The ECB and SDRs

Stephen Paduano, Théo Maret
(s.a.paduano@lse.ac.uk, tmaret@globalsov.com)[1]

The European Central Bank has not provided a formal ruling against the rechanneling of SDRs to multilateral development banks, but ECB President Christine Lagarde has expressed opposition to the concept. In comments made in October 2022, Lagarde indicated that such rechanneling might not adequately preserve the reserve asset characteristic of the SDR. This Working Paper reevaluates the accuracy and legal foundation of the ECB's informal opposition to other avenues than the IMF for putting excess SDRs to work.

First, it argues that the current architecture for SDR rechannelling, relying solely on IMF trusts, presents a significant gap with the G-20 pledge to rechannel the equivalent of $100 billion in excess SDRs towards vulnerable countries. The RST and PRGT do not have the absorptive capacity to meet the $100 billion commitment. ***If both trusts fully meet their funding target, the G-20 will still need to find rechannel mechanisms for $37 billion worth of SDRs.*** *Limited absorptive capacity of existing trusts underpins the need for the rapid development of alternative mechanisms, building on the most advanced proposals such as these by multilateral development banks to issue SDR-denominated hybrid capital or a SDR bond.*

Second, the African Development Bank's and Inter-American Development Bank's hybrid capital proposal and the proposal for a World Bank-issued SDR bond have been designed to be similarly safe as the IMF Resilience and Sustainability Trust (RST), they would preserve the reserve asset characteristic of rechannelled SDRs, and they should not be in conflict with the EU's prohibition on monetary financing. Moreover, if the ECB is of the view that rechanneling to MDBs constitutes monetary financing on the basis that MDBs are fiscal institutions, the ECB should advise MDBs and NCBs to opt for the issuance and purchase of SDR bonds, as this would be conducted on the secondary market once a market price has been determined, which is the condition under which the ECB authorizes central banks to purchase the assets of other fiscal institutions (i.e, quantitative easing).

Third, European countries hold the bulk of excess SDRs to be rechannelled, and have shown early leadership in supporting and designing alternative mechanisms to achieve their pledges. However, they are prevented from moving forward by the communications made by the ECB in this regard.

Therefore, the Working Paper argues that the ECB should formally judge these mechanisms on their merits and exempt them from the prohibition on monetary financing, just as the ECB has exempted IMF facilities, including the newly created RST and the Poverty Reduction and Growth Trust (PRGT), the IMF's arm for lending to low-income countries.

[1] We would like to thank Mark Plant (CGD), Bernat Camps Adrogué (CGD), and Adil Ababou (Gates) for their helpful feedback and guidance on this research note.

I. A need for additional mechanisms to rechannel SDRs

When the IMF membership agreed to allocate the equivalent of $650 billion in SDRs in 2021, IMF Managing Director Kristalina Georgieva committed to "identify viable options for voluntary channeling of SDRs from wealthier to poorer and more vulnerable member countries." In support of this effort, the G-20 under the Italian presidency committed to rechanneling the equivalent of $100 billion in SDRs to vulnerable countries.

The IMF subsequently established the RST to be the principal conduit for SDR rechanneling, and the ECB exempted the RST from its prohibition on monetary financing. By the IMF's own assessment, the funding target for the RST stands at SDR 33 billion ($44 billion), with contributions well underway. Indeed, it would not be realistic to stretch the RST firepower too much further since it would weigh on IMF human resources which have already been put to work with the first batch of applications.

While the IMF's PRGT constitutes another way of rechannelling SDRs, its total lending commitments peaked at SDR 6.5 billion in 2020. However, the PRGT faces a shortfall of subsidy resources that might prevent a rapid increase of its firepower to rechannel a significant volume of SDRs in the short term. Indeed, the IMF indicated in March 2023 that it could not increase PRGT access limits due to the lack of adequate subsidy resources. This issue might take significant time to be resolved. A sharp surge in PRGT lending to low-income countries which is projected to continue until 2024 (totaling 21.5 billion SDR or $28.68 billion) exceeds by three times the PRGT's required subsidy and reserve account capacity.

In an effort to shore up the encashment regime of the PRGT, the IMF announced in April 2022 a two-stage PRGT funding strategy, amounting to SDR 12.6 billion ($16.8 billion) in loan resources in the first stage and SDR 2.3 billion ($3.07 billion) in contributions for subsidy resources in the second stage. A $20 billion fundraising effort of this nature is not a simple task, and the progress of the PRGT's two-stage fundraising strategy is unclear. Moreover, as the SDR interest rate has risen by a precipitous 302 basis points since the day the funding strategy was announced—from 0.44% in April 2022 to 3.46% today—the figures underlying the strategy might have to be revisited.

Hence, it appears that the G-20's goal would require in the short- to medium-term the design of additional mechanisms to rechannel SDRs in parallel with IMF trusts. **If the G-20 aims to meet its commitment of rechanneling $100 billion in SDRs, and the RST will only absorb SDR 33 billion and PRGT's two-stage funding strategy is SDR 14.9 billion, then the G-20 must find alternate ways to rechannel $37 billion in SDRs.** Due to the complexity of the SDR, including constraints related to who can hold them, it appears straightforward to look for solutions involving the major MDBs which are prescribed holders. Such proposals include the African Development Bank's hybrid capital proposal, and the proposal for SDR-linked bonds to be issued by the World Bank.

Additionally MDBs are uniquely positioned to deal with the most pressing issues at hand, especially climate change. Indeed a significant part of the financing gap related to climate

change adaptation comes from the investment in climate-resilient infrastructure, something which falls squarely in the remit of the MDBs with their long-standing experience of support and technical assistance for infrastructure financing.

However, ECB President Christine Lagarde has informally expressed opposition to MDB rechanneling. In an address during the Annual Meetings (October 2022), Lagarde stated:

> “For contributions by EU national central banks, it is essential that claims on the RST maintain reserve asset quality. In our assessment, the modalities of the loan and deposit accounts of the RST, as well as the deposit and investment account of the Poverty Reduction and Growth Trust, are acceptable in that regard. However, we note that the channelling of special drawing rights by EU national central banks to multilateral development banks or individual countries would not be compatible with the EU's legal framework.”

While this is by no means a formal ruling of the ECB, Lagarde’s comments have disrupted EU countries’ engagement with MDB rechanneling proposals, thereby jeopardizing the ability of the G-20 to meet its $100 billion SDR rechanneling pledge.

II. What is the reserve asset characteristic and how is it generally preserved?

The utilization of SDRs is conventionally constrained by the need to preserve the reserve asset characteristic of SDRs. This requirement can be found in an annex of the Articles of Agreement (Schedule M) which holds: “*the unconditional character of special drawing rights as reserve assets shall be maintained*.” There is notably no further elaboration of what this means, and there is also no designated adjudicator of what qualifies as a sufficiently maintained reserve asset characteristic. In practice, the IMF says that this is at the discretion of individual IMF members while IMF members tend to look to the IMF for guidance.

This lack of clarity is both logistical and substantive, and it ultimately complicates and constrains SDR utilization. Multilateral development banks do not know what precisely is meant by preserving the reserve asset characteristic of SDRs, and IMF members are reluctant to contribute SDRs to anything that could be seen as violating the Articles of Agreement. Absent more specific guidance from the IMF, there seems to be room for member countries to move forward and proceed with the rechannelling if they judge it does preserve the reserve asset status.

The IMF has established its own method for preserving the reserve asset characteristic of its members’ SDRs within its financially independent trusts. The “encashment regimes” of the Poverty Reduction and Growth Trust (PRGT) and Resilience and Sustainability Trust (RST) strive to allow IMF members that have contributed to those trusts to retrieve their SDRs at any point, and thus to treat their lent SDRs as reserve assets. The encashment regime of the PRGT is maintained through a Loan Account (to which members lend at the SDR interest rate), a Subsidy Account (to which members grant resources in order to subsidize zero-interest lending to the PRGT’s low-income borrowers), and a Reserve Account (which is

funded by the IMF and allows contributors to the PRGT to withdraw resources in the event of delayed payments by the PRGT's borrowers). The RST's encashment regime was modeled after the PRGT's and is structured similarly, containing a Loan Account, Deposit Account (20% of the loan committed), and Reserve Account (2% of the loan committed).

Although the encashment regimes of the PRGT and RST may provide a standard for ensuring liquidity which other forms of SDR utilization should mirror, it is worth noting that these encashment regimes are not perfect and inevitably entail a margin of error. The whole idea of encashment is not to have zero risk but to add successive layers of protection reducing the probability of a problem happening, until that probability brings enough comfort to the stakeholders involved.

The issue of SDRs' reserve asset characteristic emerged as the defining precept of SDR utilization following the 2021 SDR allocation. Although this is understandable, given the mention of maintaining "the unconditional character of special drawing rights as reserve assets" in an annex of the Articles of Agreement, it should not be adhered to too tightly. In part this is because the standard practice for maintaining SDRs' reserve asset characteristic is itself imperfect, and inevitably so.

In the 21st century, many central banks and monetary authorities maintain official reserves in many ways, including through the purchase of corporate bonds, commercial paper, and other unsecured instruments. This has become standard practice among the world's major central banks, and it should be taken into consideration when defining what constitutes a reserve asset.

III. The hybrid capital and SDR bond options are by design at least as safe as the RST

In May 2022, the AfDB proposed a rechanneling arrangement whereby IMF members would lend surplus SDRs to the AfDB, which would hold them as hybrid capital. With the SDRs counting as equity on the balance sheet of the AfDB, the AfDB proposes leveraging them three to four times. The reserve asset status of the SDRs is protected through a "liquidity support agreement" (LSA) between the AfDB's contributing shareholders, with 25% of the hybrid capital instrument being committed to the LSA for shareholders to draw down in the event that they face balance of payments problems that necessitate access to liquidity. The hybrid capital structure also protects the reserve asset status of SDRs as it ranks senior to paid-in equity. Moreover, it rests on the AAA rating of the AfDB, the bank's preferred creditor treatment status, and the unique shareholder structure of MDBs (i.e., sovereign governments).

The AfDB's proposal has been chiefly supported by the United Kingdom, Japan, while, Canada and Saudi Arabia are in talks to do so. It is understood that France played a leadership role in earlier stages of the AfDB's proposal, in line with the declaration of the May 2021 Paris Summit on the financing of African Economies, in which the French President called specifically for a rechannelling of SDRs not only through IMF facilities but also through the World Bank and regional development banks like the AfDB. However uncertainty regarding the stance of the ECB has since complicated France's involvement.

On 14 February 2023 the AfDB conducted a briefing for the IMF's Executive Board on the hybrid capital proposal. Given the Executive Board's longstanding position that reserve asset questions are at the discretion of IMF members and prescribed holders, it is unlikely that it will provide any formal ruling on the AfDB's proposal. Nonetheless, the briefing to the Executive Board can demonstrate at a technical level that the IMF has no outstanding objections to the AfDB's proposal to preserve the SDRs' reserve asset characteristic. Moreover, the IMF's Statistics Department has ruled that countries which participate in the hybrid capital proposal can continue to score their contributed SDRs as reserve assets.

An SDR bond should also meet the ECB's criteria. In brief, the proposal is for the World Bank to issue a bond denominated in SDRs, just as the World Bank would issue a bond denominated in any other currency. All IMF members and prescribed holders could purchase this bond and trade it between themselves as they would any other security, thereby supporting the liquidity of the instrument. This SDR bond would also pay the SDR interest rate, thereby offsetting the costs of SDR utilization by IMF members. It could settle in dollars and euros, in which case market participants could also trade and hold it as any other security, further enhancing its liquidity. Both features would incentivize the purchase of the bond by members and support its ability to be traded, thus making it even more like a reserve asset. Settling in currency rather than SDRs would also mirror the World Bank's 2016 issuance of an SDR-denominated RMB-settled bond, which serves as an attractive precedent for a new SDR bond. Moreover, as the SDR bonds would be purchased by the World Bank's shareholders with the expectation that they would function as perpetuals (rolling over at par when they mature), the SDR bonds would be a uniquely low-risk instrument for the World Bank that the credit rating agencies should view as a permanent contribution to the World Bank's resources. The World Bank's AAA rating, preferred creditor treatment, and callable capital provide additional protections for such an SDR bond.

At the most elementary level, an SDR bond meets the requirements of the ECB because it is a security purchased from a highly-rated issuer, which makes it identical in form to any other security held by the ECB—be it from a sovereign issuer, a corporate issuer, or indeed any other bond issued by the World Bank. Crucially for the ECB's purposes, the SDR bond also comports with the precise logic and precedent of past ECB rulings on such things as the Asset Purchase Programs (i.e., quantitative easing). Under the ECB's Asset Purchase Programs, the ECB and NCBs conduct large-scale purchases of a variety of debt instruments, primarily those issued by fiscal institutions (i.e., government bonds). However, the ECB concluded that such asset purchases do not constitute monetary financing as the transactions are conducted on the secondary market. If the ECB continues to have reserves about the fiscal nature of the MDBs—and therefore concludes that rechanneling in the form of direct lending to the MDBs would violate the prohibition on monetary financing—the proposal for an SDR bond should emerge as a robust alternative as it would follow the Asset Purchase Programs' precedent of only allowing for transactions on the secondary market. Beyond this, the structure of the SDR bond, the ease of trading between the IMF's 210 prescribed holders, and the safety of the World Bank provide further assurances of the SDR's reserve asset status.

IV. Eurozone countries prevented from using these mechanisms despite their leadership

Claiming jurisdiction over the $199.87 billion worth of the Eurosystem's SDRs, the ECB has established itself as the largest and most important actor in the SDR system—by contrast, the United States holds $161 billion, Japan $59 billion, and China $51 billion. Eurozone members were allocated the equivalent of $134 billion in 2021, and their holdings grew by more than $139 billion between July 31, 2021 and January 31, 2023. This indicates that SDRs have mostly sat idle on the balance sheet of the Eurosystem as Eurosystem national central banks appear to interact with the SDR system only when they engage in Voluntary Trading Arrangements (VTAs) to absorb SDRs when more vulnerable countries need to sell them.

Moreover, where other large IMF members such as the United States face domestic political obstacles to SDR rechanneling and have expressed reservations about rechanneling, several major European countries have been at the forefront of efforts to develop innovative, ambitious, and responsible proposals to SDR rechanneling. Italy's spearheading of the G-20's $100 billion rechanneling commitment, France's early support for SDR rechanneling broadly and the AfDB's hybrid capital proposal specifically, and Spain's emergence as the first contributor to the RST reflect European members' interest in making productive use of their surplus SDRs. The ECB's current position against alternative methods of SDR rechanneling is therefore at odds with its own members' policies and interests, and creates a leadership vacuum in the SDR system that other large IMF members are unwilling or unable to fill. At a technical level, the opposition of the ECB may make AfDB rechanneling unviable altogether, given that the AfDB will be unlikely to secure the participation of five IMF members, the number needed to establish a working encashment regime, if the Europeans are barred from participation.

Indeed, it appears that the current legal framework of the ECB features a very specific carve out for rechannelling through IMF facilities, potentially preventing the use of other avenues including the MDBs.

The ECB has decided to exempt IMF facilities from the prohibition of monetary financing, defined in Article 123 of the Treaty on the Functioning of the European Union as "overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States [...] in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States".

The authority to exempt IMF institutions from this prohibition on monetary financing is specifically derived from Council Regulation (EC) No 3603/93, which reads:

> *"The financing by the ECB or the national central banks of obligations falling upon the public sector vis-à-vis the IMF or resulting from the implementation of the financial assistance facility is not regarded as a credit facility."*

Although this focuses the scope of ECB exemptions on the IMF, this is only a function of the fact that institutions other than the IMF have not to date constructed rechanneling arrangements that could engage the ECB's prohibition on monetary financing. Additionally, it is worth noting that the financial architecture was not the same when the exemption was granted, and the IMF was in a league of its own. Since then, major MDBs have significantly increased in importance, crucially demonstrated a stainless track record when it comes to their preferred creditor status, and the IMF continues to approve MDBs to be prescribed holders (now 20 in total) thereby recognizing them as custodians of the SDR system. Indeed, in the IMF's approval in February 2023 of five new prescribed holders—the Caribbean Development Bank (CDB), the Development Bank of Latin America (CAF), the European Bank for Reconstruction and Development (EBRD), the European Investment Bank (EIB), and the Inter-American Development Bank (IADB)—the IMF Executive Board communicated that one of the "benefits for the SDR department" of approving these multilateral development banks would be to:

> *"...enlarge the choices of members to use their SDRs, including settling financial obligations and potentially channeling SDRs to them, thereby increasing the attractiveness of the SDR as a reserve asset."*

The ECB still determines each exemption on a case-by-case basis that evaluates whether the utilization of SDRs in that instance preserves the reserve asset characteristic of the SDRs. In effect, although Council Regulation No 3603/93 specifically references the IMF, rulings of the ECB indicate that the actual substantive review is not specific to the IMF. The substantive elements that qualify for an exemption can be replicated by any prescribed holder which similarly preserves reserve asset characteristic. So far the ECB has exempted contributions to the HIPC, PRGT, and RST from Article 123. The exemptions are identical in substance and language. In August 2005, following a request by Austria's Finance Ministry to contribute to the IMF for low-income countries affected by natural disasters, the ECB exempted the arrangement in the following ruling:

> *"Recital 14 to Regulation (EC) No 3603/93 sets out the rationale behind this exemption, stating that it is appropriate to authorise the financing by the central banks of obligations falling upon the public sector vis-à-vis the IMF as this financing results in foreign claims which have all the characteristics of reserve assets. The ECB considers that the OeNB's financing of the abovementioned IMF-administered initiative falls within the scope of this exemption, and should not therefore be regarded as a form of monetary financing prohibited by the Treaty."*

In September 2008, the ECB considered a request by Austria's Finance Ministry to contribute to HIPC for Liberian debt relief. The ECB evaluated the Special Contingent Account of HIPC and its ability to allow the IMF to settle the claims of donor countries in the event that debits are unable to pay, and the ECB issued the same ruling as before:

> *"Consequently, in this case the ECB considers that the OeNB's financing of the Austrian contribution to the HIPC-Trust Fund for Liberia's debt relief, as provided for in the draft*

> *law, falls within the scope of the same exemption and should not therefore be regarded as a form of monetary financing prohibited by the Treaty."*

In March 2013, the ECB granted another exemption to the Oesterreichische Nationalbank following its request to contribute to the PRGT. This ruling cited the subsidy resources of the PRGT and considered the assurances that preserve the reserve asset characteristic of the SDR similar to the assurances of the prior two rulings. The ECB thus concluded:

> *"The OeNB's authority, under the draft law, to grant a bilateral loan to the IMF should also be considered as falling under the Article 7 exception of Regulation (EC) No 3603/93 and should therefore not be regarded as a form of monetary financing prohibited by the Treaty."*

Most recently, the ECB responded to a request by the Banca d'Italia to contribute to the RST. The ECB also provided an exemption along the same lines:

> *"In particular, Article 7 of Regulation (EC) No 3603/93 provides that the financing by NCBs of obligations falling upon the public sector vis-à-vis the IMF is not regarded as a credit facility within the meaning of Article 123 of the Treaty. The fourteenth recital of Regulation (EC) No 3603/93 clarifies the rationale behind this exemption, stating that it is appropriate to authorise the financing by the NCBs of obligations falling upon the public sector vis-à-vis the IMF because such financing 'results in foreign claims which have all the characteristics of reserve assets'. Therefore, the exemption in Article 7 of Regulation (EC) No 3603/93 must be interpreted in line with this rationale."*

More notably, however, the ECB also elaborated its approach to reserve assets:

> *"Reserve assets have been defined as those external assets that are readily available to and controlled by monetary authorities for meeting balance of payments financing needs, for interventions in exchange markets to affect the currency exchange rate, and for other related purposes, such as maintaining confidence in the currency and the economy, and serving as a basis for foreign borrowing. Under this definition, reserve assets must be foreign currency assets and, other than gold bullion, must be claims on non-residents. The need for availability on demand to meet balance of payments financing needs and other related purposes implies that the credit quality and liquidity of the claims must be ensured."*

This definition of reserve assets is important because it comes from the IMF and its *Balance of Payments and International Investment Position Manual*. Although the IMF instructs members to define the reserve asset characteristic for themselves, as an official matter the ECB turns to the IMF. This creates a notable precedent of immediate relevance to the AfDB's hybrid capital proposal: if the IMF clears a rechanneling mechanism as preserving the reserve asset characteristic of the SDR, it would fall upon the ECB to clear that rechanneling mechanism as well—or else to adopt a new definition and method of defining what constitutes a reserve asset. Moreover, turning to the list of acceptable reserve assets in the IMF's *Balance of Payments and International Investment Position Manual*, we can see that the

working definition of reserve assets is broad. It includes an unspecified range of short- and long-term debt securities, equity and investment fund shares or units, financial derivatives, claims on monetary authorities, and claims on "other entities," among other things:

Box 6.5. Components of Reserve Assets and Reserve-Related Liabilities

Reserve assets
- Monetary gold
  - Gold bullion
  - Unallocated gold accounts
- Of which: Monetary gold under swap for cash collateral[1]
- Special drawing rights
- Reserve position in the IMF
- Other reserve assets
  - Currency and deposits
  - Claims on monetary authorities
  - Claims on other entities
  - Securities
    - Debt securities
      - Short-term
      - Long-term
    - Equity and investment fund shares or units
    - Of which: Securities under repo for cash collateral[1]
  - Financial derivatives
  - Other claims

Reserve-related liabilities to nonresidents (memorandum items)
- Short-term (on a remaining maturity basis)
  - Credit and loans from the IMF
  - Debt securities
  - Deposits
  - Loans
    - Repo loans
    - Other loans
  - Other short-term foreign currency liabilities to nonresidents

(See also Appendix 9 Table V for additional supplementary items for reserve-related liabilities.)
[1]In the IIP only.

The ECB's exemption for the RST also more fully elaborates what is meant EC No 3603/93 regarding exemptions for IMF rechanneling mechanisms and their encashment regimes. Specifically, we see that the ECB emphasizes the importance of liquidity of claims and the potential for early repayment:

> *"For the exemption laid down in Article 7 of Regulation (EC) No 3603/93 to apply to the contribution to the RST loan and deposit accounts envisaged by the draft legislative provision, the terms and conditions of the agreement with the IMF must provide for a potential early repayment of the principal amount of the resources borrowed from the Banca d'Italia. Under this arrangement, the SDRs channelled by the Banca d'Italia to the RST would be readily repayable, to meet balance of payments and reserve needs, so that the liquidity of the claims of the Banca d'Italia is safeguarded with a view to ensuring their reserve asset status."*

Beyond the immediate question of how the ECB has treated IMF trusts and the reserve asset questions, there is the broader issue of the ECB's prohibition of monetary financing. It is conventionally assumed that the ECB is quite strict on the matter of monetary financing, understandably since it features in the institution's governing treaty, but in practice the ECB has adopted smarter and nimbler approaches to this issue since the financial crisis.

"Monetary financing" refers to a situation whereby a central bank *directly* finances a government's spending. A heavy emphasis is placed on the word *directly* because of the ways in which central banks *indirectly* finance a government's spending, namely through a central bank's asset purchasing programs (which primarily involve government bonds, but may include other public and private sector debt instruments). This became particularly notable following the financial crisis when many central banks adopted Quantitative Easing programs. Although central banks became by far the largest holder of their governments' debt, this was considered not to constitute monetary financing because the asset purchases were conducted *indirectly*—that is, on the secondary market. The ECB only formally initiated its own Asset Purchase Programs (APP) in 2014 and the APP has successfully withstood legal challenges suggesting it constitutes monetary financing. The position of the European Court of Justice, as communicated by the ECB, is that the APP:

> *"...adheres strictly to the prohibition on monetary financing by not buying in the primary market. It only buys bonds once a market price has been identified; this ensures it does not distort the market pricing of risk…"*

This is a sufficient argument, and it is also an encouraging one as it relates specifically to the issuance of an SDR bond. Monetary financing as the Treaty on the Functioning of the European Union defines it is indeed a very narrow practice that pertains only to *direct* purchases of debt instruments and the creation of credit facilities for government entities. Neither the ECB's asset purchase programs, nor the IMF's key rechanneling facilities, nor the new SDR rechanneling proposals fall afoul of these points. Most specifically an SDR bond would be in perfect alignment with the ECB's rules on monetary financing, as NCBs would only be purchasing an SDR bond in the secondary market once a market price has been identified. If the ECB finds that direct SDR lending by way of the hybrid capital proposal are not viable despite the accompanying liquidity support agreement—perhaps owing to the belief that MDBs are fiscal institutions—the ECB should instruct MDBs and NCBs to issue and purchase SDR bonds given the clear precedent both of the SDR bond (from the World Bank's 2016 issuance) and the ECB's approval to purchase such securities from fiscal institutions (from its rulings on Quantitative Easing).

V. The ECB should judge new SDR utilization channel based on their merits

There is clear precedent for the ECB to exempt SDR rechanneling arrangements from the EU's prohibition on monetary financing if those arrangements can be shown to preserve the reserve asset characteristic of the SDR, which should be applied to robust MDB rechanneling arrangements (such as the AfDB's) and other modalities of SDR utilization (such as the SDR bond). This exemption is how the ECB permits NCBs to rechannel to the RST and PRGT. One

could indeed argue that the IMF is different from MDBs since it lends to central banks, as opposed to financing specific projects. However, a significant share of IMF funding is earmarked for budget support instead of BoP support[2]. Similarly, despite lending to support projects, the main MDBs are not exposed to project-specific credit risk and benefit from a preferred creditor status akin to that of the IMF.

Moreover, the definition of "reserve asset" which the ECB uses is permissive of both the AfDB's hybrid capital instrument and the SDR bond. The ECB may find further comfort in the fact that the IMF's Statistics Department has indicated that SDRs used as hybrid capital could be scored as reserves for contributing countries and by the fact that the World Bank has already issued a cash-settled SDR-denominated bond in 2016. However, it is worth noting that the IMF does not rule on matters of reserve asset status as that decision is left to prescribed holders themselves: in other words, if the ECB wants to support a proposal, it can.

An exemption of MDB mechanisms for SDR rechannelling from monetary financing prohibition rules by the ECB would not constitute a reversal of an ECB position *per se* as the ECB has not yet provided a formal ruling on MDB rechanneling, and the ECB's only opposition came in the form of informal comments from ECB President Christine Lagarde.

Eurosystem NCBs should move quickly to request a formal ECB ruling on MDB rechanneling, which the ECB should rule on favorably.

VI. Looking Forward: Has the ECB overstepped its mandate?

Looking forward, it is also worth further consideration about whether the ECB has jurisdiction to issue rulings on SDR utilization. The NCBs contain multi-billion euro portfolios of assets which are bought, held, and sold entirely at the discretion of the NCBs themselves. The balance sheet of the Banque de France (BdF), for example, contains the item of "other securities" which are to be contrasted with the EUR 976.5 billion in "securities held for monetary policy purposes" that have been purchased at the discretion of the BdF. Further to the Banque de France's ability to conduct transactions independently, the Annual Report on Financial Management and Accounts indicates that there are no restrictions on the non-monetary policy investment decisions of the Banque de France, including the purchase of debt securities. Notably, the Banque de France employs entirely different accounting and valuation methods for its independent operations and holdings (following the standards established by the *Autorité des normes comptables* rather than by the ECB). Given the normalcy of purchasing debt securities independent of the ECB, an SDR bond may be a particularly viable option for NCBs to utilize their surplus SDRs.

The ability of the NCBs to conduct independent non-monetary operations can also be found in their own governing statutes. In the Statutes of the Banque de France, certain powers are clearly retained which—as the ECB similarly instructs—do not pertain to domestic or European monetary policy issues. Article L 141-9 reads:

[2] The IMF noted in 2010 that use of Fund resources for budget support is consistent with the Fund's mandate and legal framework provided a BoP need exists and the resources are used in support of policies that will address the member's BoP problem

> "The Banque de France may carry out, for its own account and for third parties, any transaction relating to gold, means of payment or securities denominated in foreign currencies or defined by reference to a weight in gold.
>
> The Banque de France may lend or borrow sums in euro or in foreign currency to and from foreign banks and foreign or international monetary institutions or bodies…"

Article L 141-9 provides an almost unequivocal indication of the Banque de France's authority to utilize its SDRs as it sees fit without the involvement of the ECB. As a transaction involving SDRs would emanate from the Banque de France's "own account" (given that the Banque de France takes custody of France's SDRs) and given the direct mention of the Banque de France's ability to interact with "foreign banks and foreign or international monetary institutions or bodies," the hybrid capital proposal and an SDR bond issued by the World Bank would appear to lie fully within the existing authority of the Banque de France.

This also does not conflict with the documents underlying the establishment of the ECB, the Treaty on the Function of the European Union (TFEU) and the Protocol on the Statute of the European System of Central Banks and the European Central Bank (the Protocol). Neither the TFEU nor the Protocol provide any guidance on SDRs or SDR rechanneling. Jurisdiction has been *assumed* by the ECB, and these matters have been left to subsequent interpretation and reinterpretation. Moreover, the legal bases for which the ECB is consulted on matters pertaining to SDRs is itself quite broad, based on an assumption that the SDR is a "matter of competence" for the ECB, and there is no indication that the judgment of the ECB is necessarily binding for the NCBs. Indeed, the TFEU (Article 127.4) only indicates that the ECB "shall be consulted" and "may submit opinions." Yet even still, it is unclear that the ECB shall be consulted on SDRs and SDR rechanneling. The ECB writes in *Foreign Exchange Reserves and Operations of the Eurosystem* that the circumstances under which a national central bank would be obliged to consult the ECB before conducting a transaction with its own foreign reserves is if they "affect foreign exchange rates or domestic liquidity conditions" or of course if they "affect the single monetary policy of the Eurosystem"

> "... operations carried out on the foreign exchange market with the NCBs' foreign reserves, which may affect foreign exchange rates or domestic liquidity conditions, are, above certain limits established within the framework of guidelines issued by the Governing Council, subject to the approval of the ECB, in order to ensure consistency with the single monetary policy of the Eurosystem. Since they do not affect the single monetary policy of the Eurosystem, NCBs' investment operations in foreign financial markets are not subject to the approval of the ECB. Transactions undertaken by NCBs in fulfillment of their obligations towards international organizations are also exempt from this requirement."

There is no plausible argument that SDR rechanneling would affect foreign exchange rates, domestic liquidity conditions, or the single monetary policy of the Eurosystem.

To the extent that the ECB can govern the use of SDRs, it would be because those SDRs constitute a portion of the ECB's foreign-exchange reserves. At year end 2022, the ECB held EUR 84.5 billion in foreign reserve assets, including EUR 1.759 billion worth of SDRs. However, following Article 30 of the Protocol, the ECB only has the "full right to hold and manage the foreign reserves that are transferred to it and use them for the purposes set out in this article." This is important given that the vast majority of the eurosystem's SDRs *have not been transferred* to the ECB: separate from the ECB, the NCBs collectively hold $199.87 billion in SDRs.

In sum, the conventional assumption that the ECB's mandate extends to the use of NCBs' SDRs is not entirely straightforward for two substantial reasons. First, NCBs purchase, hold, and sell assets in considerable volume entirely at their own discretion, they utilize their own accounting and valuation methods to do so, and they derive the authority to do so from their own governing statutes. Second, neither the TFEU nor the Protocol make specific mention of SDRs, and assumption that the ECB "shall be consulted" on SDR rechanneling is undermined by the fact that SDR rechanneling does not affect foreign exchange rates, domestic liquidity conditions, or the single monetary policy of the Eurosystem.