Making SDRs Matter: How Italy Can Use Special Drawing Rights to Support Its 2024 G-7 Agenda

Brad Setser[1] and Stephen Paduano[2]

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In 2021, the IMF membership agreed to an allocation of $650 billion in Special Drawing Rights (SDRs). Yet two years later, their reasons for doing so remain unfulfilled. The majority of the funds remain trapped on the balance sheets of the IMF's largest members, and technical issues in the SDR system prevent these countries from using their funds for domestic and global economic objectives alike. A solution to both of these problems can come in the form of an "SDR bond" issued by the World Bank and other multilateral development banks. This paper explains how an SDR bond would convert advanced economies' illiquid SDR holdings into a liquid reserve asset, while simultaneously allowing those funds to be used in the productive ways that the IMF membership originally envisioned. Furthermore, it discusses how Italy – having spearheaded the $100 billion SDR rechanneling pledge as G-20 host in 2021 – can continue its crucial work on the SDR system as the G-7 chair in 2024.

Introduction

In response to COVID-19, the IMF allocated $650 billion in Special Drawing Rights (SDRs) to its members. The SDR allocation provided all IMF members with a supply of the IMF's reserve asset that they can then convert into dollars, euros, pound sterling, yen, and yuan.

The associated funds helped many countries rebuild reserves depleted in the early days of the pandemic as well as cover the costs of critical imports. But most of the allocated funds sit unused, effectively trapped on the books of the world's major economies.

SDRs are allocated according to countries' voting shares in the IMF, which roughly tracks countries' importance in the global economy. As a result, most of the allocation went to the world's large advanced economies, China, and the big oil exporters, even though they had a limited need for additional reserves. In

[1] Council on Foreign Relations.

[2] Finance for Development Lab, LSE.

theory, these excess SDRs could be put to use creatively to support advanced economies' global economic interests, but existing mechanisms for rechanneling the world's spare SDRs are limited.

The existing mechanisms rely entirely on the IMF, which doesn't have a shortage of funds for its own mandate to provide balance of payments support and lacks a mandate to finance investment. As a result, advanced economies cannot use their surplus funds in the ways they may wish to. To make matters worse, the illiquidity of the advanced economies' SDRs means that these funds are not even able to be helpful for the countries that are left with the lion's share of them. In essence, problems in the SDR system prevent advanced economies from using their SDRs both abroad and at home.

Fortunately, there is a simple solution that would enable currently trapped SDRs reserves to become liquid and be deployed to support advanced economies' global economic objectives: let SDRs flow through the World Bank, not just the IMF.

By selling SDR linked bonds to countries that now have spare SDR deposits, the World Bank and other multilateral development banks can turn a currently underused reserve asset into long-term financing for key G-7 priorities, such as climate and new investments. What's more, a well-designed program can mobilize these funds at no cost to the advanced economies and, by boosting the liquidity of the SDRs, can bolster advanced economies' own foreign-exchange reserves. An SDR bond would be ***pari passu*** with existing MDB senior bonds. While it would pay the SDR interest rate (matching payments on countries' SDR liabilities with the IMF) and be denominated in SDRs, actual payments would be made in dollars, euros, yen, pound and other reserve currencies.

Many development advocates have proposed that SDRs be used as a source of new grant financing, but SDRs are really best suited to support long-term lending. Countries investing in SDR bonds issued by the MDBs would receive an SDR linked bond. This bond would pay the same interest rate as deposits in the IMF's SDR account while also providing the holders of the bond with an asset that can be converted into hard currency more easily than SDRs in a country's IMF' account. Given that SDRs are held as part of the foreign-exchange reserves of either the national central bank (as in the case of Italy and other Eurosystem countries) or the finance ministry (as in the case of the US and UK), the liquidity provided by an SDR bond would make advanced economies' reserve more "policy-ready" and provide greater operational flexibility for policymakers. Such SDR bonds would not provide new equity capital to the MDBs. But they would provide very long-term funding that would allow the banks to stretch existing and new equity safely while unquestionably remaining reserve assets.

It is truly a win-win – more funds for financing global investment in clean energy and infrastructure, and more liquidity for the current holders of SDRs.

Three related problems need to be solved to realize the SDR's potential

First, the SDRs created in the IMF's allocation, while part of the reserves of advanced economies, have limited practical utility right now. In theory, the advanced economies can exchange SDRs for dollars, euros, pound sterling, yen, or yuan through the IMF's Voluntary Trading Arrangements (VTAs). Yet in practice, the advanced economies are expected to supply foreign exchange to the IMF trading system, not to demand hard currency. As a result, the current system for creating SDR liquidity only works in one direction – low-income and emerging economies receive hard currency against their SDRs; advanced economies never do. Italy's $29 billion in SDRs and the G-7s $410 billion in SDRs are thus effectively frozen – they are credited as part of a country's reserves, but they wouldn't actually be available in a pinch.

Second, right now SDRs can only be rechanneled through the IMF, even though the IMF isn't really the right institution to mobilize the funds for longer-term investments. The SDR is, to simplify, the IMF's currency, so it is natural to look to the IMF to make use of the world's spare SDRs. But its capacity to do so effectively is limited. The IMF's existing rechanneling facilities (the Poverty Reduction & Growth Trust and the Resilience & Sustainability Trust) can only take in $63 billion in SDRs, a sum well below the $100 billion figure that the countries pledged to rechannel during Italy's G-20 presidency in 2021. Moreover, the bulk of the funds that have been made available to the IMF aren't really being used, as the IMF doesn't have the lending experience, capacity, or mandate to deploy these funds quickly to meet development needs. To date, the RST has delivered more photo ops than funds – the IMF has approved only $4.5 billion in RST programs and it has disbursed just $363 million.

Third, MDBs believe that they are capital constrained, and thus cannot increase their lending without new capital – whether paid-in capital or hybrid capital – from their shareholders. The MDBs have historically played an important role by mobilizing private funds looking for safe (triple AAA) dollar and euro bonds for development. But they haven't explicitly taken on a role of mobilizing underused official assets to support global public goods. Yet, very long-term debt funding from their shareholders is the safest possible form of funding; it would allow the MDBs to do more with their existing capital – and to strengthen any new capital much further.

An SDR denominated bond issuance program would solve all three of these problems

First, the advanced economies and large emerging economies with excess reserves that invest in the bond would get a more liquid reserve asset than their current trapped SDRs. The "SDR bonds" issued by the multilateral development banks would settle in dollars, euros, yen or yuan. This means that an SDR bond, unlike an SDR itself, could be held by any financial institution in the world. Any country holding an SDR bond thus could sell the bond in the private market in the unlikely event it needed access to more dollars, euros or yen in a pinch.

Second, the IMF would not be pushed to develop new channels for mobilizing SDRs and would be able to refocus on its traditional role as a source of emergency balance of payments support. This is an important role, one that the IMF needs to do well for the global economy to perform at its potential.

Third, the World Bank would gain access to a large, stable, reliable pool of funds. Countries now holding trapped SDRs would have an incentive to buy floating rate SDR bonds at par, as the new bonds provide a tradable instrument that increases the functional liquidity of their reserves. Since a bond offering a floating SDR rate offers a perfect match for countries' SDR liabilities (which have no maturity date), there is no reason why SDR linked floating rate bonds couldn't carry a very long maturity, say 20 or even 50 years. This would allow the MDBs to term out their financing, reducing the financial risk associated from their long-term development loans.

Our modelling suggests that if the MDBs raised $100 billion from an SDR bond, they could increase their overall lending by $50 billion without any additional capital. This is in part because the rating agencies have historically considered shareholder support part of their ratings, but more fundamentally because the Bank could replace $50 billion of existing short-term funding with longer term funding. An institution with $50 billion in capital that borrows $200 billion with 5 year money is in important ways more risky than an institution with $50 billion in capital, $100 billion in 20 year funding from its shareholders and only $150 billion in market borrowing.

A final point: an SDR bond would be fully consistent with the Eurosystem's current rules, unlike calls to use SDRs as a form of grant financing. A senior SDR-denominated, euro- or dollar-settled bond is unquestionably a reserve asset. Monetary authorities the world over, including many euro area central banks, have long bought the MDBs' bonds as part of their reserves. The SDR denominated bonds would be structured as senior bonds, ***pari passu*** with existing issuance – so monetary authorities wouldn't be doing anything that would normally be done through the budget. There is a significant substantive and legal difference between a senior bond and various forms of hybrid capital, which ECB President Christine

Lagarde has said cannot be purchased with SDRs (reserve assets) as doing so would constitute monetary finance – and so any hybrid capital commitment would need to be funded through European countries' budgets. As the SDR bond would increase the functional liquidity of the SDRs now held in reserves in advanced economies – i.e., holding SDRs in the form of SDR bonds would allow advanced economies to sell these assets into the market for cash, which they cannot do at present because the VTAs are too illiquid. Eurosystem national central banks would have a strong incentive to invest in these bonds on their own as a conventional reserve management operation that they can conduct at their own discretion. Such bonds would no more constitute monetary financing than the reserve assets that many Eurosystem central banks have already invested in MDB bonds.

And happily, an instrument designed to meet the ECB's need for a reserve asset also would appeal to the UK, the US and others. The United States' Exchange Stabilization Fund and the United Kingdom's Exchange Equalisation Account are explicitly authorized to deal in securities and there has been no obstacle in the past to investing in securities issued by the MDBs.

Going Forward: Continuing Italy's Leadership on SDRs

By converting SDRs into a security that can be sold into the market, the SDR bond would boost the liquidity of central bank's reserve funds – which would, at long last, make the SDR matter for advanced economies. By opening up a new funding channel for the MDBs that would help them safely mobilize long-term funding that matches their long-term project lending, an SDR bond would also be a boon to advanced economies' global economic interests by strengthening and boosting the capacity of the MDBs of which they are the leading shareholders.

Italy has long been an advocate of an expanded global role for the IMF's Special Drawing Rights (SDRs). It played a key role back in the 1960s when the SDR itself was created through the leadership and scholarship of the Bank of Italy's Director General Rinaldo Ossola in the G10 and the IMF. More recently, Italy spearheaded a commitment for G-20 countries to channel $100 billion in SDRs to low- and middle-income countries back in 2021. Finally, Giorgia Meloni, Prime Minister of Italy and incoming Chair of the G7, endorsed[3] a proposal[4] on creating an SDR-funded safety net for Italy and, possibly, the Eurozone, at the height of the COVID-19 pandemic that severely struck Italy.

[3] See the two letters of Giorgia Meloni to Il Corriere della Sera: https://www.corriere.it/digital-edition/CORRIEREFC_NAZIONALE_WEB/2020/05/27/1/pmeloni-il-mesp-pnon-e-per-noip-pla-soluzionep_U3190372386947pUG.shtml. https://www.corriere.it/politica/21_agosto_10/giorgia-meloni-diritti-speciali-prelievo-l-occasione-persa-dall-italia-5871f4ca-f9df-11eb-8ca9-234c5a5d119d.shtml.

[4] The proposal authored by Domenico Lombardi and Jim O'Neill is available on Project Syndicate: https://www.project-syndicate.org/commentary/imf-sdr-vehicle-to-finance-covid19-mitigation-by-jim-o-neill-and-domenico-lombardi-2020-04.

The main current institution for rechanneling, the IMF's Resilience and Sustainability Trust, isn't actually capable of lending out more than a small fraction of the funds that have been committed. For the SDR to deliver on its potential as a major addition to the stock of global reserves, more effective channels that maintain and enhance the SDRs role as a functional reserve asset are needed. Navigating the political, legal and institutional challenges that have prevented the multilateral development banks from mobilizing the world's trapped SDRs could be a very real and enduring legacy of Italy's 2024 G-7 presidency.

Appendix
While 210 entities are authorized to hold and trade in SDRs – 190 IMF members and an additional 20 "prescribed holders" – only 40 entities participate in the SDR market, known as the "Voluntary Trading Arrangements" (VTAs). Such under-participation inevitably makes SDR trading "thinner" than it should be.

To make matters worse, the countries with the largest foreign-exchange reserves – those most capable of participating in the VTAs – are not nearly as active as they should be. Switzerland holds over $900 billion in official foreign-exchange reserves, yet it has provided only $385 million in foreign-exchange for SDRs. South Korea holds over $400 billion in official foreign-exchange reserves, yet it has been the buyer for only $567 million in SDRs. Singapore also holds nearly $300 billion in official foreign-exchange reserves, yet it has provided only $220 million.

Countries with far smaller reserves are left to shoulder the burden. Italy, for example, has provided $688 million in exchange for SDRs (out of an allocation of $28 billion SDRs). The United Kingdom, has provided $989 million in exchange for SDRs. The United States is the single largest provider of currency in the SDR market at $8.72bn.

At present, there are only two ways to rechannel surplus SDRs – via the IMF's Poverty Reduction & Growth Trust (PRGT) and the Resilience & Sustainability Trust (RST).

PRGT's funding target is $19 billion in SDRs. The RST's is $44 billion. This means that there is only an outlet for $63 billion in SDRs at the very maximum – and scaling up these two trusts is not in the near-term realm of possibility. The PRGT's ability to take in more SDR loans is constrained by its need to take in more subsidies (donors provide subsidies that offset the interest on the SDR loans in order to allow the PRGT to lend to poor countries at 0%). Countries have been slow and unwilling to provide the PRGT more subsidy resources.

The constraint for the RST is operational rather than financial. Despite recent, significant efforts, the IMF still lacks the institutional capacity for the research that underpins RST programs, relying on the World Bank to a great extent. To date, the RST has disbursed funds to only three countries: Rwanda, Barbados, and Costa Rica and approved of programs to 7 others:

Country	RST Amount Disbursed (USD, mn)	RST Amount Approved (USD, mn)	Link
Rwanda	98.6	319	https://www.imf.org/en/News/Articles/2023/05/24/pr23176-rwanda-imf-exec-board-completes-1st-rev-policy-coord-inst-rsf
Barbados	19	190	https://www.imf.org/en/News/Articles/2023/06/22/pr23232-imf-executive-board-completes-the-review-under-the-eff-and-the-rsf-with-barbados
Costa Rica	246	725	https://www.imf.org/en/News/Articles/2023/06/26/pr23240-imf-concludes-fourth-review-of-costa-rica-eff-and-the-first-review-rsf
Bangladesh	0	1400	https://www.imf.org/en/News/Articles/2023/01/30/pr2325-bangladesh-imf-executive-board-approves-usd-ecf-eff-and-usd-under-rsf
Jamaica	0	764	https://www.imf.org/en/News/Articles/2023/03/02/pr2357-jamaica-imf-executive-board-approves-usd-million-pll-usd-million-rsf
Kosovo	0	85.2	https://www.imf.org/en/News/Articles/2023/04/20/pr23123-kosovo-imf-reaches-sla-on-sba-and-rsf
Seychelles	0	46	https://www.imf.org/en/News/Articles/2023/05/31/pr23189-seychelles-imf-executive-board-approves-extended-fund-facility-arrangement-for-seychelles

Niger	0	131.5	https://www.imf.org/en/Publications/CR/Issues/2023/07/12/Niger-Third-Review-Under-the-Extended-Credit-Facility-Arrangement-Request-for-Extension-536300
Kenya	0	551.4	https://www.imf.org/en/Publications/CR/Issues/2023/07/19/Kenya-Fifth-Reviews-Under-the-Extended-Fund-Facility-and-Extended-Credit-Facility-536772
Senegal	0	324	https://www.imf.org/en/Publications/CR/Issues/2023/07/07/Senegal-Requests-for-an-Extended-Arrangement-Under-the-Extended-Fund-Facility-an-535844
Total	$363.6 million	$4,536.1 billion	