THE SDR AS A DEVELOPMENT TOOL?

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The SDR ("Special Drawing Rights") is a form of international money. It is held by countries in (special) accounts inside the IMF. Those accounts form a separate system, the "SDR department", managed by the IMF but distinct from its other operations.

SDRs are technically easy to create. This fuels aspirations to use them to finance development. It is thought that, by issuing SDRs, the IMF could grant new and unconditional resources to poor and developing countries. This looks like a very attractive proposition at a time where advanced economies are implementing reductions in their aid budgets and the needs for investment in poor and emerging economies are exploding, in particular for fighting climate change.

However, to assess the SDR's potentialities it is necessary to look in the details on how it works. Does it really function as money and how can it really be put to use for development? This is the purpose of this Policy Brief. It looks at how SDRs are created, how they can be used and what are their potential and limits as a development financing tool.

THE COMPOSITION OF THE SDR

The SDR is defined as a basket of five different currencies: the US Dollar, the Euro, the Chinese Renminbi, the Yen and the Pound sterling[1]. Those currencies are deemed by the IMF to be "usable" as it is assumed they are generally accepted in payments.

Because it is a basket, the SDR is normally more stable with respect of each of its components than they are with respect of each other. That makes it an attractive store of value and foreign exchange reserve instrument for Central Banks.

An important and symbolic step was step taken in 2016 when the Renminbi was recognized by the IMF as a usable currency despite the tight capital controls maintained by China and its very small role as a reserve currency. Significantly, the weight attributed to the Renminbi was much larger than the Japanese Yen.

[1] The basket is defined by a fixed number of units for each, currently c. USD 0.6, EUR 0.4, CNY 1.1, JPY 13.5 and GBP 0.01. The relative weight of each currency then varies over time in line with their respective market exchange rates. In December 2022, these weights were 43.38% for the dollar, 29.31% for the euro; 12.28% for the Chinese Yuan, 7.59% for the Japanese yen and 7.44% for the British Pound

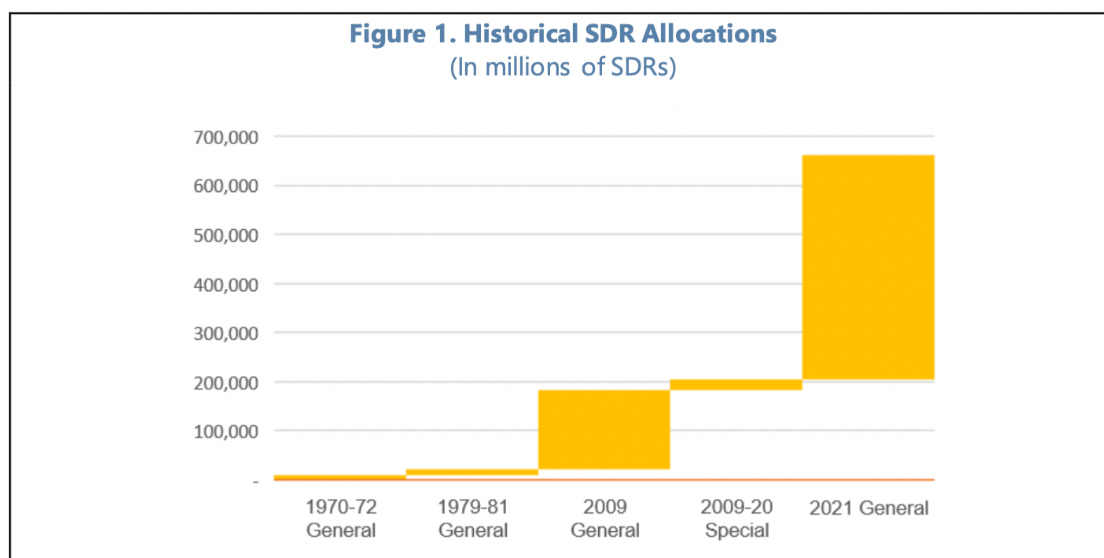
THE CREATION OF SDRS

Technically, SDRs are extremely easy to create. If instructed to do so by its members, the IMF just adds SDRs to the balances of each account that members hold. For instance, if a country has 250 million SDRs in its account, the IMF can create new SDRs just by writing in and crediting an additional amount of 150 million, therefore bringing its total SDR holdings to 400 million. This easiness of creation makes the SDR apparently very attractive.

SDR allocations

The process of creating SDRs is called an “allocation”. SDRs allocations are decided with a special majority by the members of the IMF. They are of two kinds: general allocations where all members get new SDRs; and special allocations that are reserved to some countries. There has only been one special allocation decided in 1997, to allow new members to catch up with ancient ones (but it was only approved in 2009). There have been four general allocations since the SDR was created, with increasing size. The two last general allocations took place (1) in 2008, during the Global Financial Crisis (for USD 161 bn) (2) in 2021 in the midst of the Covid crises (SDR 456.6 bn equivalent to USD 650 bn).

They were of a different by order of magnitude compared to previous ones. Each time, they more than doubled the stock of existing SDRs.



SDRs allocations are hotly debated between members, some favorable, some more reluctant. There are two traditional arguments against the creation of SDRs:

- First, to the extent that SDRs are “money”, any additional creation has a potentially impact on inflation. The same arguments that militate against money creation in a domestic setting can be transposed at the global level.

- Second, the original purpose of SDRs, as a reserve instrument, is to serve as a source of international liquidity. IMF Articles stipulate that there should be a (1) long term and (2) global need for such liquidity. A shortage of global liquidity can act on a constraint on growth. For developing economies, a lack of external reserves can prevent them to pay for imports while exports have not yet materialized. In a financially open country, where the capital account is liberalized, reserves also help absorb external capital shocks.

However, it is clear that the two last allocations have a different rationale and purpose. They were made in connection with the global financial crisis of 2008 and during the COVID-19 pandemic. Monetary policies were extremely stimulative and global liquidity was abundant, even if some countries were suffering from shortages. In that context SDRs allocations were actually an effort to provide additional financial assistance to low-income countries and emerging market economies, which were hit particularly hard by the two crises.

Those two allocations de facto expanded the purpose of the SDR. (Bundesbank) transforming it into a development tool. They made it a permanent financing instrument, potentially bringing real transfers of resources to beneficiaries. For poor countries, receiving SDRs, instead of normal IMF loans, has many advantages. In particular, SDRs do not come with any conditionality.

Benefits to poor countries, however, can be limited by the modalities of allocations. General allocations are given to each IMF members in proportion of their quota shares. Advanced economies, which have no need for SDRs therefore get the bulk (66%) of allocations. By contrast, poor countries only get 3%. The number of allocations is not a good indicator of the potential relief brought to poor countries. In effect, their share in the last allocation amounted to 21 bn USD

To circumvent that limit, there are ways for advanced economies to voluntarily “channel” their own SDRs to poorest countries (Georgieva 2021). Several mechanisms are possible, such as direct lending of SDRs or contributions to pool of resources such as the trusts administered by the IMF.

However, contrary to some perceptions, the main obstacle to using the SDR as a development tool does not come from the modalities of their allocation. It results from the architecture of the system itself and the limits of the SDR as a payment instrument.

HOW CAN SDRS BE USED

There is little focus in the policy debate on how the SDR are practically used. Up to now, this Policy Paper has referred to the imperfect metaphor of a bank account: once it has been replenished, money balances can be used indiscriminately for payments. The reality of the SDR is very different for two reasons

First, SDRs pay interest. Members who hold SDRs in excess of their allocation perceive an interest (at a rate equal to the weighted rates in the basket). This is a condition for countries to accept holding SDRs. It makes it attractive as a reserve instrument. But it means, in counterparty, that members who have used their SDRs, and therefore hold an amount lower than their allocation, must pay an interest on the difference. So, using SDRs is not like using money. It is more equivalent to benefiting from an overdraft facility with no obligation to repay (Bundesbank). An allocation of SDRs potentially increases the size of that facility.

Second, and more importantly, there are very limited uses for SDRs. Consider the three traditional functions of money: medium of exchange, store of value and unit of account. The SDR, as a basket of currencies, is a good international unit of account. It is also a good store of value as it is issued by the IMF, carries interest (see above) and is more stable that any of its components. But it is an extremely poor medium of exchange.

It is important to understand why. The SDR is a closed monetary system. SDRs only circulate between members of the SDR Department. Those members are very limited in numbers. They are countries which are members of the IMF, and 15 “prescribed holders”, essentially other international financial institutions, such as the World Bank, regional development banks and the Bank for International Settlements. SDRs may allow to settle claims between those members.

But they cannot be used outside the system itself, in the real economy. That makes them very different from ordinary money. Private firms and citizens do not have access to the SDR and, therefore, cannot accept them as payments. SDRs cannot directly finance the construction of infrastructures or the payment of teachers’ salaries. They cannot directly be used by a government to pay for ordinary expenditures. Any scheme that envisages the use of SDR as a development tool must take this reality into account. Many propositions do not.

There are only two possibilities to make direct use of the SDR: to pay another member inside the system; to convert the SDR into another currency which can then be used for payments everywhere for everything.

Settling claims between members with SDRs is common practice but it is by no mean automatic. The beneficiary has to accept to hold more SDRs as a consequence of the payment. Payments between members have averaged c. SDR 300 million annually over the last five years, with a spike at SDR 942 million in 2016. The only actor that actually accepts SDRs unconditionally and without limits is the IMF itself. Members can reimburse their loans from the IMF by using their SDRs. The new allocation would allow countries to use these new resources to make future repayments.

Converting SDRs into other currencies (dollar, euros, yens) is a prerequisite for a broader use. After the conversion, the holder (for instance a poor country) effectively holds dollars (euros, yens) and can really effect expenditures. The conversion – not the allocation – is the moment when the transfer of real resources occurs. Conversion (and conversion alone) can transform the SDR into an effective development tool.

For conversion to take place, there has to be a counterparty: the country (or the Central Bank) that sells its own currency for SDRs and therefore accepts to hold additional SDRs. That counterparty may, theoretically, be forced by the IMF to do the exchange through a procedure called “designation”. It has not been used since 1987. All conversions that effectively take place are voluntary (transactions by agreement)

The IMF has set up a framework to help those transactions: the Voluntary Trading Arrangements (VTAs). Under a VTA, a country agrees to purchase or sell SDRs against its own currency within pre-defined limits (which may be different for purchases and sales). The IMF then serves as intermediary between countries which want to transact. VTAs are non-public contracts which stipulate that a country agrees to convert specific currencies up to an agreed limit against SDR holdings upon the request of the SDR Department. Participants with a VTA are now called “market makers”. Today, there are 34 such market makers: 33 countries (out of 190 IMF member), and the ECB.

VTAs offer the best possibility for poor countries to effectively use their SDRs to finance their development. The last allocation (August 2021) is a good example. In effect most poor countries immediately sold their SDRs after the allocation. In the 12 months that followed, (from September 2021 to August 2022), 38 low-income and emerging market economies reduced their SDR holdings by at least 50% of the new allocation with 26 of the 38 countries using more than 90%. SDR 17.3 billion were converted into currencies through VTAs amongst which 5bn by Low Income Countries. There are two possible readings of those numbers[2] : (1) an allocation of 456 bn finally translated into a transfer of 5bn for poor countries, and that shows the technical limits of the SDR as a development tool; (2) on the other hand, transferring unconditionally an amount of approximatively 7bnUSD to the

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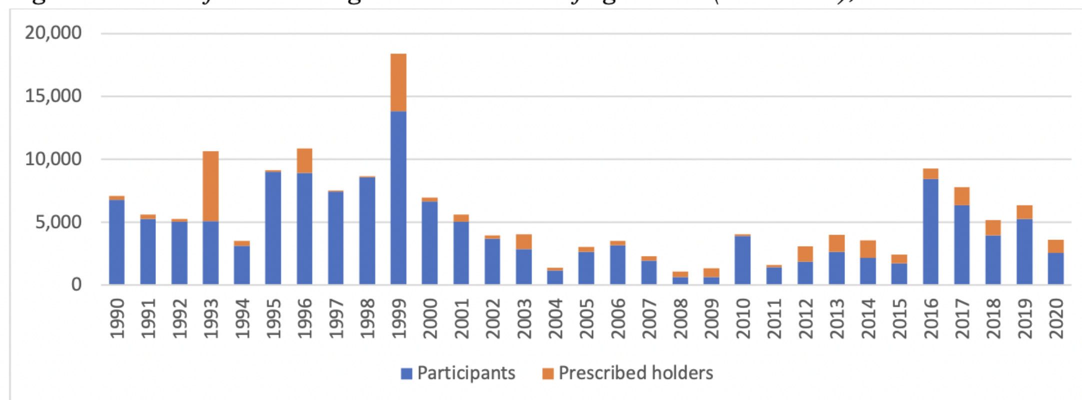
[2] The former President of the Bundesbank, Otmar Emminger is quoted as comparing the SDR mechanism to a zebra, which could be either seen as a black animal with white stripes or a white animal with black stripes (Pforr et al.)

poorest countries of the world on a period of 12 months and during times of intense economic stress is a significant result.

Figure 7—Sales of SDR holdings via transactions of agreement (1990-2020), in million XDR



Source: International Monetary Fund, Annual Reports 1990-2020

INDIRECT USES OF THE SDR

SDRs may be used to support and consolidate other mechanisms to channel aid or support fiscal expenditures.

The IMF trusts

Trusts are entities built under the aegis of the IMF and operated by the Fund but financed and fully supported by its members. Their purpose is to deliver very concessional loans to the poorest members (longer maturities and lower interest rates than normal IMF facilities). Trusts are built around three components: the loans themselves; a subsidy(or deposit) account used to fill the gap between the interest rates on resources and loans; and a reserve account to absorb the losses that may arise (if loans are not reimbursed). All three components are financed by the members

The largest trust is the *Poverty Reduction and Growth Trust* (PRGT) which provides concessionary lending to eligible EMEs and LDCs. It was originally set up in December 1987, and today has an outstanding 21 bn SDRs loan amount.

Most recently, the IMF has approved the creation of a Resilience and Sustainability Trust aiming more specifically to investments in climate transition.

The SDRs can be used in trusts to bring the resources for the loans (the SDRs are lent to the beneficiaries) and to constitute the reserve account. In each of these usages', of course, the SDRs

need ultimately to be converted into usable currencies to fulfill their function. In effect, the SDR acts as a vehicle to facilitate the operation of the trust. [3]

Backing domestic fiscal resources

In some countries, domestic institutional arrangements allow the Government – the legal owner of the SDRs- to deposit them at the Central Bank and get its account (at the Central Bank) credited in counterparty (in domestic currency). This operations amounts to (1) using the SDR to back domestic monetary creation and (2) using the money created to finance fiscal expenditures.

Those arrangements are very useful to the extent that SDRs allocations can be instantly transformed into fiscal revenues. However, what the SDR does is to serve as a "cover" for the monetary financing of the Government, with sometimes unwanted consequences on the overall macroeconomic equilibrium

Other avenues of financial engineering

The latest allocation led to a doubling of the total amount of SDRs. Many financial institutions, private and public, worked on the possibilities to exploit those new resources through sophisticated financial engineering (Lazard). Generally, those schemes use SDRs to serve two functions: for lending and for equity contribution. This creates a double ambiguity: first SDRs which are lent must be converted (and this step is often forgotten in the mechanisms which are considered); and second, using SDRs as capital is financially incorrect and should never be considered. Capital / equity is there to absorb losses, for instance to pay back depositors or lenders if the scheme becomes insolvent. No reasonable investor would consider SDR as capital due the uncertainty affecting its future conversion in usable currencies.

[3] Participant A provides SDR holdings to the Trust as a loan. The Trust then passes on the SDR holdings to Participant B as part of another loan. Finally, Participant B can convert these SDR holdings into usable currency via a transaction by agreement (Pforr et al.)

CONCLUSION.

The SDR is not money. It is literally a drawing right: the right to draw on usable currencies. This right is neither illimited nor unconditional. It ultimately depends on the willingness of the countries which issue those currencies to accept an exchange. The SDR is a vehicle for transfers which have been accepted by all the concerned parties. As such, it can bring a real and significant contribution to alleviate the problems of low-income countries. The latest allocation is a case in point. But the limits to its usage will always persist. Overall, if massive financial relief is sought for low-income countries, it would have to come either from and improbable dramatic modification of the SDR system or, more likely, from other sources such as debt restructuring and reduction.

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