The G20's impasse on Special Drawing Rights (SDRs)

By Alexander Nye

Original post here.

Policymakers have spent four months calling for the G20 to support a new allocation or a reallocation of special drawing rights (SDRs) at the IMF. An SDR allocation would help bolster the reserves of the world's countries. Nevertheless, the G20's latest July communique, much like the last one in mid-April 2020, barely mentioned the SDR. The only reference to an SDR allocation or reallocation in the communique was an admission that the G20 had indeed discussed it, but could not find a consensus on the issue. The U.S. blocked an allocation and is also blocking efforts to allow rich countries to donate their SDRs to those in need.

SDR Allocations

SDRs are an international reserve asset issued by the IMF that was created in 1969 to supplement the role of the U.S. dollar. Later, policymakers aimed to make SDRs the new "principal reserve asset in the international monetary system." The value of the SDR is currently determined using a basket of the world's five major currencies, the U.S. dollar, EU Euro, the Japanese yen, the UK pound sterling, and the Chinese renminbi. Their valuation can be changed by a supermajority of the IMF's voting power (70% of the voting power to change the valuation method and 85% to change the principles underlying valuation).

The IMF issues SDRs by way of general allocations. The IMF can issue an unlimited amount of SDRs to IMF member states through general allocations so long as the issuance is in proportion to member state quotas, a figure based on a country's size and contributions to the IMF. The IMF's articles state that the IMF should conduct allocations only when needed to meet a long-term global need to supplement existing reserve assets in a manner that will promote the attainment of the IMF's purposes, avoid economic stagnation, avoid deflation, avoid excess demand, and avoid excess inflation.

When the IMF "allocates" SDRs, it essentially creates money for member countries in the form of reserves. This is similar to a central bank creating reserves as a form of stimulus on a national level. As such, SDR allocations can be considered inflationary. Like loans, SDRs also carry an interest rate that recipients must pay; the interest rate is the higher of 0.050% and the combined market interest rates for the three-month government securities of the currencies in the SDR basket.

SDR allocations also stand in contrast to the other form of funding the IMF offers: lending facilities. The IMF disburses funding through lending facilities at extremely low-interest rates (currently 0%). This is considered much less inflationary than SDRs (as lending is usually considered less inflationary than helicopter money), but can frequently impose unpopular

conditions on recipient countries. Additional IMF lending also might require mobilizing resources from donor countries, which could make them more difficult to execute.

SDR allocations during the Global Financial Crisis (GFC) and their impact

The SDR was considered a niche feature of the IMF for the first forty years of its existence. As late as 1998, some academics asked whether the SDR was "simply a relic of the past, less "barbarous" than gold—because it is cheaper to produce—but a relic nonetheless." There were only two allocations before the 2007-09 Global Financial Crisis (GFC). The first of these was an SDR 9.3 billion allocation in 1970-1972 and the second was an SDR 12.1 billion allocation in 1979-1981. By the time the GFC began, most people in positions of authority "had never heard of the SDR," according to Ted Truman, a former Treasury and Federal Reserve official.

Then, in late 2008, when policymakers were trying to respond to the GFC's impact on the international economy, the SDR crept back into the spotlight.

The G20 approved a $250 billion allocation of SDRs in April 2008. Largely due to lobbying by Truman and others, the organization wished to bolster international economic confidence. The IMF allocated the new SDRs in August and September.

A 2018 IMF Policy Brief states that the SDR allocation increased reserves by about 19% for low-income countries and over 7% for emerging economies (excluding China and fuel exporters). Although SDRs remained a small portion of the world's international reserves, "Markets reacted favorably to the allocation, which formed part of the broader G20 crisis response." In theory, the IMF also believed that the allocation would help countries facing short-term financing shocks adjust more smoothly and that it would also help meet what they projected to be an increasing long-run demand for reserves. The IMF also acknowledged that SDR allocations have targeting problems (as they go to all IMF members regardless of need) and may create moral hazard.

An August 2010 brief from the U.S. Department of the Treasury reflected on the 2009 allocation. It said that despite limited SDR use between 2009 and mid-2010, the 2009 SDR allocation "helped to restore market confidence and support global recovery," in combination with other international crisis responses. The brief also noted that some countries used their SDR allocations to weather the storm of the GFC. SDRs helped to close fiscal gaps, meet external obligations, or counteract foreign exchange shortages in these countries. For some countries, the SDR allocation was especially significant; Uganda's SDR allocation constituted 860% of its international reserves at the time.

While there had been some concerns about moral hazard and inflation during the GFC, in 2019 Ted Truman reflected that "The SDR was employed as a crisis management tool without feared ill effects."

On the other hand, a 2016 study from the European Central Bank (ECB) that looked at the 2009 allocation, was less sanguine about SDRs. It found that countries that received SDRs worth "more than 10% of their international reserves" experienced higher inflation than other

countries. The ECB researchers attributed the results to incentives that encouraged countries to pursue more expansionary fiscal paths with the perceived safety provided by higher reserves holdings.

Still, some have reservations about the impact of SDRs. Gavyn Davies in the Financial Times said: “The size of the SDR issue had little effect on global growth in the following few years [...] because the entire allocation amounted to less than 1 per cent of the value of global trade in 2009.”

March proposals for an SDR allocation and rejection at the G20

As the world’s economy convulsed due to the COVID-19 crisis, academics started to float the idea of an SDR allocation as a response to COVID-19. What all of the proposals for SDR allocations had in common was the sentiment that the COVID-19 crisis was so significant that the current sources of global liquidity were insufficient. Swap lines and Treasury repo facilities from the U.S. Federal Reserve can provide countries with access to US dollars, but they do not create reserves and they are not available to all countries. The IMF and multilateral development banks have lending facilities, but these are under-resourced.

The first proposals were more radical; they saw an SDR allocation as an aggressive program that could work more quickly than the IMF’s lending programs. Proponents noted that the IMF’s $1 trillion in ready-to-mobilize lending was not enough and had to be supplemented. This is because only $50 billion of this figure can go to emerging market economies and only $10 billion can go to low-income countries. (For more information on the IMF’s response to COVID-19 see our blog posts here and here).

Academics and think-tankers quickly followed these first proposals with another set, which advocated for an SDR allocation and a mechanism allowing developed countries to transfer their existing SDRs to developing countries or lend excess SDRs to the IMF. The latter was accompanied by a proposed policy of having the IMF issue SDRs regularly in proportion to changes in the global demand for foreign exchange reserves and make the SDR the main financing instrument in IMF programs. Together, these would boost the IMF’s lending capacity and would make the SDR a global currency. Truman put forward and elaborated his own proposal for an SDR allocation as part of a larger G20 COVID-19 response framework. The G20 was to meet on April 15, 2020. He recommended that the G20 require the IMF to review a large, one-time SDR allocation of $500 billion to bolster countries’ reserves. One reason why he specified $500 billion is that the U.S. Treasury can vote for an SDR allocation worth up to $649 billion at the IMF without requiring approval from Congress.

Around this time, criticism of an SDR allocation started to emerge. Ousmène Jacques Mandeng of Economics Advisory argued that SDRs’ inability to be used outside the IMF and a set of designated agencies known as prescribed holders (examples of prescribed holders are the Bank for International Settlements (BIS) and the European Central Bank (ECB)) has really made their relevance limited.

Perhaps the strongest critique comes from Mark Sobel, a former IMF hand at the U.S. Department of the Treasury, who wrote that "the last SDR allocation resulted in only a paltry new net conversion of SDRs for currencies by emerging markets." His criticism mainly revolved around the political infeasibility of redistributing SDRs, the moral hazard created by an allocation, the idea that the SDR is a long-term tool for the short-term problem of COVID-19, and the fact that SDRs impose interest charges. Sobel argued that borrowing from the IMF at a 0% interest rate made it significantly better for low-income countries than SDR allocations, as they need "less debt and more grants." He also had an unrelated point that would eventually make it into U.S. government policy, however, was that SDR allocations give reserves to countries that have stuck their tongues out at the international community. Venezuela used its SDRs to repay official creditors in 2019.

Christopher Collins and Ted Truman of PIIE rebutted the argument that SDRs' interest rates made them inferior to IMF lending in an April 10 article. They countered that the current SDR interest rate was 0.050 percent (it has now increased to 0.069 percent) and would constitute a low-cost way to bolster IMF members' reserves in a time of crisis.

By this time, several countries had already asked the IMF about the possibility of a new SDR allocation and SDR supporters modified their proposals in response to criticisms. Some proposed changing the IMF quotas to solve the problem of only a fraction of the allocated SDRs going to developing and emerging economies. This would, however, face a veto from the U.S. This group also proposed that the IMF allocate SDRs counter-cyclically and establish a multilateral SDR swap facility.

As the April G20 meeting drew closer, support for an SDR allocation expanded to the Financial Times' editorial board, which on April 12 said that the G20 should put forward an SDR 1tn ($1.37tn) allocation. They too waived away concerns about inflation and proposed setting up a special purpose trust run by the IMF, WHO, and World Bank that countries with too many SDRs can donate to. By April 14, crisis veterans Gordon Brown and Larry Summers came out in favor of an SDR allocation of over $1 trillion.

The April 15 G20 meeting ended at an impasse regarding SDRs. The U.S. said that it would not approve of an SDR allocation, backed by India and several other countries. An SDR allocation might not have looked impressive to the U.S. delegation when they saw the country that would benefit most from a $500 billion SDR allocation was Iran (followed by Turkmenistan, Zimbabwe, and Venezuela). Adam Tooze echoed this potential explanation in Foreign Policy. One paper from the Observer Research Foundation, a well-known Indian think tank, posits that the U.S. did not support an allocation because, as crises are frequently used to speed up reforms:

crises are an opportunity to accelerate reforms. An expansion in SDRs could have been combined with a reallocation of voting rights as in 2010, thereby increasing the voice of emerging markets in the governance of the IMF. It is obvious why the U.S [...] would want to avoid this – particularly as it risks losing its veto.

Truman and Tooze also criticized the delay. Government talks of an SDR allocation slowed down significantly until July 2020.

China tries to spark a conversation in the run-up to the July G20 meeting

Policymakers and academics continued to make SDR-related proposals after the April G20 meeting. In the weeks leading up to the July 18 G20 meeting, the Managing Director of the IMF said that the IMF was working with its members to use advanced economy SDRs to help "low-income countries and tourism-dependent small island economies."

This was followed by a July 16, 2020, op-ed from the governor of the People's Bank of China (PBOC), which advocated for the G20 to take up an SDR allocation at their next meeting. The article again countered critics of an SDR allocation by arguing that COVID-19 represented an exogenous shock to the world economy whose responses, like the SDR, should not require conditional reforms or create concerns about moral hazard. One interesting portion of the article, later noticed by economist Anthony Elson, was the governor's comment that "developed countries can use their SDR allocations to ease domestic fiscal pressures, leaving more resources for international aid." It is not clear how exactly an SDR allocation would relieve China's fiscal pressures, but this does reveal that the PBOC was not contemplating donating the SDRs it would receive in such an allocation.

This push did not lead to a change in the U.S. position and the July G20 meeting communique only contained this single sentence on SDRs:

The G20 International Financial Architecture Working Group also discussed the possibility of an Special Drawing Right (SDR) allocation or of countries that have excess SDRs granting or lending them to countries that need them.

Sobel, a critic of a COVID-19 SDR allocation, reflected that an IMF program that could redistribute already issued SDRs from rich to needy countries was not mentioned in the G20 communique.

Potential solutions to the impasse

There have not been major policy proposals aimed at breaking the impasse since July. China may go on advocating for an SDR allocation and the U.S. will continue blocking it. The main issue that academics and think-tankers seem to agree on is that SDR allocation would work best if it goes hand-and-hand with a facility for lending or donating developed countries' excess SDRs to those in need. The more conservative version utilizing SDRs to help out those needier countries would be closer to Sobel's proposal, in which existing SDRs are voluntarily distributed from SDR-rich to SDR-poor countries.

Since the G20 failed to reach an agreement on SDRs early enough in the crisis, we are now left with the policy question of whether it is better to distribute funding through an SDR allocation, through (concessional, low-conditionality, low-interest) lending facilities, or through both. The

next G20 meeting is scheduled for October, but one may have to wait until at least November to see a real change in the U.S. position on this issue.