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Economy and international financing

Special drawing rights issued by the IMF and the challenge of chanelling them to the most vulnerable countries

The Summit for a New Global Financing Pact held on 22 and 23 June 2023 drew up a roadmap for future international summits, aimed at strengthening international financial solidarity for the benefit of the poorest and most vulnerable countries in the South. Discussions focused in particular on Special Drawing Rights (SDRs), the international reserve asset issued by the International Monetary Fund (IMF). As currently defined, SDRs are allocated on the basis of country quotas, which correspond to the Fund's shareholding structure but not necessarily to the needs of individual countries. International discussions have therefore established options for channeling SDRs to the countries that need them most, and other proposals are being discussed, such as a new channeling option, and regular or targeted general allocations of SDRs to these countries.

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JEL codes
F33, F34,
H87, Q54

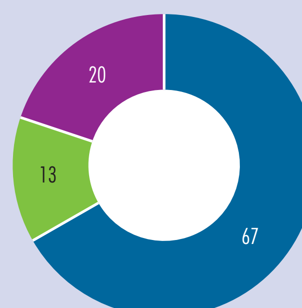
650 billion US dollars
amount of the last general allocation of Special Drawing Rights (SDRs) by the International Monetary Fund (IMF, August 2021)

20%
share of SDRs allocated (in August 2021) to countries with reserve needs

100 billion US dollars
floor target (set by the G20 and achieved) for channeling SDRs to the most vulnerable countries

40%
French target for channeling its allocated SDRs, i.e. around 8 billion SDRs (USD 10.6 billion), to the most vulnerable countries

Breakdown of Special Drawing Rights (SDRs) issued at the last IMF general allocation in August 2021
(%)



Sources: IMF, Arslanalp et al. (2022), and Banque de France calculations.

1 SDRs were created to supplement the official reserves of IMF Member States

IMF general allocations: lending money without conditionality

Since the amendment to its Articles of Agreement in 1969, the International Monetary Fund (IMF) has issued an international foreign exchange reserve asset, known as the Special Drawing Right (SDR), to meet liquidity needs and supplement the official reserves of Member States facing balance of payments crises. The SDR is not a currency, but an asset that holders can exchange for foreign currency if necessary. The allocation of SDRs creates a debt of Member States vis-à-vis the IMF.

The IMF can therefore decide to allocate new SDRs to Member States. Of the four general allocations made since its creation, the latest (August 2021) is the largest ever: 456 billion SDRs, which corresponds to USD 650 billion.[1] Previous allocations amounted to 9.3 billion SDRs in 1969, 12.1 in 1979 and 161.2 in 2009. General SDR allocations have several advantages for Member States:

- Allocations are not subject to any ex ante or ex post conditionality for Member States. This is a major difference from IMF financial assistance facilities, which are subject to strong conditionality (implementation of economic and financial structural adjustment programmes) or at least ex ante qualification criteria (linked to external debt sustainability and ability to repay the IMF);
- Allocated SDRs do not generate any costs for Member States if they are not converted, and costs remain moderate if they are used (see Box 1 below);
- Finally, the use of allocated SDRs is at the discretion of Member States:
  - A State may keep the SDRs received as an additional reserve, which makes it possible to improve market access (for example by reducing borrowing costs) and ease external financing constraints. Thus, in practice, the central bank may commonly keep the SDRs by extending a loan to the Member State in local currency in return;
  - A Member State may also use the SDRs allocated to it to repay any debts it owes to the IMF;
  - A Member State may also exchange SDRs for freely usable currencies (US dollar, euro, pound sterling, yen, yuan) in order to adjust the composition of its international reserves, repay external debts other than those linked to the IMF, or finance additional budget expenditure.

For example, in an ex-post assessment report of the 2021 allocation, published at the end of August 2023, the IMF uses data from the SDR-Tracker,[2] which tracks 142 of the 190 Member States, to determine how the allocated SDRs were used. It notes that the SDRs were mostly used to build up reserves, at least in part, in the case of 115 countries. While financing budget expenditure was the second most common use of the allocation (46 countries), the report notes that only 5% of the SDRs in the allocation were exchanged for freely usable currencies (US dollar, euro, pound sterling, yen, yuan).

The general allocation of SDRs thus almost corresponds to money creation. In the IMF's activities, a distinction should therefore be made between general SDR allocations (based on this issuing power) and financial assistance programmes (based on resources derived from Member States' contributions). In the first case, the allocation is almost similar to central bank-type money creation (monetary base). In the second case, the IMF creates money in the same way as a commercial bank, according to the expression "loans make deposits": the loan is entered on the IMF's assets side as a receivable. At the same time, the IMF credits the account of the Member State concerned on the liabilities side. The accounting balance is thus preserved, but an injection of liquidity has been made ex nihilo.

1 At the exchange rate of USD 1 = SDR 0.706 (29 October 2021).
2 *https://www.imf.org/en/Topics/special-drawing-right/SDR-Tracker*

BOX 1

The costs associated with holding and using special drawing rights

The International Monetary Fund (IMF) remunerates the Special Drawing Rights (SDRs) actually held by a given country (SDR holdings) and at the same time levies charges based on the initial allocation of SDRs (SDR allocations), at the same rate (SDR interest rate – see below). Consequently, if the SDRs are not used, the interest flows cancel each other out.

An allocation simultaneously raises the SDR-denominated assets and liabilities of a given country. If the SDRs allocated are not used (because they are not needed or because they are held as an additional reserve buffer), they increase a country's level of gross indebtedness, but do not generate additional costs since the ratio of SDR-denominated assets to allocations remains constant. However, if the SDRs received are then used (to be converted into foreign currency and spent), the ratio of SDR-denominated assets to allocations falls below 100%: this means that the country's expense flows exceed its remuneration flows. Any SDR used (conversion into foreign currency, loan, etc.) can therefore generate a cost equal to the SDR interest rate.

The SDR interest rate is the average of the interest rates on the short-term (three-month) bonds or bills of governments whose currencies are included in the basket of currencies to which the SDR is pegged (US dollar, euro, pound sterling, yen, yuan). It therefore represents the cost of international liquidity (without any risk premium).

However, the issuance of SDRs is not fully equivalent to the power of creating money, because SDRs are not money. On the one hand, SDRs cannot be held by private actors and, on the other, SDRs are a reserve asset and the IMF's Articles of Agreement state that "a participant will be expected to use its SDRs only if it has a need because of its balance of payments or its reserve position or developments in its reserves" (Article XIX, section 3, a).

Recourse to general allocations is linked to the need for international liquidity

The terms and conditions governing the use of general allocations clearly underline the money creation nature of SDRs. This recourse is conditioned by "a collective judgment that there is a global need to supplement reserves, and the attainment of a better balance of payments equilibrium, as well as the likelihood of a better working of the adjustment process in the future" (Article XVIII, b). The same article states that the allocation must also "avoid economic stagnation and deflation as well as excess demand and inflation in the world".

Ahead of the last general allocation of around 456 billion SDRs (USD 650 billion) in August 2021, the IMF therefore carried out an assessment of long-term (five years in practice in its approach) needs in terms of reserve assets. In the context of the Covid-19 crisis, these needs were estimated at between USD 1.1 and 1.9 trillion. The IMF also assessed alternative sources of such reserves (current account surpluses, net private capital inflows, bilateral financial assistance), estimated at between USD 0.5 trillion and USD 0.6 trillion over five years. The amount of the general allocation decided on was thus intended to meet 30-60% of the total need.

The risk of inflationary pressures generated by the allocation was considered low. Indeed, the IMF points out in the aforementioned August 2023 report that the allocation represented only a small share (less than 0.5%) of total broad money at the global level in 2021 and that it was implemented when the global output gap was large and negative.

The distribution of SDRs mainly benefits G7 countries

The distribution of SDRs within the framework of a general allocation is based on Member States' quotas (see Box 2 below). It mainly benefits countries that do not need SDRs (80% of allocated SDRs), i.e. on the one hand reserve currency issuing countries (67%, of which the G7 countries,[3] which account for 45%), and on the other countries that already have a high level of reserves (13%) – see chart 1. Thus, of the USD 650 billion in the last general allocation of SDRs, around USD 375 billion (264 billion SDRs) went to high-income countries, while USD 275 billion (193 billion SDRs) went to emerging markets and developing countries, of which around USD 21 billion (15 billion SDRs) to low-income countries (IMF, 2021).

However, the IMF qualifies this observation by pointing out that most low-income countries received a higher SDR allocation than the average for emerging or advanced countries as a percentage of 2021 GDP (IMF, 2023) – see Chart 2.

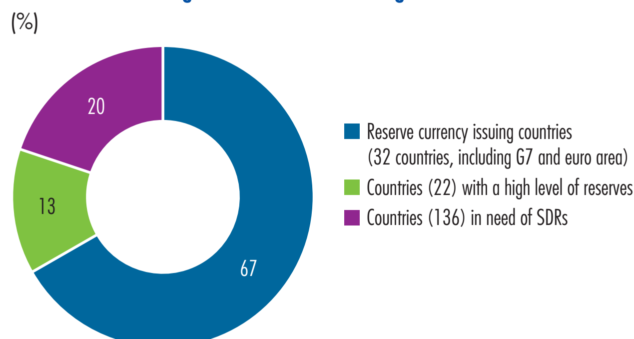
More generally, this link between quotas and SDR allocations means that around 70% (450 billion SDRs) of the total SDRs issued during the IMF's four historic general allocations went to the 57 richest countries. By contrast, the most vulnerable countries received a smaller share of the IMF's total SDR allocations: low-income countries received less than 2% (10.5 billion SDRs) of total SDR allocations. More broadly, all countries outside the group of richest countries received around 204 billion SDRs (30%) – see chart 3 below.

In addition, some countries that do not need reserves tend to accumulate SDRs, from the allocation obtained and the additional SDRs received when they accept a transaction with countries wishing to exchange their SDRs for freely usable currencies. This explains why their utilisation rate can be negative (see Chart 4 below).

However, the needs of middle- and low-income countries to deal with climate change and biodiversity loss exceed their financial capacity. According to a report produced for COP 27, the annual financing needs for climate action amount to around USD 1,000 billion per year between now and 2030 for emerging markets and developing countries (EMDCs) other than China (Songwe et al., 2022). To this must be added the investment needs for biodiversity conservation, estimated at USD 8.1 trillion at the international

C1 Breakdown of quotas, voting rights and SDRs issued at the last IMF general allocation in August 2021

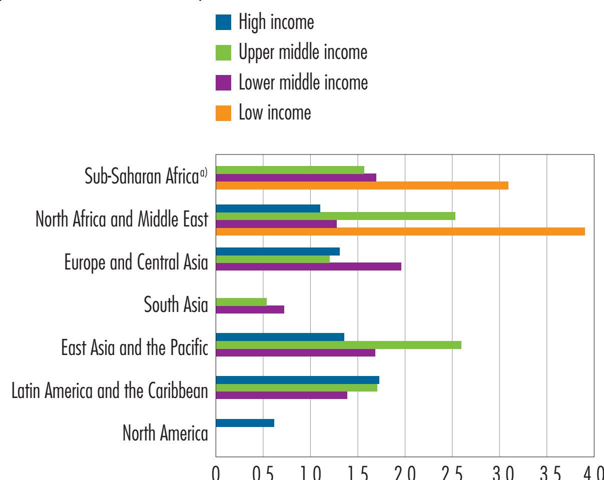
(%)



Note: Reserve currency issuing countries refer to the US dollar, euro, pound sterling, yen and yuan, as well as the Australian, Canadian, Singaporean, New Zealand, Hong Kong dollars, Swedish krona, Danish krone, Norwegian krone, Swiss franc and won. Countries with a high level of reserves are those which, in 2020, had the most reserves according to the assessing reserve adequacy (ARA) metric, which is here greater than or equal to 1.5, and the oil-exporting Gulf States.
Sources: IMF (ARA database), Arslanalp et al. (2022), and Banque de France calculations.

C2 Breakdown of SDRs issued at the last IMF general allocation in August 2021, by region and by income

(as a % of 2021 GDP)



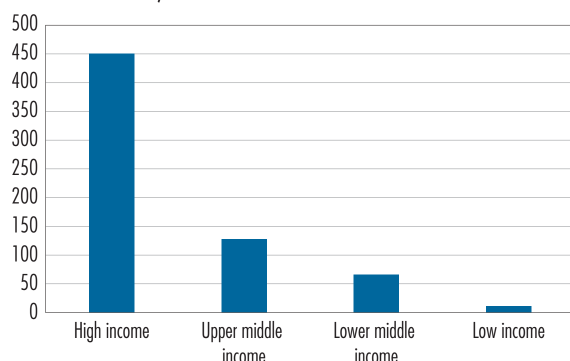
a) The Seychelles is an exception in the "Sub-Saharan Africa" group as it is the only country in the region classified by the World Bank as a high-income country. In order not to distort the reading of the chart, it is not represented.
Note: On average, low-income countries received more special drawing rights as a share of 2021 GDP.
Sources: IMF, World Bank, and Banque de France calculations.

3 Canada, France, Germany, Italy, Japan, United Kingdom, United States.

level between now and 2050 (UNEP, 2021). These financing needs should be set against other economic and financial challenges that these countries have had to face and continue to face: high levels of debt, the financial impact of the Covid-19 crisis and the war in Ukraine, etc. (Grieco et al., 2023). Comparatively, the richest countries are on average less likely to use their SDRs than the poorest countries (see Chart 3, "PRGT-eligible countries"[4] curve).

C3 Total SDR allocations by the IMF by income group, following the last allocation in 2021

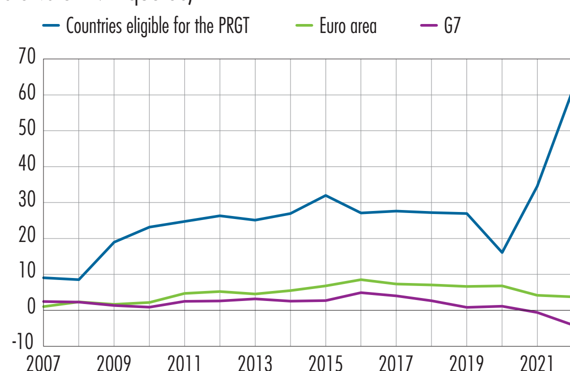
(in billions of SDRs)



Sources: IMF, World Bank (classification of countries by income level).

C4 SDR utilisation rate from 2007 to 2022

(as a % of IMF quotas)



Notes: PRGT, Poverty Reduction and Growth Trust. G7 includes Canada, France, Germany, Italy, Japan, the United Kingdom and the United States. The utilisation rate of Special Drawing Rights (SDRs, as a % of IMF quotas) corresponds to the difference between SDR allocations and holdings, divided by quota (according to the methodology of ECA-ECLAC [UN], 2022). This categorisation masks major disparities. In the euro area, for example, Greece displays a utilisation rate of 10% or more over the entire period studied, rising to 95% in 2022.
Source: IMF.

BOX 2

International Monetary Fund quotas

A quota is allocated to a country when it joins the International Monetary Fund (IMF), based on its relative position in the world economy. Quotas represent both financing and governance issues, and determine for a Member State: the amount of its contribution to IMF resources; the maximum level of financial assistance it can obtain from the Fund; its share of voting rights on the Executive Board; and the proportion of SDRs it is entitled to in the event of a general allocation.

In order to determine a member country's relative position in the world economy, the IMF uses a formula that is a guide, but is not binding.

The current formula for calculating quotas comprises a number of variables, with different weightings, including:

- gross domestic product (60% of market GDP and 40% of PPP GDP – purchasing power parity);
- openness (current payments and receipts – in goods, services, income and transfers);
- variability (variability of current receipts and capital flows);
- reserves (official gold and foreign exchange reserves);
- a compression factor (K) of 0.95.

The formula is written as follows: (0.50*GDP + 0.30*Openness + 0.15*Variability + 0.05*Reserves)^K

The inclusion of the amount of reserves in the formula (even with a low weighting of 5% compared with the other variables) highlights the contradiction in the allocation mechanism: the countries with the most reserves are likely to receive more SDRs.

4 The Poverty Reduction and Growth Trust (PRGT), set up in 1999 and dedicated to low-income countries, aims to provide financial assistance programmes that place greater emphasis on economic and social development and poverty reduction strategies.

2 Channeling allocated SDRs to the countries that need them most

Commitments to channel SDRs to the most vulnerable countries

Channeling SDRs is not new: since 2010, several countries, including France, have voluntarily lent SDRs to the Poverty Reduction and Growth Trust (PRGT). Since the last general allocation of USD 650 billion in August 2021, just over USD 100 billion worth of channeling pledges have been made, mainly from G7 members and China. France is the country with the most ambitious channeling target (40% of the allocation, i.e. around 8 billion SDRs), alongside Japan and Canada. However, its contribution, whether in the form of SDR loans or budgetary contributions (see below), must be made under conditions of fair international sharing of the effort by ensuring that countries with a sound external position also participate in a substantial manner.

The existing and most immediate channeling options have limitations

Beyond countries' commitment to channel their SDRs, the operational aspects need to be clarified so that this channeling is compatible with the constraints and legal rules specific to each State.

The simplest way to mobilise SDRs for the benefit of the most vulnerable countries is to rely on two IMF-administered trusts: the PRGT, which has already been partly financed by channeled SDRs since 2010 (see above), and the Resilience and Sustainability Trust (RST),[5] created in October 2022. These two trusts, in their financial configuration, help to maintain reserve asset status for the contributions received (see Box 3).

BOX 3

Special drawing rights and foreign exchange reserves of European central banks

For the central banks of the European Union, which manage the SDR-denominated assets of their Member States, maintaining reserve asset status is one of the necessary conditions to ensure that a loan in SDRs to one of the International Monetary Fund (IMF) trusts is not considered as monetary financing, as this would be in breach of Article 123 of the Treaty on the Functioning of the European Union (TFEU). The key requirement is that the reserve asset be liquid, with a low level of risk. The liquidity of SDRs lent to IMF trusts is secured on certain accounts of these trusts. For these accounts, the lending central bank may request early repayment of the loan if necessary, i.e. in the event of balance of payments difficulties or withdrawal of the allocation, while allowing recourse to their own loans to meet early repayment requests from other lenders.

Beyond the legal and operational issues surrounding the maintenance of reserve asset status, a more fundamental debate is underway, particularly within the Eurosystem, but not exclusively, on the use of these reserve assets. Article 123 TFEU prohibits the "direct" monetary financing of European Member States by their central banks (acquisition of government securities, through money creation or reserves), but it can also be interpreted as prohibiting "indirect" monetary financing, i.e. the financing of Member States' public policies (subject to Article 127 TFEU).

Some Member States take a more conservative approach to preserving the monetary nature of SDRs and regard certain SDR channeling options as indirect monetary financing of national development aid policies. They consider that channeling SDRs may mark a shift in nature between reserve asset and development financing instruments. In the case of the IMF's Resilience and Sustainability Trust (RST), for example, some European countries, such as Germany and Estonia, participate solely through budgetary contributions and therefore have no plans at this stage to channel SDRs through this trust. This also has consequences for the position of central banks with regard to the option of channeling by multilateral development banks (see below).

5 The Resilience and Sustainability Trust (RST) is designed to provide long-term financing to address structural challenges such as climate change and pandemic preparedness.

The IMF hopes that around 76% (around 57 billion SDRs) of the G20 commitment to channel USD 100 billion for the benefit of vulnerable countries will be lent to these two trusts in the short term. This, of course, assumes that the financial targets set by the IMF are met, respectively 12.6 billion SDRs for the PRGT and 33 billion SDRs for the RST (45 since the Summit for a New Global Financing Pact in June 2023). Achieving the targets set by the IMF will also require persuading countries that have not yet mobilised 20% of their SDRs (potentially around USD 12 billion), as well as partners who may even step up their efforts to 30% of SDRs (around USD 13 billion).

Regardless of whether these objectives are achieved, these SDR channeling options nevertheless have their limitations. On the one hand, access to the financing provided by these trusts remains subject to conditionality similar to that for other IMF financing; this limits demand for such financing, while SDRs are allocated unconditionally (but they increase countries' indebtedness). On the other, SDRs are channeled in the form of loans at the SDR interest rate (see Box 1 above) from contributing countries to the two trust funds, the PRGT and the RST. As these trusts then lend to the recipient countries at lower, so-called concessional rates (for example, 0% for the PRGT), resources in the form of donations must be found to finance this concessionality.

This need has grown under the combined effect of the increase in demand for loans and the rise in the SDR rate in line with the monetary tightening cycle. The IMF estimates the financing need for the concessionality subsidy fund at 3.5 billion SDRs. The channeling of SDRs to the PRGT therefore depends on the willingness of IMF Member States to top up the subsidy fund to finance this concessionality. For the RST, the same logic applies, and even more directly because of a rule of proportionality that links payments of new financing to the various accounts that make it up.

Channeling SDRs through multilateral development banks would be a third option

In addition to the first two channeling options mentioned above, a third option is being discussed, with two variants: i) the first consists in channeling countries using their SDRs to buy hybrid capital instruments issued by the multilateral development banks (MDBs); the second consists in the same countries buying bonds issued by the World Bank or the other MDBs, denominated in SDRs but settled in foreign currencies.

The first variant is supported by the African Development Bank (ADB, 2022) and the Inter-American Development Bank (IDB). As a vehicle for channeling SDRs, they propose a hybrid capital instrument that the MDBs can record as equity. This would enable them to borrow more on the capital markets, with, according to the proponents of the proposal, a significant leverage effect (estimated at 4 by the ADB). This leverage far exceeds that of existing options, since for every SDR channeled through the PRGT or the RST, less than one SDR can be lent, due to the financial architecture of these trusts.

In addition, the proposed mechanism aims at replicating the PRGT and RST collection mechanism in order to maintain reserve asset status and, according to the proponents of the proposal, would not require any budgetary contributions, unlike the PRGT and RST.

This proposal was one of the key operational issues at the Summit for a New Global Financing Pact, organised by France in June 2023.

At the European Union level, according to the prevailing interpretation at this stage, the institutional framework does not authorise this option for Member States, by reference to Article 123 of the Treaty on the Functioning of the European Union (TFEU) and Article 7 of Regulation (EC) No. 3603/93 (derogation from the ban on monetary financing, which applies only to the IMF, not to the MDBs). An amendment to the aforementioned Article 7 or at least a change in its interpretation by the ECB would be necessary to open up this avenue. Beyond this legal-institutional issue, there also exists a fundamental debate on the nature and purpose of SDRs (see Box 3 above).

The second variant was developed by Brad Setser and Stephen Paduano (2023). However, like the channeling of SDRs through the PRGT and the RST, this solution does not offer any leverage, which makes it less attractive for MDBs and their debtors. For European countries, it also comes up against the same constraints as those mentioned above.

⁂

Other options have been put forward. Several researchers and non-governmental organisations, as well as the Bridgetown Initiative, led by Mia Mottley, Prime Minister of Barbados, and the United Nations Secretariat (2023), are calling for new general allocations of SDRs. These could be either regular (on an annual basis, for example), or independent of Member States' quotas (but linked to needs, with vulnerability as an allocation criterion, for example (Cabrillac and Guillaumont Jeanneney, 2022), or both regular and needs-related.

However, this would mean endorsing the use of SDRs for development aid policies, which some governments and central banks may oppose (see above). Moreover, the prevailing view (within the G7 and even the G20) is that there is currently no global need for liquidity. Finally, a targeted allocation would require revising the IMF's Articles of Agreement.

All of these considerations on the creation of SDRs and their distribution do not, of course, exhaust the debate on optimising the financing of global public goods (goods, services and resources that are accessible and benefit everyone on the planet). The strong needs in this area call for further discussions on how to integrate SDRs as a particular source of financing into an overall picture of available financing instruments. There are three possible approaches: a monopoly of the International Monetary Fund, recourse to multilateral development banks, or use of cross-sector funds with or without coordination by the G20 and/or the United Nations.

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