Implications of the IMF's SDR Allocation for Australia and the Global Economy

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Abstract

As part of the global policy response to address the economic challenges associated with the COVID-19 pandemic, in August 2021 the International Monetary Fund (IMF) allocated US$650 billion worth of Special Drawing Rights (SDRs) to its members, providing a significant boost to global liquidity. This article details the workings of SDRs and describes how vulnerable countries can use this additional liquidity in a range of ways, including to support spending on their country's crisis response. It also considers how countries that do not have a need for this liquidity, like Australia, may use a share of their SDR allocation to assist more vulnerable countries.

Introduction

Policymakers around the world have responded to the ongoing challenges facing the global economy as a result of the COVID-19 pandemic by providing significant policy support. This has included substantial monetary and fiscal support in individual countries as well as assistance via international organisations, such as the International Monetary Fund (IMF), and via other international arrangements, such as bilateral swap lines established between central banks.[1]

As part of the global policy response, the IMF allocated the equivalent of US$650 billion in Special Drawing Rights (SDRs) to its members in August this year. This was the first allocation of SDRs since the global financial crisis. The allocation was intended to support the resilience and stability of the global economy by assisting countries to address balance of payments pressures that have arisen due to the pandemic. While the allocation benefits all countries that are IMF members, it is particularly helpful for emerging market economies and low-income countries that have had less capacity to respond to the effects of the COVID-19 crisis.

What is an SDR?

SDRs are an international reserve asset created by the IMF to supplement the official reserve holdings

of its member countries.[2] Reserve assets are owned by country authorities and are a key layer of defence in a foreign currency liquidity crisis. Other types of reserve assets include official foreign currency holdings, gold holdings and reserve positions at the IMF (i.e. funds lent by a country to the IMF). Reserves can be used to dampen volatility in a country's exchange rate, manage the level of a country's exchange rate, repay official sector international debts and provide foreign currency liquidity to the financial system during periods of stress.

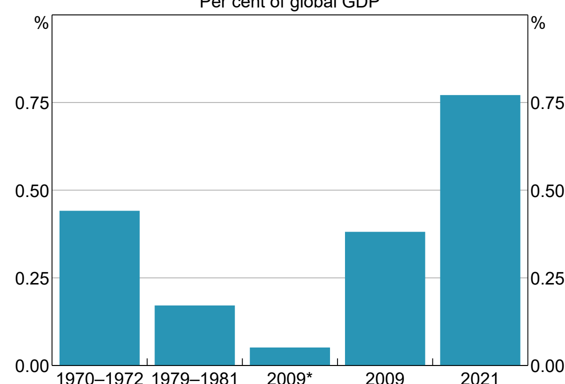
The SDR is not a currency and so cannot be used directly in transactions. However, it can be sold to other member countries in exchange for five 'freely usable' currencies (US dollars, euros, Chinese renminbi, Japanese yen and pounds sterling) and therefore acts as a source of liquidity.[3] Essentially, the SDR system allows a country to access reserves that are held by countries whose holdings are more than adequate, thereby broadening the protection afforded by the global pool of reserve assets.

While countries can buy and sell SDRs directly with each other, in practice the exchange is usually coordinated by the IMF through voluntary trading arrangements (VTA), where a number of IMF members with strong external positions (including Australia) agree to exchange SDRs for specific currencies within pre-agreed limits with other IMF members.[4] The value of the SDR is determined daily by the IMF based on a weighted average of these five freely usable currencies. Conceptually, SDRs derive their value from the fact that countries are willing to hold them and accept them in exchange for actual currencies.

While the IMF has the authority to create new SDRs, under the IMF's Articles of Agreement it can only do so to meet a long-term global need to supplement existing reserve assets. It also needs to be done in a manner that promotes the attainment of the IMF's goals and that avoids economic stagnation and deflation, or excess demand and inflation (IMF 2021e). Given these conditions, SDR allocations are rare in practice and have only occurred in exceptional circumstances, including during the global financial crisis. Indeed, there have only been four general allocations of SDRs to this point (1970–1972, 1979–1981, 2009 and 2021) (Graph 1). In a general allocation, countries receive both an asset (SDR holdings) and a liability (SDR allocation) of equal value. (The allocation is a liability because it would have to be repaid if a country withdrew from the IMF or the SDR scheme itself was dissolved.) The value is proportional to each country's quota in the IMF.[5] There was also a one-time special SDR allocation, which occurred in September 2009 to correct for the fact that members that had joined since 1981 had not received an SDR allocation from the IMF over that time. It is worth highlighting that, given an SDR allocation involves an increase in assets and a matching rise in liabilities, an allocation does not represent a transfer of wealth.

There is a cost involved in using SDRs. Countries receive interest on their SDR holdings and are required to pay interest on their SDR allocation. Accordingly, if a country keeps its SDR holdings equal to its allocation, it will earn zero net return. However, if it decides to sell some of its SDRs in exchange for one of the five freely usable currencies – and so its SDR holdings fall below its SDR allocation – a country will be required to make a net interest payment on the difference between its holdings and allocation. In contrast, if a country buys SDRs – and so its holdings are above its allocation – it will receive a net interest payment. The relevant interest rate (the SDR interest rate) is calculated weekly by the IMF and is based on relevant interest rates for each of the five freely usable currencies (Graph 2).[6] Overall, the SDR

Graph 1



* A special allocation occured in September 2009, all others were general allocations

Sources: IMF; World Bank

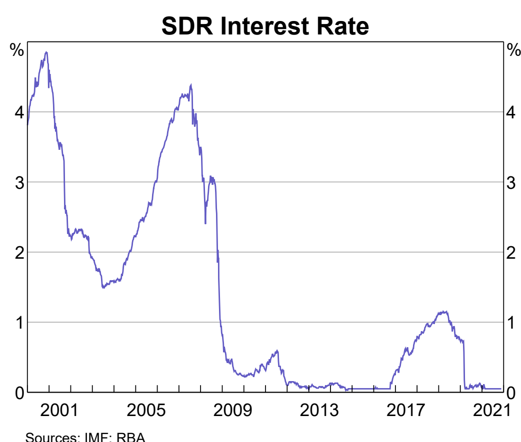
mechanism is self-financing because at an aggregate level interest payments and receipts cancel each other out (IMF 2018).

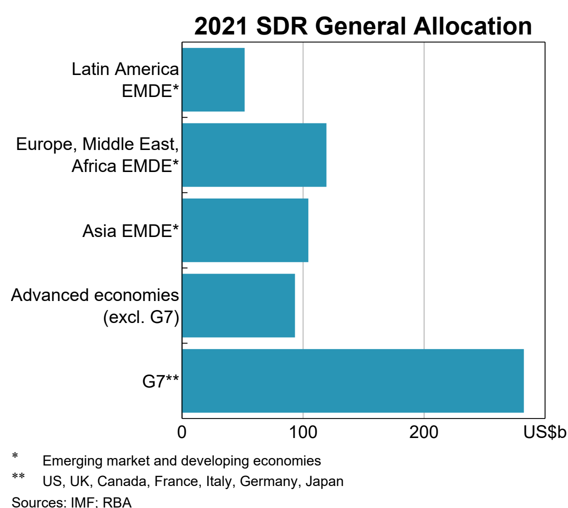
Implications of the 2021 general SDR allocation

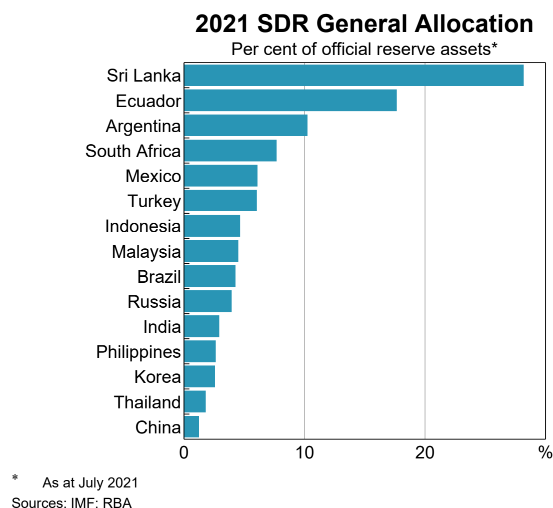
Overseas economies

Many countries experienced notable falls in their reserve assets as a result of the COVID-19 crisis. For example, reserves in emerging market and developing economies (EMDEs) outside Asia declined by around US$95 billion in 2020, reflecting the contraction in exports and global economic activity as well as strong and persistent capital outflows (IMF 2021d).[7] Overall, the IMF estimated that the pandemic increased the global shortfall between the current level of reserves and the projected long-term level of required reserves by around US$200 billion, to between US$1.1 trillion and US$1.9 trillion (IMF 2021d). The recent SDR allocation will go some way to addressing this long-term demand for global reserves. However, as a general allocation, SDRs were distributed to IMF member countries in line with their quota shares in the IMF rather than their relative need for reserves. As a result, around 40 per cent of the total allocation went to the G7 countries, with a similar share going to all EMDEs combined (Graph 3).

The extent to which the allocation addresses countries' individual needs for reserves varies significantly, reflecting not only differences in the value of SDRs received but also the differences in countries' existing reserves. In particular, the allocation increased advanced economies' official reserve assets (ORA) by an average of around 18 per cent, compared to an average increase of around just 7 per cent for EMDEs.[8] This difference partly reflects the fact that advanced economies typically choose to hold modest reserves (as a share of the size of their economies) compared with many EMDEs. That said, while the allocation had a relatively small impact on the ORA of most major emerging market economies, it provided a significant boost for a number of developing economies that had low levels of reserves (Graph 4). For example, the allocation increased Sri Lanka's ORA by 28 per cent and Ecuador's ORA by 18 per cent.







While all IMF member countries received a share of the allocation, countries with strong external positions generally have no immediate need to make use of this additional liquidity. As a result, these countries are well placed to use a share of the additional SDRs to support concessional lending for vulnerable countries. In fact, some countries, including Australia, have already made commitments to use specific shares of their allocation to scale up the lending capacity of the IMF's existing Poverty Reduction and Growth Trust (PRGT). This trust is used to provide loans to low-income countries at concessional rates. The G20 has also called on the IMF to develop other options for countries with strong external positions to voluntarily channel a share of their allocated SDRs towards vulnerable countries (G20 2021a). The creation of a new IMF-administered Resilience and Sustainability Trust to assist low-income countries, small states and vulnerable middle-income countries is the main alternative option currently being explored. Overall, countries with strong external positions have already pledged to use around US$45 billion worth of their recent allocations to support more vulnerable countries, and the G20 has set a 'global ambition' to ultimately channel US$100 billion to vulnerable countries in this way (G20 2021b).

For countries with more vulnerable external positions, the increase in their stock of SDR holdings provides them with additional policy capacity. These countries can exchange some (or all) of their SDR holdings for freely usable currencies, which can then be used to purchase goods and services (such as vaccines), invest in public infrastructure or pay down existing foreign currency debt, for example. The decision on what share of SDR holdings to exchange for freely usable currency is likely to be influenced by a number of factors, including:

- *Adequacy of reserves:* countries that experienced a rundown in their reserves during the pandemic may use their SDR allocation to rebuild their buffers of foreign currency assets. Reserves are important for supporting market confidence and preventing destabilising runs on foreign exchange markets, particularly for countries that maintain managed exchange rates.
- *Policy capacity*: countries with large needs and limited market access may look to use their SDR allocation for fiscal purposes. Funds acquired by exchanging SDRs for freely useable currencies could, for example, be used to finance COVID-19 health or vaccination-related expenditures. While the IMF has not provided specific advice on how the additional policy capacity should be used, it has noted that 'consideration could be given to using the policy space provided by the SDR allocation to limit the fallout from COVID-19 and minimise long-term scarring' (IMF 2021b). That said, the IMF has stressed that countries should not use the policy capacity provided to delay needed debt restructuring or macroeconomic reforms, or to pursue unsustainable macroeconomic policies.
- *Institutional arrangements*: a number of countries face institutional restrictions on the interactions between the government and the central bank – for example, central banks may face restrictions on (or be prohibited from) lending to the government in perpetuity in a currency other than the local currency – which may limit their options for using the newly allocated SDRs (IMF 2021b).
- *Availability of IMF facilities*: some countries are already eligible for IMF programs that provide funding at concessional interest rates that are lower than the SDR interest rate. However, typically when a country borrows from the IMF it must agree to adjust its economic policies to address the issues that led it to seek assistance. In contrast, SDRs created in a general allocation can be used *unconditionally*. This means that members can use them to meet short-term liquidity needs without needing to agree to make any adjustments to existing economic policies. This may motivate countries to acquire foreign currency by selling their new SDRs before turning to other IMF facilities.

To date, some countries have used their new SDRs either to bolster reserve assets to assist with prospective foreign exchange needs or to

strengthen their government's fiscal position. For example:

- Ecuador converted all of its new SDRs to US dollars and intends to use the proceeds to address immediate cash flow deficiencies (IMF 2021a).
- Colombia's central bank has sold the US dollar equivalent of the country's SDR allocation to the government in exchange for government bonds, providing US dollar liquidity to the government (Banco de la República 2021).
- The Bahamas intends to use the SDR allocation to add to its reserves in order to support the exchange rate peg (Central Bank of the Bahamas 2021).

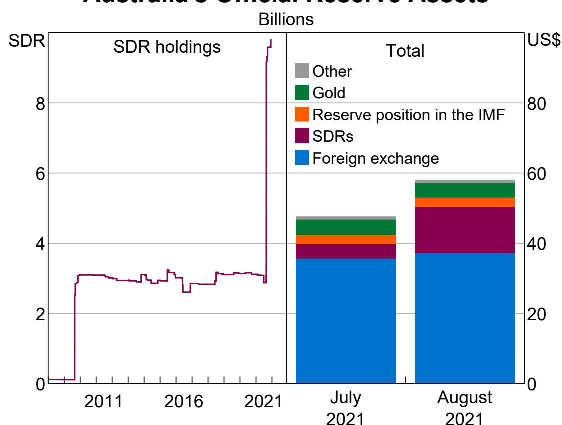
Australia

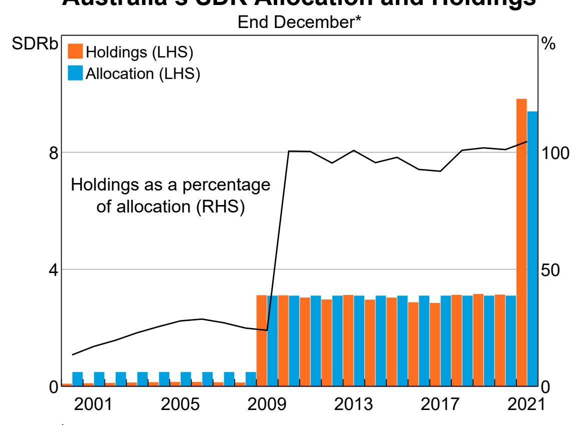
The IMF's recent general SDR allocation increased Australia's SDR holdings by almost SDR6.3 billion to over SDR9 billion. This provided a sizeable boost to Australia's ORA, which includes SDRs as well as foreign currency-denominated assets, gold bullion and Australia's reserve position in the IMF (Graph 5).[9] As outlined above, there is a zero net return from this allocation if Australia keeps SDR holdings equal to the allocation.

Prior to the most recent SDR allocation, Australia's holdings of SDRs were typically lower than Australia's SDR allocation and so Australia often made small net interest payments in SDRs to the IMF (Graph 6). This partly reflected the fact that, as part of Australia's participation in the IMF's VTA mechanism, Australia received a number of requests to *sell* SDRs to other member countries to allow them to meet their obligations to the IMF or to replenish their SDR holdings. In contrast, it is expected that the most recent allocation will generate an increased demand for Australia (and other countries that are part of the VTA mechanism) to *buy* SDRs from vulnerable countries in exchange for freely usable currencies. Indeed, since the allocation in August, a number of countries have sold SDRs to Australia in exchange for US dollars through the VTA mechanism, which has increased Australia's SDR holdings by around SDR636 million. Hence, Australia's SDR holdings are currently *above* Australia's SDR allocation. If this is maintained Australia will receive small net interest payments from the IMF.

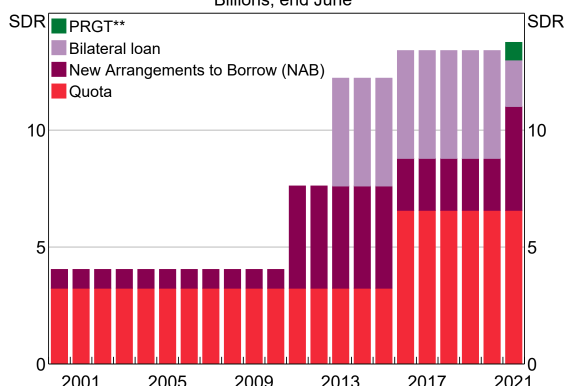
It is worth noting that Australia's participation in VTA transactions does not alter the *level* of Australia's reserve assets (only the respective proportions held in SDRs and foreign currency). That said, the Reserve Bank typically replenishes foreign currency sold in exchange for SDRs by purchasing foreign currency in long-term swaps against Australian dollars, which does increase the level of Australia's reserve assets (RBA 2021).

Australia has committed to channel approximately SDR250 million of its recent SDR allocation to the IMF's PRGT to support vulnerable countries (Frydenberg 2021). Alongside Australia's existing financial commitments to the IMF, including





Australia's existing SDR6.57 billion quota subscription, this new commitment will raise Australia's total financial commitment to the IMF to around SDR13.7 billion (Graph 7).



Conclusion

The IMF's allocation of US$650 billion worth of SDRs has boosted global liquidity. It will help to foster the resilience and stability of the global economy by addressing the long-term need for reserve assets. In particular, the allocation will reduce the need for liquidity constrained countries to pursue contractionary policies, while also providing scope for spending to assist countries recovering from the effects of the pandemic. However, countries with stronger external positions (including Australia) have no immediate need to utilise this allocation, and so they may use a share of their recent allocation to support more vulnerable countries. This would amplify the benefit of the allocation on the global economy.

Footnotes

[*] The authors are from International Department. They would like to thank Anna Park for her advice and comments on earlier drafts.

[1] For more information on the global financial safety net, see Ball, Clarke and Noone (2020).

[2] SDRs status as a reserve asset is derived from the commitments of IMF members to hold and exchange SDRs and accept the value of SDRs as determined by the IMF (IMF 2018).

[3] A 'freely usable' currency is one that is widely used to make payments for international transactions and is widely traded in the principal exchange markets (IMF 2021c).

[4] The IMF also has the power to designate countries with strong external positions to purchase SDRs from countries with weak external positions if necessary. However, since 1987 the SDR market has functioned entirely through voluntary arrangements. There are currently over 30 countries, including Australia, with voluntary SDR trading arrangements.

[5] An individual member country's quota broadly reflects its relative position in the world economy. A country's quota determines not just its share in a SDR allocation, but also the amount of finance it can receive from the IMF, the amount of resources it is obliged to provide the IMF and its voting power.

[6] In 2014, the IMF introduced a floor of 0.05 per cent for the SDR interest rate (IMF 2014).

[7] In contrast, emerging market economies within Asia were able to increase their reserve asset levels in 2020.

[8] Limitations on data availability meant that a subset of advanced economies (Australia, Austria, Belgium, Canada, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Ireland, Israel, Italy, Japan, Korea, Latvia, Lithuania, Malta, Netherlands, New Zealand, Norway, Portugal, Singapore, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, United Kingdom, United States) and EMDEs (Argentina, South Africa, Hungary, Mexico, Turkey, Chile, Colombia, Indonesia, Malaysia, Brazil, Russia, Poland, India, Philippines, Korea, Thailand, China, Sri Lanka, Ecuador, El Salvador, Belarus, Lithuania, Ukraine, Egypt, Bolivia, Panama, Dominican Republic, Romania, Kazakhstan, Bulgaria, Morocco, Croatia, Uruguay, Guatemala) were used to calculate the average increase in official reserve assets.

[9] For more information on the composition of Australia's ORA, see Potter (2017).

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