where they would be expected to remain, is an appropriate use of the SDR. The SDRs placed in the fund would be exchanged for an equity stake rather than currencies. As noted earlier, the articles do allow the IMF to authorize (by a 70 percent majority vote) operations other than simple exchanges for currencies but

14 Direct lending of SDRs to LICs would also be complicated by the resulting pattern of interest payments. The lender's SDR holdings would be reduced by the amount lent, while the borrower's holdings would increase. These movements would thus entail the payment of the SDR interest rate by the lender on the amount lent, while the borrower would earn the SDR interest rate on the amount borrowed. To offset these amounts, the lender would need to charge a premium over the SDR interest rate to bring the effective interest rate to above zero.

15 "Financing the Response to Climate Change", Bredenkamp and Pattillo
https://www.imf.org/~/media/Websites/IMF/Imported/external/pubs/ft/spn/2010/_spn1006pdf.ashx

these must be consistent with the "proper use of SDRs." More generally, this structure could be seen as running counter to the reserve asset function of the SDR. As was recognized in the Green Fund proposal, if contributors wanted to their SDR contributions to retain the character of reserve assets this would require an arrangement among contributors that would allow a Green Fund shareholder encountering liquidity needs to encash its equity stake in the fund.[16]

Although it may not be possible to use SDRs *directly* to support a new fund, an allocation could still provide an avenue for *indirect* support. As was noted earlier the increase in reserves provided by an SDR allocation is fungible, so that the SDRs themselves do not need to be used for a country to benefit from the flexibility provided by an allocation. In this context, the key point is that countries could, in principle, place existing reserve assets up to the value of their SDR allocations in the new fund rather than placing SDRs. Their total reserve holdings before and after the allocation would then be the same; only the composition of their reserves would have changed. This approach would enable the resources provided by the allocation to be mobilized for the new fund but without having to confront the concerns noted above that could limit the direct use of SDRs. The feasibility of such a step for each country would however still depend on domestic arrangements that could, for example, limit the scope for the central bank to participate in the fund.

BRIEF CONCLUDING REMARKS

The priority is to reach some consensus on an SDR allocation that could assist LICs in addressing the immediate economic pressures brought on the pandemic. As argued above, an orchestrated mechanism to commit and then deliver voluntary donations from advanced countries could help in providing adequate support for LICs without inflating the headline size of the allocation. Ideally, this would involve a commitment to donate SDRs to all LICS (defined as PRGT eligible countries) based on quota shares.

Lending SDRs via the PRGT will continue to make an important contribution. But this lending is best regarded as a supplement to SDR donations and a vehicle for distributing or recycling SRDs in a new allocation.

Proposals to use SDRs to capitalize special funds raise a number of questions that, at the very least, will take time of resolve. Seeking to include these issues would risk a long delay in approving a new allocation. Possible vehicles of this type could be included as the size of the allocation is considered. But those skeptical of the merits of using SDRs in future to set up such a fund would have the safeguard that an 85 percent majority would be required before the fund could have access to SDRs. Alternatively, the fungible nature of the SDRs as reserve assets could provide a means of indirect support for the fund. But here too, it may take time to address possible domestic legal and political constraints.

16 The convertibility of SDRs held by members is, as noted at the outset, guaranteed by the backstop of a designation plan that could in effect force some countries to accept SDRs from countries with weaker external positions. But the designation plan would not apply to prescribed holders; convertibility would need to rely on other guarantees.

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