SDRs and The Global Financial Architecture: History, Economics, Mechanics—and a Return to the Original System[1]

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Abstract

The IMF established the SDR system in 1968 in order to supplement the growth of official reserves of IMF members and provide regular injections of liquidity into the global economy. To do this, the IMF envisioned that SDRs allocations would be considered *both* every five years and in the event of "Unexpected Major Developments." Although the circumstances of the international monetary system changed with the fall of the dollar-gold standard, the need for SDRs by IMF members has remained. With the 2021 SDR allocation of $650 billion, the international community was reminded of the role, value, and potential of SDRs. However, with the most recent allocation failing to be comprehensively utilized or efficiently rechanneled, and with SDRs historically failing to fulfill their purpose of serving as the "principal reserve asset of the international monetary system," it is clear that the SDR system requires near- and long-term re-thinking.

This Working Paper functions as a history and economics of the SDR system, an exploration of the mechanics of SDRs, and a reform proposal. It proposes that the SDR system return to its original design: general allocations should be considered in good faith during all five-year basic periods, and the IMF should clarify and operationalize the "Unexpected Major Developments" provision of the Articles of Agreement such that special allocations are made automatically upon the breach of certain macro-critical thresholds (*force-majeure shocks*, *global technical recessions*, and a *reversal of global capital flows*). Given that SDRs are allocated to countries least likely to need or use them—with $450bn of the most recent allocation going to high-income countries vs. $200bn to low- and middle-income countries—this Working Paper also proposes reforms to the "SDR rechanneling infrastructure." These cover modernizing the 'Reserve Asset Characteristic', which unnecessarily holds back SDR utilization; reforming the SDR dual-interest rate system, by either replacing the existing dual interest rate system with a single interest rate to be paid by members on unutilized SDRs, or by bringing the SDR interest rate to zero and substantially increasing the floor rate and annual levy; establishing an SDR intermediation function, which would allow the IMF to operate more naturally and efficiently as the "SDR Bank" that it is and circumvent domestic bureaucratic obstacles to SDR rechanneling; promoting transparency in the SDR market, which would help the public, policymakers, and other stakeholders hold countries to their rechanneling pledges and help potential beneficiaries access available funds; and providing greater guidance on SDR accounting to members, who have voiced technical uncertainties around receiving and on-lending SDRs.

Key Recommendations

- Near-Term: The G-20 should honor its pledge to rechannel $100bn of the most recent SDR allocation, the Executive Board should update and substantially expand the SDR "reserve asset characteristic," IMF staff should provide greater technical assistance to members and MDBs on devising rechanneling programs/encashment regimes and navigating other uncertainties around SDR accounting
- Medium-Term: The IMF should improve the SDR rechanneling infrastructure by establishing an SDR intermediation function and bringing the SDR interest rate to zero while substantially increasing the floor rate and levy
- Long-Term: Members should amend the Articles of Agreement to establish SDR allocations every five years and operationalize the "Unexpected Major Developments" provision to establish SDR allocations in the event *force-majeure shocks*, *global technical recessions*, and a *reversal of global capital flows*; replace the SDR dual interest rate system with a single SDR holding rate

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[2] I would like to thank Dobrina Gogova-Poirier (UNECA) for her contributions on all facets of the SDR topic, particularly with respect to "basic periods" and the graphs on SDR utilization; Dominik Leusder (LSE) for his brainstorming on SDRs in the earlier iterations of this reform proposal; and Mark Plant (Center for Global Development), for his research and leadership on SDRs.

Although the Special Drawing Rights (SDR) system was designed with wider-ranging objectives in mind, the catalyst for the SDRs' creation was the urgent need in the 1960s to supplement official reserves and facilitate global liquidity and growth in a way which the Bretton Woods system could not. As all currencies under the Bretton Woods system were pegged to the U.S. dollar, and the dollar was pegged to gold at $35 per ounce, dollar reserves could only rise *organically* with the discovery of new gold deposits. Barring regular discoveries of new gold, the dollar-gold peg of the Bretton Woods would prove unsustainable: dollar reserves might rise (as indeed they did) but they would become delinked from, and in excess of, the U.S.' underlying gold reserves. That would provide the liquidity the world needed but upon unsteady foundations in the framing of a gold standard—the U.S. would not in truth have the gold reserves to redeem dollars at $35 per ounce. This unsteady and unsustainable foundation of the Bretton Woods system was demonstrated by Robert Triffin by way of the "Triffin Dilemma." To support global growth, the United States would be called upon to provide ever more liquidity to the global economy by running ever larger deficits, yet in turn these deficits would undermine the dollar-gold peg as dollar holdings would grow faster than the US gold stock. Either the United States would have to tighten its macroeconomic policy to rein in dollar assets and rebuild its capacity to redeem dollars at $35 per ounce (thereby causing a major domestic and global recession), or the U.S. would have to abandon the existing dollar-gold peg entirely.

In the long run, Triffin saw no alternative to the eventual demise of the Bretton Woods system and its dollar-gold peg. In the short run, however, proposals were considered to mitigate the global macroeconomic problems arising from the inadequate growth of gold reserves and the dollar liquidity and convertibility problems this caused. Discussions began with the IMF and the G-10 in 1965—by 1968 the SDR system was agreed, and in 1969 the IMF's Articles of Agreement were amended to include provisions for "Special Drawing Rights."[3] In the same year, the first allocation of SDRs was agreed, and SDR 9.3 billion were allocated in yearly installments from 1970 to 1972. By the letter of the law, SDR allocations were subsequently meant to be considered and, most probably allocated, every five years. As the Articles of Agreement read: "**Decisions of the Fund to allocate or cancel special drawing rights shall be made for basic periods which shall run consecutively and shall be <u>five years</u> in duration**."[4] (Article XVIII, Section 2a) In addition to these five-year "basic periods," SDRs would also be allocated "**if at any time the Fund finds it desirable to do so because of <u>unexpected major developments</u>.**" (Article XVIII, Section 3)

The SDR system co-existed only briefly with the Bretton Woods system. In 1971, US President Richard Nixon "closed the gold window," ending the convertibility of dollars into gold and giving way to a new system of floating currencies. Although the challenge that had catalyzed the creation of the SDR system was now eliminated—the rigidity of Bretton Woods' dollar-gold peg—the SDR system endured, and for good reason. When the Articles of Agreement were amended to include SDRs, the objectives reached beyond the world's difficulties with the

[3] Edwin M. Truman. "Promoting the Special Drawing Right." Harvard Kennedy School. May 2022. https://www.hks.harvard.edu/sites/default/files/centers/mrcbg/programs/senior.fellows/2021-22/Ted%20Truman%20revised%20paper%20The%20Future%20of%20the%20SDR%20--%20May%202022%20Draft.pdf
[4] The full text of the IMF Articles of Agreement can be found here: https://www.imf.org/external/pubs/ft/aa/pdf/aa.pdf

dollar-gold peg and had hoped to create a lasting solution to stagnation, deflation, excess demand, and inflation. As the Articles of Agreement read:

> 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**. (Article XVIII, Section 1a—emphasis added)

This "long-term global need" would naturally continue even as the Bretton Woods system came to an end. With the IMF's second allocation—SDR 12.1 billion, allocated in yearly installments from 1979 to 1981 in response to the many macroeconomic difficulties of those years—it was clear that the IMF was honoring the original plan and recognizing the continued utility of the SDR system. SDRs were still the critical tool for injecting liquidity into the global economy during moments when it was sorely needed. Indeed in 1978, after the end of the dollar-gold peg, the Articles of Agreement were amended once more to call for the SDR to become "**the principal reserve asset of the international monetary system**." (Article IX, Section 7)

Yet at the same time in the late 1970s and early 1980s, the SDR system was being quietly abandoned. No allocation had come in the five-year period after the 1971 allocation or again after the 1979 allocation, despite the clear stipulation in the Articles of Agreement. "Unexpected major developments" which were meant to trigger SDR allocations as well—of which there were many during those tumultuous years—were left undefined and did not compel any allocations either. The original ambition of the SDR system was so great as to include multiple provisions for the "cancellation" of SDRs in order to withdraw liquidity in moments of global overheating. However, as the IMF membership gradually ignored and effectively abandoned the SDR system in the succeeding decades, the notion of ever having to cancel SDRs would seem nonsensical: without regular allocations and injections of liquidity, there was nothing to cancel in a way that could meaningfully reduce global liquidity to bring down "excess demand and inflation."

After the 1979-1981 allocation, the SDR system fell into disrepair. The lack of SDR allocations was not a reflection of such sound global macroeconomic conditions during this time that obviated the need for SDRs. The early 1980s were marked by the most severe global recession since the Second World War, and the remainder of the 1980s (through the 1990s) were beset by multiple emerging market crises in Latin America, sub-Saharan Africa, the post-Soviet sphere, and East Asia. The lack of SDR allocations during this time was instead a reflection of a grave breakdown in global economic governance. One proposal of IMF Managing Director Michel Camdessus in 1997 to double the existing outstanding stock of SDRs had been supported by the vast majority of the IMF membership, but lacking the consent of the United States that is needed to attain 85% approval, it too was abandoned.[5]

In theory, SDR allocations continued to be formally considered during the five-year basic periods during which SDR allocations did not come about. In practice, however, participants in these processes attest that assessments "worked backwards" from the conclusion that no SDR allocation would come about. With each five year period during which an SDR allocation was not substantially considered or put into effect, IMF members were doing themselves an unnecessary economic disservice. The strain on the global economy was evident as the world entered a period of "secular stagnation,"[6] a protracted form of one of the key problems ("**stagnation**," Article XVIII, Section 1a) which the SDR system had been intended to solve. Successive years of low growth should have been enough to trigger an SDR allocation, or to return the SDR allocation schedule to its original five-year "**basic period**" plan. No such allocations came about. That overarching ambition agreed in 1978 of "**making the Special Drawing Right the principal reserve asset in the international monetary system**" had been quietly but comprehensively discarded. (Articles IX, Section 7)

The Global Financial Crisis of 2007-2008 would eventually revive the SDR tool. At the London Summit of the G-20 in April 2009, led by UK Prime Minister Gordon Brown, IMF members agreed to a special allocation amounting to $250 billion. Two months later, the US Congress also gave its long-awaited approval to the 1997 proposal to double the outstanding number of SDRs (an SDR 21.4 billion or $33 billion allocation). These allocations came nearly a year after the fall of Lehman Brothers when financial contagion had long since spread from the US mortgage market into the global economy.

Despite the delays, these allocations were a positive step. On the back of these allocations—drawn directly from the Articles of Agreement's provision to allocate SDRs in the event of "Unexpected Major Developments" (Article XVIII, Section 3)—the IMF membership could have heeded the rest of the "Unexpected Major Developments" provision to "start a new basic period" for SDR allocations (i.e., to issue SDRs every five years after the 2009 allocation). Unfortunately, they did not. A proposal for an SDR issuance in 2011 to ease the global pressures of the Eurozone crisis was not taken up either.[7] In subsequent years, SDR discussions would turn almost exclusively to the matter of the SDR currency basket, with the Chinese renminbi being added in September 2016, as the matters of five-year allocations and Unexpected Major Development allocations were again passed over.[8]

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[5] Michel Camdessus. "The Asian Financial Crisis and the Opportunities of Globalization." Speech at the Second Committee of the United Nations General Assembly, New York. October 31, 1997. https://www.imf.org/en/News/Articles/2015/09/28/04/53/spmds9715

[6] Summers, Lawrence H. "U.S. Economic Prospects: Secular Stagnation, Hysteresis, and the Zero Lower Bound." Keynote Address at the NABE Policy Conference. Business Economics Vol. 49, No. 2. February 24, 2014. http://larrysummers.com/wp-content/uploads/2014/06/NABE-speech-Lawrence-H.-Summers1.pdf

[7] Lowerey, Annie and Steven Erlanger. "Leaders Look to I.M.F., Again, as Euro Crisis Lingers," in The New York Times. 3 December 2011. https://www.nytimes.com/2011/12/04/world/europe/europe-looks-to-imf-again-for-help-in-euro-crisis.html?searchResultPosition=32

[8] IMF News. "IMF Adds Chinese Renminbi to Special Drawing Rights Basket." 30 September 2016. https://www.imf.org/en/News/Articles/2016/09/29/AM16-NA093016IMF-Adds-Chinese-Renminbi-to-Special-Drawing-Rights-Basket

In August 2021, a year-and-a-half after the World Health Organization had declared a global pandemic, the IMF membership approved a $650 billion allocation of Special Drawing Rights (SDRs). The objective fit the original mold of an "Unexpected Major Development" allocation: to provide countries the liquidity they needed to weather the health and economic shocks of Covid-19. Although the 2021 allocation was more ambitious in size and thoughtful in application (given early designs for SDR rechannelling) than past allocations, this $650 billion allocation faced similar design flaws relating to the timeliness of the allocation decision, the majority-allocation of SDRs to high-income countries which neither need nor use them, and the lack of readily usable rechanneling facilities.

The Quinquennial Allocation: Bringing Back Five-Year Basic Periods

First and foremost, this Working Paper calls for a return to the original SDR system contained in the Articles of Agreement: SDRs should be considered *in good faith* and allocated both <u>every five years</u> and in the event of <u>Major Unexpected Developments</u>.

The IMF is currently in its 12th Basic Period, which commenced on 1 January 2021 and is due to be completed on 31 December 2026. The IMF and the Managing Director have historically recognized these basic periods by conducting reviews of long-term reserve asset needs every five years (before coming to the decision not to allocate SDRs). Although this practice is in accordance with the obligations placed on the IMF by the Articles of Agreement, the decision not to make SDR allocations in all but four basic periods in the history of the IMF—and with only two substantive allocations, in 2009 and 2021—represent that the IMF and IMF membership have veered away from the intention of the basic period framework for five-year allocations. The global annual investment and development spending needed to meet the UN's Sustainable Development Goals, $6.95 trillion in the years to 2025 and $5.880 trillion in the years to 2030 (Bhattacharya 2022), will prove unattainable without large and recurring growth in global reserves. Given the SDR's foundational objective to meet the world's long-term reserve needs, it is critical for the IMF to consider and advocate five-year allocations in a more regular, public, and affirmative manner. The methodological matter of calibrating five-year allocations in line with global reserve needs has been dealt with effectively by *The Case for a General Allocation of SDRs During the Eleventh Basic Period*.[9]

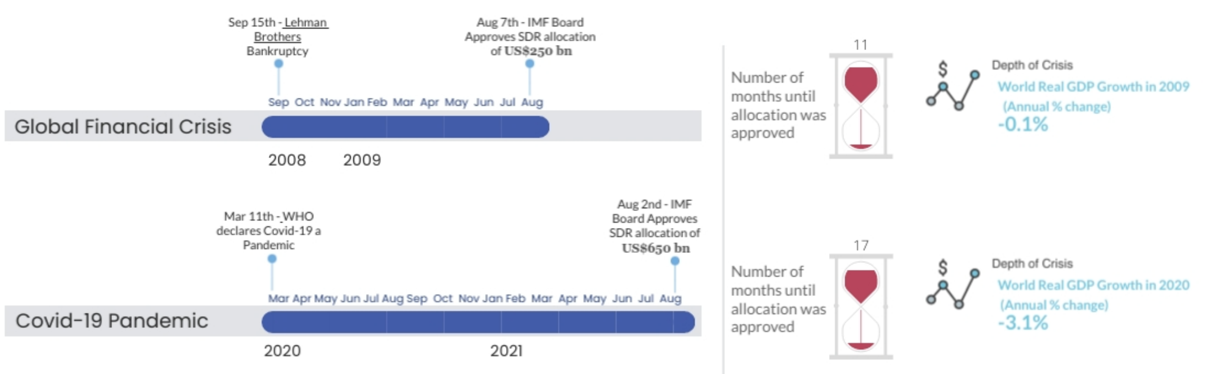
In the short-run, five-year basic periods for SDR allocations may be honored through more open and deliberate advocacy work by the IMF around the need for continuous supplements to global reserves. **In the longer-run, the IMF membership should consider reforms to the Articles of Agreement to allocate SDRs automatically every five years with a pre-set methodology to calculate the size of the allocation.** Removing the political process from SDR allocations would insert greater certainty in the global financial architecture by creating the regularized conditions for global economic stability and growth, and by providing the long-term funding needed to achieve critical climate and development goals.

[9] International Monetary Fund. "Report of the Managing Director to the Board of Governors and to the Executive Board Pursuant to Article XVIII, Section 4(c)." June 29, 2016. https://www.imf.org/external/np/pp/eng/2016/062916.pdf

Unexpected Major Developments: Clarifying and Modernizing The Criteria

Second, this Working Paper calls for a modernization of the "Unexpected Major Developments" provision for SDR allocations. Although the Articles of Agreement contain a clear mandate to allocate SDRs as soon as crises arise, the few allocations that have been made came about slowly and arbitrarily. For example, although calls for an SDR allocation emerged as soon as the pandemic began, it took more than a year-and-a-half for the IMF membership to authorize one. The turnaround time for the SDR allocation amid the Global Financial Crisis was faster as compared to the Covid-19 pandemic, but it still took the IMF membership 11 months to approve it.

Select SDR General Allocation Events -Allocation timeline



Lengthy delays in SDR allocations allow short-term macroeconomic complications—e.g., difficulties conducting macroeconomic stabilization measures during acute moments of investor concern, difficulties servicing debt or covering import bills amidst sudden demands on foreign-exchange reserves, difficulties tending to urgent crisis-related expenditures, etc.—to metastasize into longer-term setbacks for countries' market access, development agendas, and more. The problem of delays is compounded by the problem of arbitrary, and generally limited, sums for SDR allocations. Rather than providing the $2.5 trillion which UNCTAD calculated as the necessary figure to offset the global impact of Covid-19, or provide a different figure in some way corresponding to the empirical health and economic shocks of Covid-19, the allocation was fixed at $650 billion.[10] This was not based on empirical underlying needs, but rather it was the maximum that can be authorized by the U.S. Treasury alone, given that SDR allocations beyond 100% of the U.S.' quota would require gaining the support of the U.S. Congress pursuant to the

[10] UN Conference on Trade and Development. "The Covid-19 Shock to Developing Countries: Towards a "whatever it takes" programme for the two-thirds of the world's population being left behind." March 2020. https://unctad.org/news/un-calls-25-trillion-coronavirus-crisis-package-developing-countries

U.S.' Special Drawing Rights Act of 1968, which Congress is unlikely to provide.[11] Delays to and political dilutions of SDR allocations greatly reduce the utility (and legitimacy) of the SDR system.

There are many reasons for the slow and arbitrary nature of such SDR allocations—namely, the economic uncertainties surrounding the crisis at hand and divergent political perspectives and interests. However one overarching obstacle to delivering efficient and well-calibrated SDR allocations is the lack of clarity around what an "Unexpected Major Development" is. To correct for the slow and arbitrary nature of SDR allocations, the IMF should clarify and modernize upon the "Unexpected Major Developments" (Article XVIII, Section 3) provision.[12] While this provision exists to ensure the rapid allocation of SDRs in the event of a global economic crisis, the provision does not offer clear guidance on what constitutes an "Unexpected Major Development" and what SDR amount would be necessitated by that development. The "Unexpected Major Developments" provision should be interpreted in the spirit of the Articles of Agreement to contain both *specificity* and *automaticity*—setting out clear thresholds that trigger SDR allocations in clear amounts. Inserting this information into the Articles of Agreements is therefore necessary to ensure the healthy functioning of the SDR system.

Although the IMF should undertake its own analysis to determine specific and automatic criteria for "Unexpected Major Developments," this Working Paper recommends the IMF consider defining "Unexpected Major Developments" in terms of "Force-Majeure Shocks," "Global Recessions," and "Reversals of Global Capital Flows." Future allocations being triggered as soon as thresholds for these crises are breached in the following ways:

(1) ***Force-Majeure Allocation:*** Force-majeure declarations of pandemics, famines and global food crises, natural disasters, and others should automatically trigger SDR allocations. These declarations can be made by relevant UN bodies (the World Health Organization, the World Food Programme, the UN Environmental Programme) together with the IMF, with the dollar figure of the SDR allocation being derived from impact assessments of the crisis. UN bodies that monitor and tend to such exogenous shocks should work with the IMF to develop a generalizable system for the declaration of *force-majeure* exogenous shocks, as well as for the rapid development of impact assessments to determine the scale of the SDR allocation. In the event that an Exogenous Shock

[11] Section 6 of the Special Drawing Rights Act holds that Congressional approval is required for SDR allocations in a basic period if they "exceed an amount equal to the U.S. quota." This Act boxes in other dynamics of SDR rechanneling and utilization for the United States as Section 3 of the SDR Act calls for SDRs to be deposited in the "Exchange Stabilization Fund," which is part of the U.S. Treasury. As a result, using SDRs would be a fiscal measure requiring Congressional approval. However, a closer reading of the Exchange Stabilization Fund (Amarnath, Datta, and Williams 2022) suggests that the U.S. could in fact on-lend SDRs to other countries only with notification to Congress—without Congressional approval. 31 USC 5302 reads: "... However, a loan or credit to a foreign entity or government of a foreign country may be made for more than 6 months in any 12-month period only if the President gives Congress a written statement that unique or emergency circumstances require the loan or credit be for more than 6 months." While more interpretative creativity may allow for repeated loans over multiple 12-month periods, on-lending for short durations defeats the concessionality element of SDRs and does not make for best rechanneling practice. Nonetheless, more work can be done here to examine the latitude the U.S. Treasury may have to operate without Congressional approval. https://www.employamerica.org/researchreports/discretion-is-the-point/, https://www.govinfo.gov/content/pkg/COMPS-1359/pdf/COMPS-1359.pdf

[12] IMF Articles of Agreement. Article XVIII, Section 3. https://www.imf.org/external/pubs/ft/aa/pdf/aa.pdf

Allocation is triggered, the relevant UN body should provide advisory services to the IMF regarding the form, duration, and management body for SDR rechanneling through both short- and long-term IMF and 'prescribed holder' facilities.

(2) ***Global Recession Allocation:*** Low- and middle-income countries are particularly exposed to global economic downturns. A reduction in industrial activity creates foreign-exchange and tax revenue shortfalls for commodity-exporting countries. The drop in expendable incomes among advanced economies is similarly quickly transmitted to low- and middle-income countries through a decline in service sector-related revenues. In these difficult times, the critical lifeline of global remittance flows may also dry up as workers abroad earn less money to send home. In turn, global recessions can severely impact an economy's immediate well-being as well as their long-term development trajectories. A Global Recession Allocation would help to mitigate the short- and long-term impacts of global downturns. The "automaticity" of a Global Recession Allocation is complicated by the difficulty of establishing the existence of a recession quickly, given that the availability of official GDP data can operate on lags of one year or more. A Global Recession Allocation could therefore be triggered in one of three ways: through the IMF's *post-factum* identification of two consecutive quarters of negative global GDP growth, through IMF *econometric nowcasting* of two consecutive quarters of negative global GDP growth (Dauphin et al. 2022), or in the event that 3 out of 5 SDR currency members (the US, China, EU, UK, and Japan) enact stimulus packages.[13] In order to guarantee a non-inflationary impact of the Global Recession Allocation, a back-of-the-envelope methodology would assume an upper-bound *fiscal multiplier* of 1.5 – meaning that every $1 allocated in SDRs will be expected to generate $1.50 in global output. The dollar sum of a global Global Recession Allocation will accordingly be equal to the *global output gap divided by 1.5* so that SDR allocations do not cause any economic overheating.[14]

(3) ***Capital Flow Reversal Allocation:*** Monetary tightening measures by the world's major central banks can erode the macroeconomic stability of low- and middle-income countries despite the better efforts of those countries. Interest rate increases, tapering asset purchases, balance-sheet shrinking, as well as the communication of future monetary tightening measures produce large and sudden capital outflows from the world's low- and middle-income countries and constitute the greatest *systemic* threat to such countries' foreign-exchange reserves. While some countries may be better or worse insulated against a reversal of global capital flows—e.g., through the existence of

[13] Dauphin et al., "Nowcasting GDP - A Scalable Approach Using DFM, Machine Learning and Novel Data, Applied to European Economies."IMF Working Paper No. 2022/052. March 2022.

[14] Nicoletta Batini, Mario di Serio, Matteo Fragetta, Giovanni Melina, Anthony Waldron. "Building Back Better: How Big Are Green Fiscal Multipliers?" IMF Working Paper No. 2021/087. March 2021. https://www.imf.org/en/Publications/WP/Issues/2021/03/19/Building-Back-Better-How-Big-Are-Green-Spending-Multipliers-50264; Alan Auerbach & Yuriy Gorodnichenko, "How Powerful Are Fiscal Multipliers in Recessions?" National Bureau of Economic Research. June 2015. https://www.nber.org/reporter/2015number2/how-powerful-are-fiscal-multipliers-recessions

local-currency financing sources or the build-up of foreign-exchange reserves—the ongoing experience of monetary tightening, as well as prior historical experiences in the 1980s, 1990s, and 2010s, demonstrate that there is an indiscriminate nature to capital outflows and emerging/frontier-market sovereign debt sell-offs, against which sound macroeconomic policies can do little to correct. In order to mitigate the short-term macroeconomic shock of a reversal of global capital flows and to prevent the long-term developmental setbacks that such shocks can produce, a *Capital Flow Reversal Allocation* is necessary. As a general heuristic, a Capital Flow Reversal Allocation could be triggered when the central banks of the three of the five SDR currencies—the dollar, the euro, the pound sterling, the yen, and the yuan—undertake an average increase of 100bps or more over a 12 month period. However the IMF should conduct further research into a potential threshold for when monetary tightening by major central banks creates macro-critical challenges for the global economy and should thus trigger a Capital Flow Reversal allocation. The IMF should similarly conduct more research into ways to calibrate the SDR sum for Capital Flow Reversal Allocation as a factor of how severe the monetary tightening measures are (e.g., Engler et al. 2022; Ogawa et al. 2019).[15] The rechanneling of Capital Flow Reversal Allocations should be conducted predominantly through the IMF's short-term macroeconomic stabilization facilities.

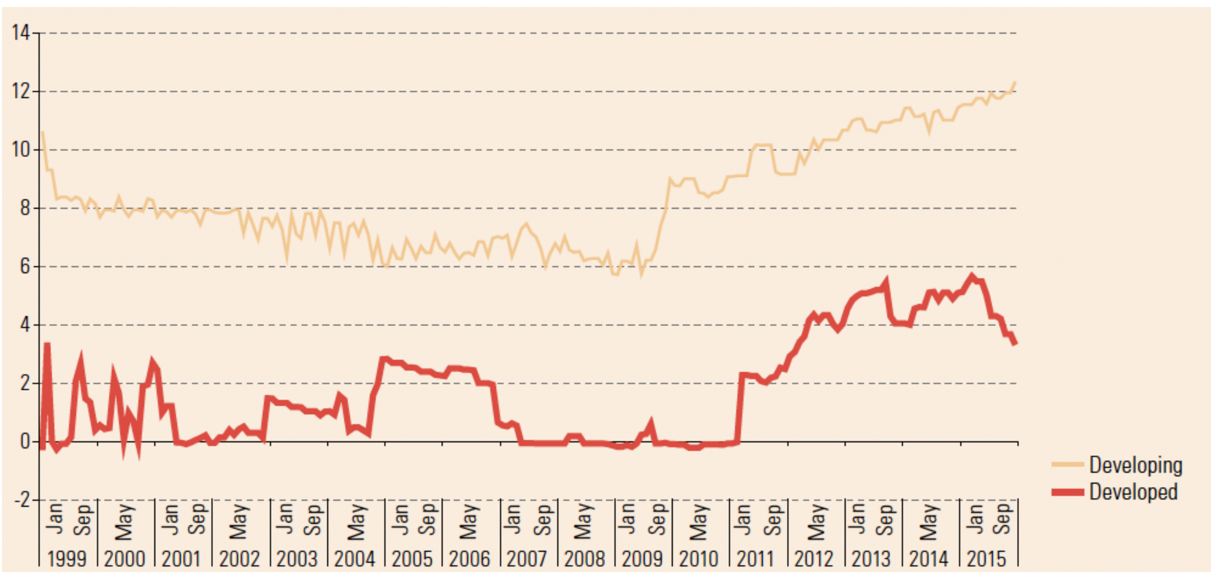
	Force-Majeure Allocation	**Global Recession Allocation**	**Capital Flow Reversal Allocation**
Trigger	IMF-UN Consortium declares a *force-majeure* natural or humanitarian disaster	Nowcasted two quarters of negative global GDP growth, post factum identification of two quarters of negative global GDP growth, 3 of 5 SDR currency members enact stimulus packages	3 of 5 SDR currency central banks conduct 100bps or more in rate hikes over a 12 month period
Calibration	Pursuant to the IMF-UN Consortium's impact assessment	Global Output Gap divided by IMF upper-bound fiscal multiplier (1.5)	Calibrated to the rate hike

[15] Philipp Engler, Roberto Piazza and Galen Sher. "How Rising Interest Rates Could Affect Emerging Markets." IMF. 5 April 2021. https://blogs.imf.org/2021/04/05/how-rising-interest-rates-could-affect-emerging-markets/; Ogawa, Eiji, Junko Shimizu, and Pengfei Luo. "Effects of US Interest Rate Hikes and Global Risk on Daily Capital Flows in Emerging Market Countries." RIETI Discussion Paper Series 19-E-019. March 2019. https://www.rieti.go.jp/jp/publications/dp/19e019.pdf

Reforming the SDR Rechanneling Infrastructure
Interest Rates, Intermediation, Rechanneling Consortium, Reserve Asset Characteristics

Providing regular and rapid allocations of SDRs is critical to the future of the SDR system. However, allocations alone will not ensure the utility of SDRs. At present, approximately $992 billion in SDRs remain idle in the reserve accounts of IMF members owing to the fact that allocations are delivered predominantly to Advanced Economy members, which generally neither need nor use their SDRs, but nonetheless face various institutional difficulties in their efforts to on-lend or grant SDRs to other members and prescribed holders. This problem is reflected in the divergent SDR utilization rates of developed and developing economies—just 5.90% for developed economies versus 42.90% for developing economies:

Median SDR utilization rates as a proportion of IMF quotas, 1999–2015 (percent)



Source: COVID-19 Report, UNECA and ECLAC 2022, based on International Monetary Fund (IMF), "IMF Finances", Washington, D.C., 2021 [online] https://www.imf.
org/external/np/fin/tad/query.aspx; and "Data Template on International Reserves and Foreign Currency Liquidity", Washington, D.C., 2021[online] https://data.imf.org/?sk=2DFB3380-3603-4D2C-90BE-A04D8BBCE237.
Note: The utilization rate (in proportion to the IMF quota) refers to the difference between allocations and holdings divided by the quota share.

Selected country groupings: median SDR utilization rates, 2021

Grouping	Utilization rate *(median)*
Developed economies *(average)*	**5.90**
Developing economies *(average)*	**42.90**
Africa	52.37
East Asia and the Pacific	25.28
South Asia	75.32
Western Asia	12.80
Latin America and the Caribbean	48.77
Central America	59.64
The Caribbean	85.00

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of International Monetary Fund (IMF), "General SDR Allocation (in SDRs)", 21 August 2022 [online] https://www.imf.org/en/Topics/special-drawing-right/2021-SDR-Allocation; "IMF Finances", Washington, D.C. [online] https://www.imf.org/external/np/fin/tad/query.aspx; "Data Template on International Reserves and Foreign Currency Liquidity", Washington, D.C., 2021 [online] https://data.imf.org/?sk=2DFB3380-3603-4D2C-90BE-A04D8BBCE237; "Data Template onInternational Reserves and Foreign Currency Liquidity", Washington, D.C., 2021 [online] https://data.imf.org/?sk=2DFB3380-3603-4D2C-90BEA04D8BBCE237.

In the most recent allocation, higher-income countries were provided approximately $450 billion while low- and middle-income ones were provided $200 billion — with the United States allocated $113 billion while the entirety of the African continent was allocated just $33 billion. As a result, the world faces a persistent and growing challenge of the non-use of SDR holdings. Urgent efforts to fund global anti-poverty initiatives, global health initiatives, the closing of the global infrastructure gap, and the acceleration of the global clean energy transition remain chronically underfunded despite an immense pool of idle SDR reserves.

To correct for the non-use of SDRs, the IMF should reform the SDR interest rate system, establish an intermediation function for idle SDRs, establish a working definition of the SDRs' "reserve asset characteristic," and promote greater transparency in the SDR market:

(1) **Fix the SDR Interest Rate Policy:** The SDR interest rate is set by multiplying the currency amount of each SDR currency (dollar, sterling, euro, yuan, yen) by the currency's exchange rate against the SDR by the interest rate on the instrument of each currency, and adding each up for the the five countries—and then adding a floor rate (of 0.50%) to this value.[16] At the time of writing, this formula yields an SDR interest rate of 2.723%. IMF members pay identical interest on their *allocations* of SDR, but they collect interest on their *holdings* of SDRs. In effect, this means that when countries' allocations equal their holdings – i.e., when they do not use their SDRs – they pay no interest. But when

[16] https://www.imf.org/external/np/fin/data/sdr_ir.aspx

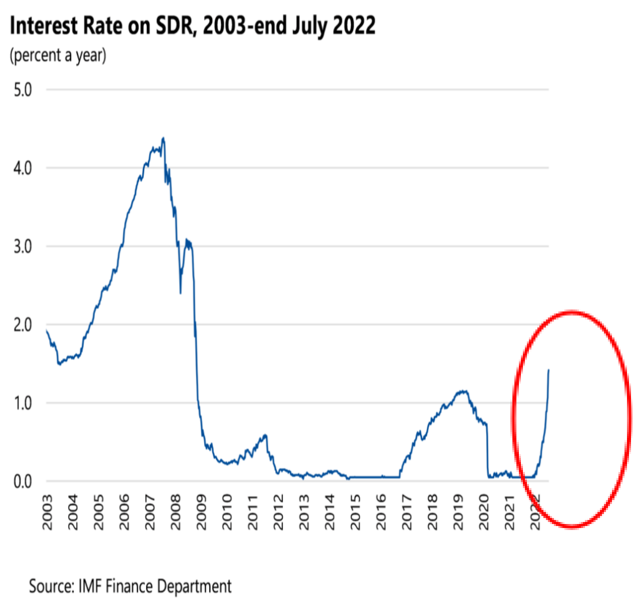
members use their SDRs in any way and their holdings drop below their allocations, they must make interest payments to the IMF. With an SDR interest rate of 2.723%, which represents a small but palpable cost to doing anything with one's SDRs, as countries will need to make interest payments in hard currency (likely to be in short supply if they are forced to tap their SDRs) to cover the difference between their SDR allocation and holdings. In the event of 'using' SDRs for rechanneling, the present system creates uncertainty about who owes the interest rate costs, and conventionally penalizes the end-user of the SDRs (the low- and middle-income countries) by obliging them to cover the SDR interest rate cost in foreign-exchange payments.

In all facets of the global economy, interest rates and small interest rate adjustments can be very powerful in shaping macroeconomic outcomes. **However, interest rate policies as they relate to SDRs consistently work counterproductively to desired macroeconomic outcomes by *disincentivizing* the use and rechanneling of SDRs**. To correct for this, the IMF should <u>restructure the SDR interest policy such that countries are obliged to make interest payments to the IMF on their total SDR Holdings</u>. This can be brought into operation in two ways.

- The IMF should consider replacing the existing dual-interest rate mechanism, of having members pay interest on their allocations of SDR but having the IMF pay interest on the member's holdings of SDRs, with a single interest rate policy by which members make interest payments to the IMF on their total SDR holdings. Such a single interest rate policy could be called an **SDR Holding Rate**. In effect, this would mean the only interest payments being made are by members, to the IMF, on unused SDRs. In the event that SDRs have been on-lent to other members or prescribed holders, the SDR Holding Rate would apply to the recipient member until the SDRs are utilized. This would incentivize not only on-lending (to get idle SDRs and the accompanying charges out of one's account) but also more rapid utilization of those SDRs by recipient members. In familiar monetary policy terms, this can be thought of as adopting a negative interest rate policy that discourages saving and encourages borrowing.

- Alternatively, this policy can be conceptualized and implemented as **a large increase in either the SDR Department's floor rate (which is currently 0.050%) or its annual operational levy (~.0001%)**. By eliminating the current SDR interest rate system but leaving intact and increasing the floor rate and/or annual operational levy, the SDR Department would institute a recurring foreign-exchange fee that would incentivize members to reduce their SDR holdings through domestic usage or foreign/multilateral on-lending and granting.

Given the fact that the SDR interest rate system has implications for IMF operations that stretch beyond SDR allocations, **the IMF should consider further methods to disaggregate the SDR interest rate system in ways that facilitate SDR utilization without disrupting other operations.** Reforming the SDR interest rate system has its obstacles—despite renewed attention to the SDR system in recent years, it would appear that no one else has called for reinspecting and reforming the SDR interest rate system—however it is procedurally not as complicated as other reform measures (such as automating allocations). Whereas automating allocations would require an amendment to the IMF's Articles of Agreement that gains the support of 85% of the total voting power (likely to be shot down by the U.S. Congress at the current moment or by other inflation-weary countries such as China and Germany), the SDR interest rate can be reformed by only a 70% vote (**Section 3, Article XX**). Critically, the current formula underlying the SDR interest rate is not established in the Articles of Agreement, meaning that the Articles of Agreement do not need to be amended in order to undertake the second option, **bringing the interest rate to zero while substantially increasing the floor rate and operational levy.** However, replacing the SDR's dual interest rate system with a single interest rate would indeed require an 85% majority.



Rising SDR interest rates in the current crisis represent a rising cost to members to use, grant, or on-lend their SDRs—rendering SDRs less useful. SDR interest rates pro-cyclically rise with rising interest rates.

(2) **<u>Establishing an SDR Intermediation Function</u>**: Although Advanced Economy members have endorsed SDR rechanneling through on-lending to IMF facilities, prescribed holder facilities, and directly to other members, the process of doing so has been challenging.

The core logistical obstacle is that SDR allocations are, in effect, *externalized* upon allocation: members take a peculiar form of ownership of their SDRs externally to the IMF, and the subsequent use of them requires the approval of the member country's domestic bureaucracies which are often in conflict with respect to their agendas, mandates, and protocols—e.g., coordination between the executive and legislative branches or between central banks and finance ministries. In the case of the United States, the largest holder of SDRs, Congressional approval is required to use any amount of SDRs, which has led the U.S. Treasury to pursue funding various arrangements (e.g., the IMF's new Resilience & Sustainability Trust) through conventional budget bills. Although Germany has indicated a willingness to rechannel its SDRs, tension between the government and the Bundesbank (the custodian of Germany's SDRs) has meant that German "rechanneling" will most likely also be conventional budgetary items (and not actual SDR rechanneling). Other uncertainty exists for Eurozone countries, and for members of other currency unions (e.g., the CFA Franc zone), given that SDRs are conventionally meant to be supplements to official reserves and thus in the custody of the central bank—which in the case of currency unions means the SDRs may not be under the full jurisdiction of the member government.

This *externalization* of SDR allocations has a variety of logistical problems, but chief among them is that it is functionally a misrepresentation of the mechanics of SDR allocations. SDRs *remain within* the IMF system: the IMF charges members for the management of SDRs, and SDR allocations and holdings are subject to different interest payment arrangements (covered above). In effect, the SDR system makes the IMF a *bank of SDRs*, but it simultaneously places illogical constraints on what the IMF can do in its role as an 'SDR bank' by making intermediation decisions *external* to the IMF. This arrangement is akin to giving savers total discretion over how, to whom, and on what terms their banks lend out their savings. Banks do not exist this way because such an arrangement would be inefficient for the borrower, lender, and bank alike. What savers have a right to is the withdrawing of their savings at any time. The SDR system should (and can already) operate in this way.

The IMF should work towards the establishment of an SDR Intermediation Function. In future SDR allocations, member countries should be granted claims to, but not direct management of their SDR allocations, which would remain under the management of the IMF and SDR Department. Member countries would still be able to exercise their claim to their SDRs, and convert their SDRs into hard currency whenever they wish. The ability of countries to use or convert their SDRs at any time is guaranteed by the SDR Department's "Designation Mechanism," which gives the IMF the authority to create an SDR market and instruct members to exchange spare hard currency for SDRs at any time. In this way, the Designation Mechanism serves as a form of 'deposit insurance' for SDRs and SDR convertibility, meaning that SDR intermediation would in no way jeopardize a member's ability to access and convert their SDRs whenever they so choose. Under these changes, SDRs will no longer be idly accumulated by certain members; instead the IMF will be in a position to intermediate SDR allocations between SDR "savers" and SDR "borrowers" – in effect, between Advanced Economies and low- and middle-income countries.

While the creation of an SDR Intermediation Function would have to be achieved in the longer-term through an amendment to the Articles of Agreement, in the shorter term the IMF should conduct a pilot program by encouraging non-discretionary rechanneling pledges from G-20 members. Before the adoption of a full amendment, **G-20 members should agree to post a substantial percentage of their idle SDRs for intermediation — perhaps 50%, which in the case of the U.S. alone would free up $54 billion.**

(3) **Reserve Asset Characteristic**: One core obstacle to the utility of SDRs is the stringent definition that is conventionally (though not formally) applied to the "reserve asset characteristic" of SDRs. The IMF's Articles of Agreement call upon members to "preserve the reserve asset characteristic"[17] of SDRs, which has been cited as a reason against granting or on-lending SDRs to countries or prescribed holders that may seek to spend or borrow against SDRs for investments that may not be fully liquid. In effect, this would obstruct a member with surplus SDRs from rechanneling via a multilateral development bank that may wish to commit SDRs towards such things as clean energy investments. Although the PRGT can be financed using SDRs, the "reserve asset characteristic" is preserved through an "encashment regime" that subsidizes and facilitates repayment on SDR loans, while introducing other asset-liability mismatch issues. Although there is no official guidance on what preserving the SDRs' "reserve asset characteristic" entails, rechanneling remains obstructed by this clause, and efforts by members and prescribed holders to develop encashment regimes that may circumvent this clause remain forthcoming.

While members and prescribed holders should continue to work on PRGT-style encashment regimes for SDR rechanneling, the IMF should also issue a more accurate interpretation of SDR utilization procedures that breaks with the strict and cumbersome interpretations that exist today. A new interpretation of the "reserve asset characteristic" is needed for three reasons.

First, SDRs are primarily defined by their "unconditionality,"[18] yet restrictions on their utilization in the form of liquidity requirements introduce substantial and inappropriate conditions. Past efforts to restrict SDR utilization—namely, the "reconstitution rate"—have been discarded given the importance of SDR unconditionality, and their

[17] "...the unconditional character of special drawing rights as reserve assets shall be maintained." https://www.imf.org/external/pubs/ft/aa/pdf/aa.pdf
[18] International Monetary Fund. "GUIDANCE NOTE FOR FUND STAFF ON THE TREATMENT AND USE OF SDR ALLOCATIONS." August 2021. https://www.imf.org/en/Publications/Policy-Papers/Issues/2021/08/19/Guidance-Note-for-Fund-Staff-on-the-Treatment-and-Use-of-SDR-Allocations-464319

discarding should be cited as clear guidance on the "reserve asset characteristic" issue.[19] The old "reconstitution rate" debate is particularly instructive today as its purpose and consequences were very similar to the purpose and consequences of strict interpretations of reserve assets. By obliging members to maintain average daily holdings not less than 30% of net cumulative accumulation over a five year period, the IMF strived to create a "safeguard for the SDR" in the 1975 words of Germany's executive director, Gerhard Laske—or more bluntly in the words of the Netherland's executive director, Tom de Vries, "'reconstitution helped prevent members spending their SDRs imprudently."[20] In effect, however, the reconstitution rate prevented members from spending their SDRs unconditionally, and imposed needless macroeconomic adjustments upon members in order to reconstitute their holdings and post an arbitrary percentage of SDRs at the end of every five year period. The reserve asset characteristic requirement may be seen as a superior safeguard than the reconstitution rate in that it does not impose any direct costs on members, yet it does impose an equivalent *opportunity cost* on members by restricting their ability—exactly as in the case of the reconstitution rate—to make unconditional use of their SDR holdings. A report on Zambia's difficulties with its reconstitution obligations authored in 1978, shortly before the reconstitution rate's abolition in 1981, appropriately characterizes the counterproductive nature of both policies generally and in times of crisis:

> "The reconstitution requirement as presently formulated clearly defeats the purpose for which reserve assets are held by a country and it displays at the same time that the present formula is far from being an appropriate instrument to purpose the objectives it was intended to fulfill. Zambia's practical experience shows that it had to set aside, read immobilize, substantial parts of its foreign reserves at a time when it had to face the most serious exchange crisis ever."[21]

Second and more practically, strict interpretations of the "reserve asset characteristic" break with real-world cases of how reserve assets are contemporarily used. In the 20th and 21st centuries, countries regularly mobilize their reserve assets in risky and illiquid ways, such as by investing in foreign and domestic infrastructure projects, or by reinvesting foreign-exchange reserves into private equity and other investment funds. Restricting SDR utilization to highly liquid investment or less liquid investment protected by an encashment regime due to an effort to preserve their "reserve asset characteristic" not only breaks with the primary characteristic of the SDR (its unconditionality), it also breaks with any contemporary understanding of what reserve assets are and how they are used. Third and more broadly, strict interpretations prohibit the long-term investments in clean energy, infrastructure, health, and other areas that the IMF has itself

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[19] Jeker, Rolf M. "The reconstitution of SDRs: Procedure and proposal for modification." Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 13, Iss. 1/2, pp. 12-17. https://www.econstor.eu/bitstream/10419/139517/1/v13-i01-a05-BF02928833.pdf

[20] Wilkie, Christopher M.D. "SDRs and the negotiation of the Second Amendment to the Fund's Articles of Agreement," in *Special Drawing Rights: The First International Money*. Oxford University Press. 2011.

[21] Jeker, Rolf M. "The reconstitution of SDRs: Procedure and proposal for modification." Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 13, Iss. 1/2, pp. 12-17. https://www.econstor.eu/bitstream/10419/139517/1/v13-i01-a05-BF02928833.pdf

identified as being most essential to future global macroeconomic robustness. While the IMF has capably identified key challenges in the global economy and developed new policies (such as a variation of sectoral financing via the RST and Food Shock Window) to respond to them, the IMF must also engage in the critical work of reinterpreting and reimagining old policies (such as the SDR) to make them more suited for the challenges of the day. Loosening the reserve asset characteristic and unclogging the nearly $1 trillion SDR market will support this effort.

(4) **SDR Market Transparency**: One critical component of the SDR rechanneling architecture is a focus on transparency. As documented by Plant and Sala (2022), there is a grave lack of transparency around SDR commitments and transactions. Although G-20 countries have pledged $100 of SDRs to rechannel, no public record exist of whether these pledges have materialized as officials commitments (or as disbursed funds) and no public record exists of the facility to which the funds have been pledged/through which they have been rechanneled. This opacity undermines SDR rechanneling by allowing pledges to go unfulfilled by members despite broad domestic political, popular, and civil society support for SDR rechanneling; and by obscuring for potential users of SDRs (low- and middle-income countries and other prescribed holders) the potential for accessing rechanneled SDRs. Particularly in sensitive post-allocation periods during which time members are making pledges and seeking rechanneled SDR, the IMF should maintain publicly available datasets that cover: members' pledges; the IMF facilities, prescribed holders, or other members to which those pledges have been made; the funds that have been officially committed to those facilities, prescribed holders, and other members for rechanneling; and the funds that have been disbursed by the facilities and prescribed holders or spent by the other members.[22]

(5) **Guidance on SDR Accounting:** IMF members have also expressed uncertainties around SDR accounting. SDR accounting problems are reflected in the need for an SDR Intermediation Function, in order to bypass logistical obstacles and make efficient use of surplus SDRs, as well as in the need for SDR interest rate reform, in order to establish certain SDR mechanics that promote rather than obstruct utilization. While these two action items may prove to be "longer-term" SDR reforms, near-term rechanneling requires greater technical assistance to members and other prescribed holders on SDR accounting methods. In principle, SDR accounting is rather straightforward: the allocation of SDRs is not a wealth transfer, but rather an equivalent increase in assets (with an increase in one's SDR holdings) and liabilities (with an increase in one's SDR

[22] Mark Plant and Lucas Sala. "Tracking Recycled SDRs: More on the Hunt for Bigfoot." Center for Global Development. August 31, 2022. https://www.cgdev.org/publication/tracking-recycled-sdrs-more-hunt-bigfoot

allocation).[23] As previously noted with respect to the dual-interest rate mechanism, members pay interest on both their SDR holdings and allocation, which negate each other. As making use of one's SDRs, at present, carries an interest rate burden (when SDR holdings drop below SDR allocation, members pay the SDR interest rate on the difference), in the short-run the IMF should provide increased technical assistance to help low- and middle-income countries calculate the potential debt service burden associated with these charges. In the longer-run, SDR interest rate reform will help mitigate this obstacle and the accounting challenges involved. Greater SDR accounting guidance is also needed for high-income members facing uncertainties around SDR on-lending and donations. On-lending may refer to member-to-member on-lending, but also domestically as central bank-to-government on-lending (or "SDR retrocession), which may have distinct accounting implications—particularly if involving currency unions and joint monetary authorities such as the European Central Bank.[24] SDR donations will also incur charges on the difference between one's allocation and holdings, and may introduce other accounting questions. The IMF should be ready to provide tailor-made SDR accounting guidance to members navigating SDR rechanneling.

Conclusion

This working paper has presented near-, medium-, and long-term reforms that can be introduced to make proper use of the nearly $1 trillion SDR market. In the near term, it has called for the G-20 to honor its pledge to rechannel $100bn of the most recent SDR allocation, for the Executive Board to update and substantially expand the SDR "reserve asset characteristic," and for IMF staff to provide greater technical assistance to members and MDBs on devising rechanneling programs/encashment regimes and navigating other uncertainties around SDR accounting. The "near term" has been defined as measures that require no major vote of the IMF membership and that are politically feasible and immediately actionable. In the medium-term, it has proposed that the IMF improve the SDR rechanneling infrastructure by establishing an SDR intermediation function through a pilot program of voluntary G-20 pledges and by reforming the SDR interest rate system by bringing the SDR interest rate to zero while substantially increasing the floor rate and levy. These "medium term" measures will require votes of 70% of the IMF voting power, which does not rise to the level of the U.S. veto, and these measures should be politically feasible if for no other reason than the merits of the proposals and the complexity of the undertaking: there is no lobby *for* a 2.73% SDR interest rate (or for a "multiplicative" SDR interest rate formula, for that matter) and there is no reason oppose reforms to the system given the benefits that such reform would offer. Though again, pursuing ways to delink the SDR

[23] International Monetary Fund. "GUIDANCE NOTE FOR FUND STAFF ON THE TREATMENT AND USE OF SDR ALLOCATIONS." August 2021.
https://www.imf.org/en/Publications/Policy-Papers/Issues/2021/08/19/Guidance-Note-for-Fund-Staff-on-the-Treatment-and-Use-of-SDR-Allocations-464319

[24] International Monetary Fund. "How to Record the Allocations of Special Drawing Rights in Government Finance Statistics." IMF Statistics Department, Government Finance Division. 2022.
https://www.imf.org/en/Publications/TNM/Issues/2022/06/07/How-to-Record-the-Allocations-of-Special-Drawing-Rights-in-Government-Finance-Statistics-518063

interest rate from other IMF lending terms would be needed to contain these reforms to the SDR system without disrupting other IMF operations. In the long-term, it has proposed amendments to the the Articles of Agreement for a full SDR intermediation function, a comprehensive reform of the SDR dual interest rate system, and above all the the establishment of SDR allocations every five years and in the event of “Unexpected Major Developments,” as defined by *force-majeure shocks*, *global technical recessions*, and a *reversal of global capital flows*. These amendments would indeed require a vote of 85% of the IMF, which seems unlikely for some time to come.

In the process of proposing these reforms, this working paper has also sought to explain the peculiar, misunderstood, and sadly neglected tool of global economic governance that is the Special Drawing Right. It was created in global economic circumstances that have little outwardly in common with the world today: providing the liquidity needed to sustain a dollar-gold peg would seem a far cry from unlocking more capital for climate finance and development. However, they are essentially equivalent in basic macroeconomic terms: the international monetary system is unforgiving to most of its members and it inspires a *beggar-thy-neighbor/beggar-thyself* spiral of accumulating large foreign exchange reserves (winning market share away from peer countries, thus “beggar-thy-neighbor”) and not spending those reserves at home (thus “beggar-thyself”) if left ungoverned. Governing that dynamic and reining in its consequences can come in many ways: reforming the SDR system is by no means the only or even best solution to the problems of the international monetary system, to problems of climate change, development, debt, and the like. But the SDR remains a good tool, and with nearly $1 trillion of SDRs sitting as dry powder, paying and receiving equal rates of interest so as to ensure their non-usage by bureaucracies either uncertain of or incapable of how to use them, it is a tool worth fixing and using.