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**Research Report**

## Getting special drawing rights right: Opportunities for re-channelling SDRs to vulnerable countries

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## Getting Special Drawing Rights Right: Opportunities for Re-channelling SDRs to Vulnerable Countries

Jürgen K. Zattler

### Summary

Many developing countries are still grappling with the consequences of the pandemic and the associated high debt burdens while facing huge financing needs, inter alia related to climate change. In response, the International Monetary Fund (IMF) issued \$650 billion in Special Drawing Rights (SDRs). The G7 and G20 have committed to re-channelling SDR 100 billion of their allocation to developing countries (on-lending, recycling and re-channelling are used interchangeably in this policy brief). The question now is how to implement these commitments in a way that promotes the global transformation and at the same time supports debt sustainability.

It is important to note that there are certain restrictions on the re-channelling of SDRs. Most importantly, the re-channelling must be consistent with the SDR's status as an international reserve asset. There are different interpretations of these requirements. The IMF has encouraged the use of the Poverty Reduction and Growth Trust (PRGT) and the Resilience and Sustainability Trust (RST) for re-channelling. It has also signalled general support for re-channelling SDRs to the multilateral development banks (MDBs). The European Central Bank (ECB) has taken a more restrictive stance.

Does the re-channelling of SDRs through the above-mentioned IMF trusts ("the current on-lending option") effectively support the global transformation? Measured against this objective, the current on-lending regime has two shortcomings.

First, it does not sufficiently link foreign exchange support to deep structural transformation. Second, it does not allow funds to be leveraged in the private capital market. In this policy brief, we discuss a promising alternative: recycling SDRs for MDB hybrid capital ("the hybrid capital option"). This option can overcome the two drawbacks of the current system. At the same time, it has its own challenges.

Moreover, both the current on-lending option and the hybrid capital option raise concerns about debt sustainability. If implemented in their current forms, they would risk exacerbating vulnerable countries' debt problems. It would therefore be desirable to modify these options to better integrate debt implications. This could be done by using the on-lent SDRs primarily for programmes that are not "expenditure-based", but rather help to improve the composition of expenditure and revenue in a socially equitable manner, for example the introduction of regulatory standards, feebates and carbon pricing, or the phasing out of fossil fuel subsidies. Such an approach could have the added benefit of making previously sceptical member states more receptive to the hybrid capital proposal.

The mid-term review of the RST, scheduled for May 2024, as well as the full review in 2025 provide good opportunities to further explore some of the issues raised in this policy brief. In addition, the brief identifies three ways in which interested shareholders of the IMF and MDBs could advance the debate on the hybrid capital option.

## The challenge: debt and financing needs

Many developing countries are still grappling with the economic impact of the pandemic. Combined with longer-term structural factors, this has resulted in high debt burdens, particularly for low-income countries. International capital markets have recently reopened to emerging market borrowers, albeit at high interest rates that appear unsustainable for some. Some 60 per cent of low-income countries are in debt distress or at high risk of debt distress. A major concern is the long-term trend towards lower economic growth rates. According to the World Bank (2023), the increase in the external debt stock of low- and middle-income countries has outpaced economic growth over the past decade. This has increasingly constrained fiscal space. Total net debt flows (loan disbursements minus repayments) to low- and middle-income countries will turn negative by 2022.

At the same time, these countries face huge financing needs. The World Bank (2023) estimates that the total amount of spending needed to address climate, pandemic and conflict challenges in developing countries will cost around \$2.4 trillion per year by 2030. The International Energy Agency calculates that developing countries (excluding China) will need to invest between \$1.4 trillion and \$1.9 trillion per year over the next decade (up from \$260 billion per year today) to meet their Paris Agreement commitments. They must also urgently prepare to adapt to the new normal of higher temperatures and their impacts. To put these financing needs into perspective, the World Bank provided \$128 billion in loans, grants and investments last year.

As representatives of the so-called Bridgetown Initiative emphasised (see e.g. Persaud, 2022), the two challenges of climate change and debt are interlinked. The cost of environmental damage, the loss of revenue from natural disasters and the high price of reconstruction all contribute to higher debt levels. Debt-constrained fiscal policies severely limit investment in resilience. This real

risk lowers the creditworthiness of affected countries, increases the cost of external financing for resilience-building and further reduces fiscal space.

To address the impact of the pandemic and also longer-term climate-related vulnerabilities, the IMF decided in August 2021 to issue \$650 billion in Special Drawing Rights (SDRs). There has been a long-standing debate about the role of SDRs in the international financial architecture, including how SDR issuance could support development and global objectives.

This policy brief focuses on one particular aspect, namely the on-lending of SDRs. This is a topical issue, as at the G7 Summit in Carbis Bay in June 2022, when the G7 countries committed to a target of making SDR 100 billion available to developing countries by on-lending some of their SDRs to them. The G20 and the African Union have also endorsed this target. At the Summit for a New Global Financing Pact in Paris in 2023, IMF Managing Director Kristalina Georgieva announced that the on-lending target had been met.

Do SDRs have the potential to reconcile the seemingly conflicting objectives of responding to countries' short-term financing needs in the aftermath of successive crises, while at the same time ensuring countries' debt sustainability in the longer term? How can the above-mentioned on-lending commitments be implemented in a way that supports global transformation, particularly in the context of climate change, while at the same time supporting debt sustainability?

To answer these questions, the next section ("Background") outlines the current on-lending regime and recalls the rules governing the use of SDRs, in particular with regard to their recycling. Section 3 ("Upside and downsides") assesses the advantages and disadvantages of the current system. Section 4 ("An alternative") presents an alternative recycling option, which we call the hybrid capital option. Both the current on-lending regime and the hybrid capital option aim to support transformational goals, including the fight against

climate change. Although the debt implications are not explicitly part of the objectives of the options, they are important side effects. In section 5 (“Let’s talk about debt”), we therefore look at the debt implications of the two options and discuss how these options could be redesigned to avoid debt accumulation or, better still, improve debt profiles. Section 6 draws conclusions and outlines the next steps.

## **Background to the re-channelling of SDRs**

SDRs are an international reserve asset created by the IMF to supplement the official reserves of its member countries. Their value is based on a basket of five currencies. SDRs are issued on the basis of countries’ IMF quotas and give holders the right to borrow hard currency from other IMF members. Since the amendment of its Articles of Agreement in 1969, the International Monetary Fund (IMF) has decided on four general allocations of SDRs. The most recent allocation, the largest ever, was for SDR 456 billion (equivalent to \$650 billion). It was approved in August 2021 in the midst of the COVID-19 pandemic.

Surplus countries and others with no immediate need for additional reserves can transfer their SDR allocations to countries in need, which are usually vulnerable developing countries. The IMF provides several vehicles for member countries to channel SDRs, notably the Poverty Reduction and Growth Trust (PRGT) and the Resilience and Sustainability Trust (RST). It explicitly encourages member countries to participate in the on-lending of SDRs through both trusts. The PRGT provides concessional assistance to low-income countries. The mandate of the RST, established in 2022, is to help low-income and vulnerable middle-income countries build resilience to external shocks and address structural challenges related to climate change and pandemic preparedness. Both facilities are subject to conditionality, including IMF-supported structural policy reforms.

Both the PRGT and the RST are structured in such a way that the lending of SDRs through them

is essentially risk-free for the lender, so that they continue to be considered international reserve assets. They are also redeemable through an encashment regime. The key element is a liquidity buffer equal to 20 per cent of the amounts committed by the lenders. This can be drawn upon if another contributor facing balance of payments difficulties requests an early repayment of its claims. In addition, the operations are supported by the SDR Voluntary Trading Arrangement market – where central banks commit to buy and sell SDRs – and by a so-called designation mechanism, under which the IMF can oblige members with strong balance of payments positions to provide hard currency in exchange for SDRs.

An SDR allocation is “cost free”. It involves two elements: an increase in the member’s allocation (liability) and a corresponding increase in its holding of SDRs (asset). Whereas the IMF pays interest on a member’s holdings, it charges fees on its allocations at the same rate; that is, fees and interest balance to zero if countries do not use their SDR allocations. However, if a member uses its SDR allocation and thereby reduces its net holdings, it incurs net charges (see below). What does this mean for on-lending? When a country on-lends its SDRs to a vulnerable country, thereby reducing its holdings, the borrowing country has to pay interest to the IMF, while the recipient country receives interest on its increased holdings. This cost is offset if the borrowing country charges interest on the on-lent funds (assuming the interest rate charged is the same as the SDR interest rate). The recipient country, in turn, has to pay interest to the on-lending country and receives interest from the IMF on its increased SDR holdings. Again, the net effect for both countries is zero. The SDR interest rate is based on a weighted average of representative three-month money market rates for the five currencies in the SDR basket. The current rate (April 2024) is around 4 per cent.

Recipient countries can use SDRs for a wide range of operations, including to meet financial obligations to the IMF and its member countries,

to augment their international reserves and to support their fiscal budgets in times of need. However, on-lending must be consistent with the status of SDRs as an international reserve asset: On-lent SDRs must be essentially risk-free for the lender, and they must be redeemable, that is, the lender must be able to call in the loans early if it faces liquidity problems of its own.

There are different interpretations of these requirements:

- On the key requirement of maintaining international reserve status, the IMF has adopted a relatively open interpretation. It has encouraged the use of the PRGT and the RST for on-lending. In addition, the IMF staff has generally supported the transfer of SDRs to other so-called prescribed entities and explicitly welcomed a proposal by the African Development Bank (AfDB) to use SDRs for a hybrid capital vehicle (see below). In particular, the IMF staff has indicated that it would count as reserves any SDRs used as multilateral development bank (MDB) hybrid capital, as proposed by the AfDB.
- The European Central Bank (ECB) has taken a more restrictive view. Although it has allowed the re-channelling of SDRs to the IMF trusts, the ECB has informally argued that re-channelling to prescribed entities other than the IMF is inconsistent with liquidity and safety requirements. In addition, European Union law prohibits member states from using monetary policy instruments to finance government budgets. Exceptions have been made for the IMF trusts, mainly on the grounds that they maintain the reserve currency status of SDRs. Similar exemptions would be needed for other conduits.

For euro area countries, the decision on re-channelling depends on the specific legal environments in the euro area countries themselves. Member states have taken different positions on this issue. Whereas France and Italy, for example, have supported recycling to MDBs, the German Bundesbank has taken a more

restrictive view. It argues that there is no legal basis allowing the Bundesbank to on-lend SDRs – including to the PRGT and the RST – and that such on-lending would be development finance in disguise, which is not legitimised by democratically elected institutions.

There is little doubt that on-lending is in tension with the ban on monetary financing. But there are already well-founded exceptions, most notably for the IMF trusts. Moreover, the issue goes well beyond legal considerations. One could argue that the world is facing unprecedented and existential challenges, while the political economy is not equipped to deal with them. We are facing inadequate global governance with severe collective action problems. Individual countries can free-ride and there is no mechanism for burden-sharing. Using SDRs for the above purposes would be second-best; however, in the absence of appropriate global governance, this alternative is acceptable and should be supported.

## **Upside and downsides of the current on-lending regime**

Does the current on-lending regime effectively support global transformation, particularly in the context of climate change? Measured against this objective, there is both an upside as well as downsides to the current on-lending through IMF trusts. The upside is that these trusts are widely accepted as recycling vehicles and provide a high degree of confidence in the maintenance of the reserve character of SDRs.

The downsides are twofold. First, it is questionable whether the current RST- and PRGT-funded operations achieve climate-related transformation in an optimal way. Diamond and Gupta (2024) found that most programmes financed under the RST are lacking robustness, even if some progress has been made more recently. We know from past experience that such macro programmes need to be accompanied by other forms of support – such as investment financing, capacity-building, analytical work, and intensive policy dialogue with governments and other



stakeholders – in order to be effective. The World Bank’s Independent Evaluation Group (2018), the International Development Agency (2006), and Koeberle, Stavreski and Walliser (2006) found that the complementarity of instruments is key, and that technical assistance and capacity support during implementation are important for success. Multi-sector operations such as climate, human development and sustainable development performed better than operations that focused mainly on pure economic reforms. Looking at the different components of such an ideal assistance package, it is clear that very little falls within the core mandate of the IMF, which itself has recognised this problem, stressing that its financing must be part of a broader strategy. It has entered into a coordination agreement with the World Bank to implement the RST. However, it is questionable whether this agreement can ensure the necessary comprehensiveness and synergy of instruments. There is a second major drawback to on-lending through the PRGT and the RST. Lending through these trusts does not allow the funds to be leveraged on the capital market. In fact, the leverage is less than one because of the liquidity buffer mentioned above.

Moreover, as Plant and Adrogué (2023) point out, a significant proportion of the SDRs available for on-lending remains inaccessible to countries in need. To date, the IMF has only disbursed less than \$1 billion. As Paduano and Maret (2023) outline, even if both trusts fully meet their funding targets, countries that have committed to the \$100 billion target will still need to find recycling mechanisms for \$37 billion. There are several reasons for the slow uptake. One is that the access thresholds are relatively high. Besides, the RST and PRGT face capacity constraints to absorb the \$100 billion. In addition, as these trusts lend at concessional rates (0 per cent in the case of the PRGT), grant resources are needed to finance the concessional element. This need has increased as market interest rates (and hence SDR interest rates) have risen.

## **An alternative: recycling for MDB hybrid capital?**

As we have seen above, the current on-lending regime – while meeting the main requirement of preserving the character of the SDRs as reserve currency – has two drawbacks. Given these drawbacks, the question is whether there are other recycling options that could overcome them while preserving the benefits of the current on-lending practice.

One prominent proposal is to use SDRs to purchase hybrid capital instruments issued by MDBs. Both the AfDB and the Inter-American Development Bank (IDB) have proposed a new platform for recycling SDRs into hybrid capital instruments that can be accounted for as equity. The hybrid capital would rank senior to paid-in capital but junior to other unsecured debt. The hybrid capital must be sufficiently subordinated to convince rating agencies that it is “real” capital, while ensuring a high degree of liquidity and safety.

This proposal to use SDRs to purchase hybrid capital issued by MDBs is well-suited to address the above shortcomings of the current on-lending regime and is therefore very promising:

- First, it has better transformational potential, as MDBs could use all their instruments in a synergistic and effective way: policy-based lending linked to policy dialogue, public investment, capacity development and technical assistance. They could even link this support to mobilising and enabling private-sector investment, which is key to greening economies. This option would also leverage in many ways the role of MDBs in addressing global challenges such as climate change. The current MDB reform process offers a particular opportunity. As part of this process, the World Bank is discussing a proposal to create a hybrid capital option that would underpin the Bank’s enhanced role as a provider of global public goods. Germany has already pledged some \$320 million, and other

shareholders are expected to join. The operationalisation of the option to lend SDRs for hybrid capital at the World Bank would dovetail perfectly with these ongoing reforms.

- Second, the increased equity of the MDBs would allow them to borrow more on the capital market, thereby leveraging private capital and substantially increasing their lending volume. Depending on the financial strength of the MDB, the leverage is estimated to be between 3-4x (AfDB and IDB) and 4-6x (International Bank for Reconstruction and Development – IBRD). As the IBRD's current lending volume is more than \$35 billion, with an on-lending amount of, for example, \$5 billion for hybrid capital, the IBRD could mobilise another \$20-30 billion on the capital market, thus doubling its lending volume.

IMF management has presented the AfDB proposal to recycle SDRs into hybrid capital instruments to its Executive Board and is currently studying the legal and operational modalities of such an approach. According to Caldentey, Villarreal and Moscoso (2023) and Plant (2023b), the IMF staff has confirmed that it would count any SDRs used under the proposed hybrid capital arrangements as reserve assets and has signalled its willingness to take the proposal to the IMF Executive Board in the near future. Ultimately, the decision will be taken by the member countries of the IMF. The governments of France, Japan, Spain and the United Kingdom have already expressed support for the proposals and pledged resources, whereas they still have to reconcile this pledge with the restrictive ECB view.

The difficulty with this proposal is that there is a degree of tension between two objectives: on the one hand, the loan needs to be seen as capital (as a permanent contribution to the MDBs' capital base) and considered as such by the rating agencies; on the other hand, it needs to provide a high degree of liquidity and safety to central banks in order to maintain its reserve asset status.

The AfDB, in particular, has already done a very good job of managing these conflicting demands.

As Plant (2023a) points out, the recycled SDRs would never be spent. The MDBs would hold them as capital in their SDR accounts at the IMF and only withdraw them if large amounts of loans went bad, and even then only as a last resort. The liquidity requirement is to be met through a "liquidity support agreement" and a liquidity buffer that can be used if reserves are needed. In addition, the Bank has established a threshold of at least five SDR contributors, which spreads the risk. Although these assurances of safety and liquidity are strong, they certainly do not match the safeguards associated with the current on-lending regime through the IMF trusts, including the comprehensive encashment regime, the SDR Voluntary Trading Arrangement market and the designation mechanism.

There are other proposals similar to those of the AfDB and IDB that also aim to use SDRs to mobilise MDB hybrid capital, such as those of Setzer and Paduano (2023), Paduano and Maret (2023) and Zucker-Marques and Gallagher (2023). The main difference is that SDRs would be used for direct balance sheet financing: Countries with surplus SDRs would buy SDR bonds issued by MDBs; as these bonds would be rolled over, they would become permanent and, so the argument goes, count as capital. These proposals have similar pros and cons to those of the AfDB and IDB. These authors argue that if the proposal is not supported because of doubts about the maintenance of the reserve character of SDRs, the ECB should advise MDBs and national central banks to opt for the purchase of SDR bonds issued by MDBs. This argument is problematic, since there is no shortage of demand for MDB bonds, but rather a shortage of MDB capital. The AfDB approach to use SDRs to mobilise MDB hybrid capital is thus currently the most promising way forward.

## **Let's talk about debt**

As we noted at the outset, developing countries currently face two overwhelming and interlinked financing challenges: First, they have high levels

of debt, and second, they urgently need to prepare for climate-related emergencies. Both of the above recycling options address the second challenge. However, although they certainly have implications for debt sustainability, they do not explicitly address this challenge.

What are the implications of the two options – that is, the current on-lending option and the hybrid capital option – for debt sustainability? How can these options be improved to better address the debt implications?

In general, the impact of recycling on the debt of recipient countries depends essentially on how the on-lent funds are used by the recipient countries. Broadly speaking, there are three ways in which on-lent SDRs can be used:

- a) Recipient countries may hold the SDRs as additional foreign exchange. The resulting increase in international reserves can improve a country's risk perception, reduce risk premia and hence borrowing costs, and reduce capital flight.
- b) Countries can use SDRs to repay IMF or other debts. In this case, recipient countries can replace more expensive debt with cheaper debt, thereby improving their creditworthiness and debt sustainability. Kharas and Dooley (2021) have calculated the impact of a hypothetical lending of \$40 billion in SDRs to PRGT-eligible countries. Based on these estimates, the 26 high-risk PRGT countries would receive \$25 billion, enough to cover 57 per cent of their outstanding debt service, or 7 per cent of gross domestic product (GDP).
- c) Countries can convert the SDRs into hard currency. This reduces the country's net SDR holdings. This implies that there is an immediate increase in debt service (even though SDR debt is relatively cheap). In the longer term, the effect depends on how the funds are used. They might, for example, help to improve the productivity of the economy, increase exports or improve the composition

of public expenditure. In those cases, longer-term debt sustainability may remain unaffected or even improve.

Both above-mentioned recycling options focus on (c), the use of on-lent resources for additional expenditure. Implementing these options could therefore have the side effect of further worsening the debt situation of recipient countries. In last year's Fiscal Monitor, the IMF itself sounded the alarm, warning that relying too heavily on "expenditure-based policies" such as subsidies and sweeteners for the private sector to achieve net-zero targets by mid-century would be unsustainable. The IMF (2023) estimates that focusing on these policies will become increasingly costly, potentially increasing public debt by 45-50 per cent of GDP for a representative large emitting country, putting debt on an unsustainable path.

Therefore, debt considerations should be explicitly taken into account in the design and operationalisation of both options. For countries with already high debt levels, policies that do not entail large fiscal costs or even have the potential to increase public revenues, such as carbon pricing or the phasing out of fossil fuel subsidies, should be of particular importance. Regulatory policies are also key, such as the introduction of regulations requiring companies to set or monitor emissions targets. In addition, public policies should provide a framework that encourages private-sector participation in investment and financing (Zattler, 2023). Incorporating these implications into the discussed options for SDR recycling could have the added benefit of convincing hitherto sceptical IMF members to reconsider the above proposal for hybrid capital.

## Conclusion and possible next steps

*How can SDRs be re-channelled in a way that promotes the global transformation while not exacerbating the debt crisis?* To respond to this question, this policy brief identifies two drawbacks of the existing SDR on-lending regime: First, there



are challenges in terms of structural impact due to the lack of breadth and depth of the PRGT and RST programmes; and second, the recycled SDRs cannot be leveraged in the private capital market. In addition, the brief outlines a promising alternative of recycling SDRs for MDB hybrid capital. Although this “hybrid capital option” can overcome the identified drawbacks of the current system, it comes with its own challenges, in particular related to the requirement to maintain the reserve currency status of SDRs. Moreover, both options raise debt sustainability concerns, which should be addressed. This can be done by making sure that loans supported by the recycled SDRs are used primarily to support climate-friendly policy reforms in recipient countries, avoiding spending-based expenditure.

Looking ahead, the interim review of the RST, scheduled for May 2024, as well as the full review in 2025 provide good opportunities for exploring some of the issues raised in this brief, in particular:

- whether and to what extent RST operations have been able to deliver deep climate-related reforms;
- whether the working arrangement between the IMF and the World Bank has worked well and served its purpose, or whether there are ways to better integrate the expertise and potential of the MDBs;
- how to adjust the eligibility criteria of the two IMF trusts. As suggested by Hicklin (2024), one possibility is to introduce a low-access credit tranche to the RST, allowing more countries to access the RST by relaxing the requirement to have a regular IMF programme or surveillance arrangement in place;
- whether RST operations have had a positive impact on short- and longer-term debt sustainability and whether there are ways to improve this impact.

In addition, there should be a focus on promoting the “hybrid capital option”. IMF and MDB shareholders interested in the hybrid capital option could advance the debate in three ways:

- 1) Shareholders could invite those MDBs that are prescribed entities of SDRs and have not yet made an SDR–hybrid capital proposal to do so. They can build on the good approaches already put on the table by the AfDB and the IDB. The World Bank is the most obvious candidate, as there is already a general understanding in the Bank that hybrid capital should be mobilised. A proposal to recycle SDRs for this purpose would therefore be timely and fit well into this ongoing process. The proposal should address issues such as country coverage, conditionalities, governance, risk mitigation, mechanisms to provide a high degree of liquidity, lending conditions and maturities, and lending instruments (with a preference for policy-based lending). Particular attention should be paid to focusing on policy reforms that minimise the impact on current expenditure.
- 2) Potential providers of hybrid capital could ask the management of MDBs to present a comprehensive plan to reform client countries’ fiscal and macroeconomic policies in line with the Paris climate goals. This should be done by designing large-scale policy-based lending operations (Development Policy Operations, Programs-for-Results or other results-based financing) for all major developing countries.
- 3) Euro area member states should ask the ECB for an opinion on the use of SDRs by MDBs, in particular for hybrid capital, recognising that the final decision has to be taken by member states. The ECB should also explain what assurances it considers helpful for the qualification of hybrid capital as an international reserve asset.

In sum, opening up other recycling options beyond the current on-lending regime would be positive. It would give countries more choices in implementing their commitments. Those G7 and

G20 countries that are not in a position – or for other reasons do not wish – to recycle part of their SDR allocations should be allowed to meet their burden share in other ways, such as through budgetary resources for the IMF's trusts, the

subsidy account or MDB hybrid capital. However, they should not stand in the way of finding workable solutions for other countries, such as the hybrid capital option.

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