T20 Policy Brief

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Task Force 03

REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE

Reallocating Special Drawing Rights (SDRs) to African Financial Institutions

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Abstract

Special Drawing Rights (SDRs) provide countries with a means to reduce dependence on domestic and external debt, fostering financial resilience. However, the allocation of SDRs is based on IMF quota shares, thus disadvantaging low- and middle-income countries in Africa.

In response to COVID-19, the IMF allocated its largest-ever SDRs of USD 650 billion in 2021. Regrettably, the reliance on quota shares resulted in only 5%, approximately USD 33 billion, reaching the African continent. This is significantly inadequate given the economic challenges faced by African countries.

Acknowledging the limitations of the quota-share approach, there is a global push for high-income countries to reallocate their unused SDRs to low- and middle-income nations.

Despite the G20's commitment to reallocate USD 100 billion, funding is still tied to IMF instruments, which have many limitations.

African financial institutions (AFI), particularly the African Development Bank (AfDB), are prepared to facilitate the reallocation process. The AfDB's Hybrid Capital Instrument (HCI) proposal offers an innovative approach, leveraging contributions three to four times without imposing policy conditionalities. However, no country has officially reallocated their SDRs to AfDB or any other AFI to date.

In support of their newest member, G20 countries should reallocate SDRs to AFIs with a commitment to a minimum USD 25 billion reallocation to the AfDB and USD 12.5 billion to other AFIs and expanding the list of African prescribed holders of SDRs.

This paper underscores the importance of SDR reallocation to AFIs, ensuring direct funding for African countries through credible institutions like the AfDB. The recommendations aim to mobilize a minimum of USD 50 billion for Africa, aligning with the continent's needs. The G20, with its collective influence, can help bridge existing gaps and promote equitable development.

Diagnosis of the Issue

Special Drawing Rights (SDRs) are an international reserve asset created by the International Monetary Fund (IMF) in 1969 to supplement the official reserves of its member countries. SDRs, which are not a currency but rather a basket of international currencies (the US dollar, the Pound Sterling, the Japanese Yen, the Euro, and the Chinese Renminbi) are allocated to member states periodically by the IMF through "general allocations" and are distributed amongst member states based on their IMF quota shares.

SDRs are a unique financial instrument as members receive unconditional liquidity through an interest-bearing asset (referred to as an **SDR holding**) and a long-term liability to the IMF SDR Department (**SDR allocation**).[1] Countries receive interests on their holdings and pay interests based on their allocation position.

Apart from IMF member countries, specific entities, referred to as prescribed holders can hold and use SDRs. From the list of the 20 official prescribed holders[2], there are **four African Financial Institutions (AFIs)** considered prescribed holders – **the Central**

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[1] "Questions and Answers on Special Drawing Rights," International Monetary Fund, August 23, 2021. https://www.imf.org/en/About/FAQ/special-drawing-right#:~:text=The%20SDR%20Department%20pays%20interest,not%20use%20their%20SDR%20allocation

[2] "IMF Executive Board Approves the Applications of Five Institutions to Become Holders of Special Drawing Rights," International Monetary Fund, February 21, 2023. https://www.imf.org/en/News/Articles/2023/02/21/exec-board-approves-applications-5-institutions-become-holders-sdr

Bank of West African States (BCEAO), Bank of Central African States (BEAC), the African Development Bank (AfDB), the African Development Fund (ADF).

In August 2021, the IMF approved a **historic** allocation equivalent to **USD 650 billion or SDR 456 billion** to support countries in their COVID-19 recovery.[3] Unfortunately, low and middle-income countries have significantly fewer quotas than high-income countries, resulting in a disproportionate distribution of SDRs. For instance, from the 2021 allocation, low-income countries and emerging markets received approximately **42.3%** (approximately **USD 275 billion**) of the general allocation.[4] The entire African continent received a mere **5%** (**USD 33 billion**) of the total allocation. In contrast, the United States received 17% of the total allocation.[5]

The unequal distribution is also visible within the African continent (see Figure 2 below).

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[3] "IMF Governors Approve a Historic US$650 Billion SDR Allocation of Special Drawing Rights," International Monetary Fund, August 2, 2021. https://www.imf.org/en/News/Articles/2021/07/30/pr21235-imf-governors-approve-a-historic-us-650-billion-sdr-allocation-of-special-drawing-rights.

[4] "Questions and Answers on Special Drawing Rights," International Monetary Fund, August 23, 2021. https://www.imf.org/en/About/FAQ/special-drawing-right#:~:text=The%20SDR%20Department%20pays%20interest,not%20use%20their%20SDR%20allocations.

[5] Warah, Rasna. "SDRs: A Shot in the Arm for African Economies?" ONE Africa, October 6, 2021. https://www.one.org/africa/stories/special-drawing-rights-sdrs-africa/.

South Africa and **Nigeria,** for instance, received more of the SDR allocation than 23 of the continent's lowest-income countries.[6] South Africa, for instance, received USD 4.15 billion while Sao Tome and Principe received USD 20 million.[7]

SDRs are beneficial to African countries for several reasons. **First**, by increasing the reserve assets of member countries, SDRs can help African countries decrease their dependence on both domestic and external debt and help grow their national savings.

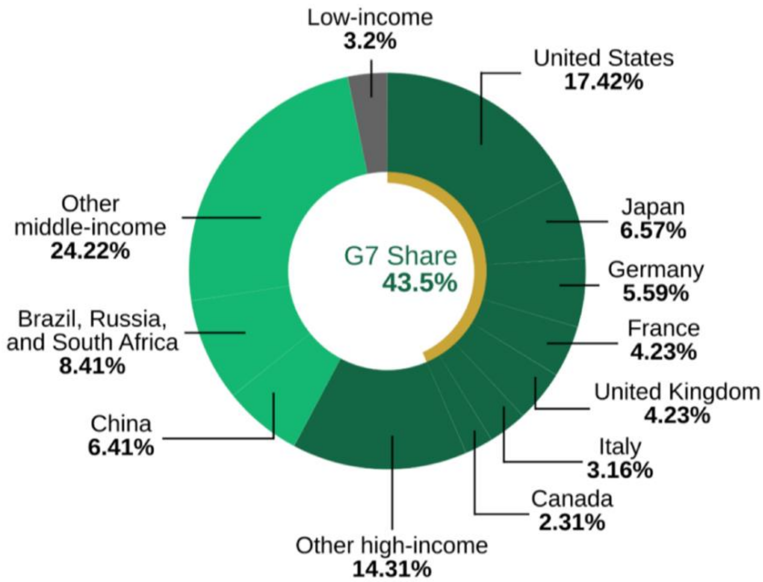

FIGURE 1. Share of the 2021 IMF SDR Global Allocation

[6] Ibid.

[7] "2021 General SDR Allocation." International Monetary Fund, August 23, 2021. https://www.imf.org/en/Topics/special-drawing-right/2021-SDR-Allocation.

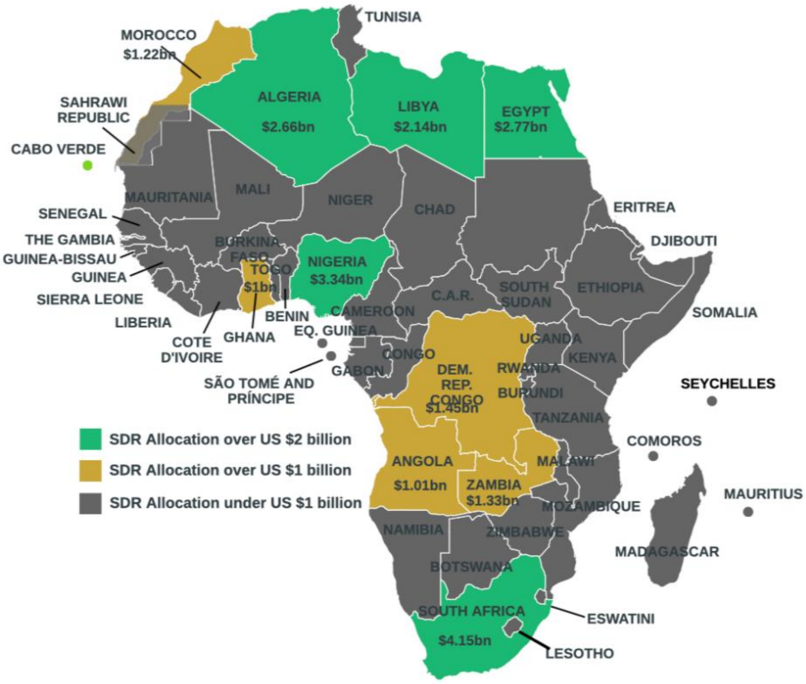

FIGURE 2. Distribution of SDRs across Africa

Second, SDRs do not come with conditionalities, giving governments, who ultimately understand the needs and priorities of their citizens the most, the opportunity to use SDRs in areas that will have the most impact on their economies. **Third**, through Voluntary trading agreements (VTAs), IMF member states can trade their SDRs for any currency in the SDR basket (listed above). If a country is low on foreign currency, like the US Dollar, that country can exchange its SDRs for the needed currency. **Fourth**, when a country uses its SDRs, its SDR holdings fall below its SDR allocation, meaning the country has to pay an SDR interest rate. However, this interest rate (currently at **4.13%**[8]) is often lower than alternative sources of financing which means African countries can borrow at relatively cheaper rates.

[8] SDR interest rate calculation. International Monetary Fund. Accessed March 24, 2024. https://www.imf.org/external/np/fin/data/sdr_ir.aspx.

Although African countries have received a very small portion of the SDR pie, available data reveals that African countries have used their SDRs more than any other region in the world (see Figure 3 below). In 2022, African countries had a **take-up rate of approximately 90%**.[9] More than half of the continent has used SDRs to supplement their national budgets, 33.9% have used SDRs to bolster their foreign reserves and 22.6% have used SDRs to support their pandemic spending.[10]

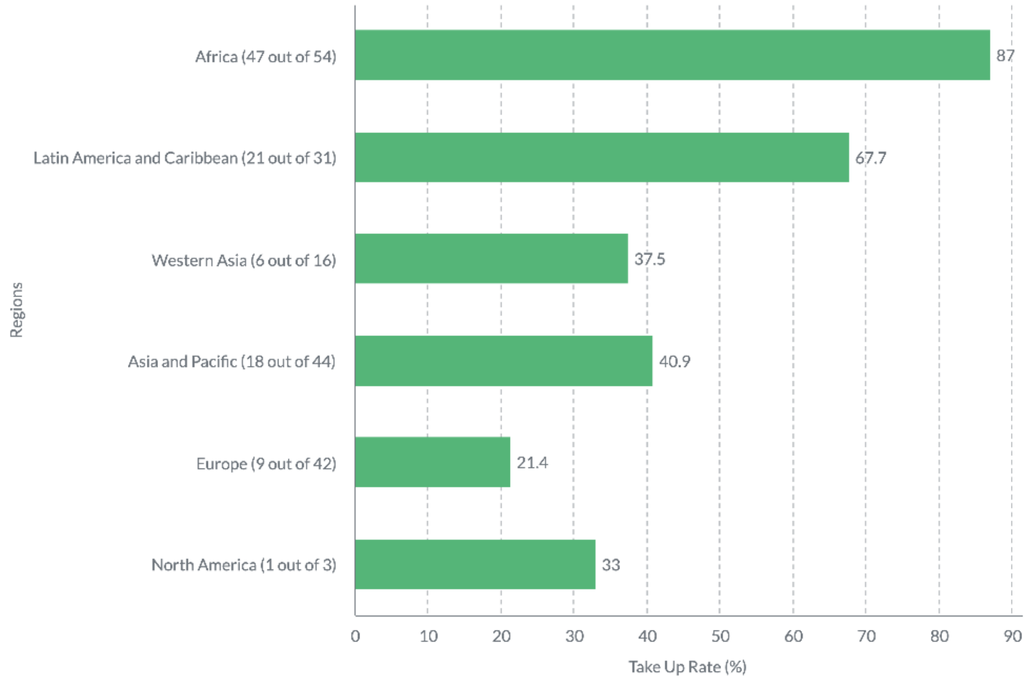

FIGURE 3. Take up Rate of 2021 SDR Allocation in different regions

[9] "Special Drawing Rights One Year Later, by the Numbers." Center for Economic and Policy Research, August 24, 2022. https://www.cepr.net/special-drawing-rights-one-year-later-by-the-numbers/.

[10] "Infographic: African SDRS - How They Are Used, Distributed, and What Needs to Change." Development Reimagined, March 2023. https://developmentreimagined.com/african-sdrs-how-they-are-used-distributed-and-what-needs-to-change/.

As a result of the stark inequalities in the SDR distribution system and the continuous fiscal constraints faced by low-and-middle-income countries, a critical debate has arisen around the need for the reform of the IMF quota system and for more innovative mechanisms of rechanneling SDRs.

In October 2021, **the G20 pledged to reallocate USD 100 billion of its SDRs** to vulnerable countries. At the Paris Financing Summit in June 2023, it was officially announced that this pledge was met. However, 60%[11] of the pledges were made to IMF instruments[12] that have limited SDR absorption capacity, strict conditionalities and are not able to be earmarked for African countries. In addition, of the USD 100 billion, a very small portion has been disbursed. For instance, through the IMF's Poverty Reduction and Growth instrument between 2021-2022, African countries only received USD 10.9 billion.

During the last **G20 Leaders Declaration in September 2023**, it was stated that[13] *"The G20 reiterates its continued support to Africa...We look forward to further progress on the exploration of viable options for voluntary channeling of SDRs through MDBs, while respecting relevant legal frameworks and the need to preserve the reserve asset*

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[11] "Remarks by the IMF Managing Director Kristalina Georgieva at the Paris Summit Closing Press Conference." International Monetary Fund, June 23, 2023. https://www.imf.org/en/News/Articles/2023/06/23/sp062323-mdremarks-paris-summit-closing-presser.

[12] The IMF's Poverty Reduction and Growth Trust (PRGT) and Resilience and Sustainability Trust (RST)

[13] "G20 New Delhi Leaders' declaration", G20, September 2023. https://www.mea.gov.in/Images/CPV/G20-New-Delhi-Leaders-Declaration.pdf.

character and status of SDR. We look forward to review of precautionary arrangements and take note of the discussions held on the IMF surcharge policy."

Furthermore, in the Brazilian G20 concept note it was clear that *"Beyond increased capital, MDBs need to be more responsive to the needs of developing countries, streamline access to their existing resources and operate as a cohesive system where appropriate, leveraging their knowledge and catalytic roles."*[14]

It is therefore clear that the G20 understands the need for a reform of international financial institutions and the importance of reallocating SDRs to vulnerable countries, in particular African countries. As the Brazilian presidency discusses concrete measures to achieve a more equitable and fair international financial system, it is imperative that the reform of the IMF quota system (and the SDR distribution system) as well as innovative ideas of SDR reallocation are fully considered.

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[14] "G20 Concept Note Documents." G20 Brazil Documents, n.d. https://www.g20.org/en/news/documents.

Recommendations and Scenarios

It is estimated that USD 1.3 trillion is needed to meet Africa's Sustainable Development Goals (SDGs).[15] For infrastructure alone, the African Development Bank estimates that the continent needs between USD 130-170 billion annually.[16] African governments will not be able to mobilize this financing domestically and therefore continue to rely on external financing. Financing mechanisms like SDRs are one way to get such financing.

The Brazilian G20 Presidency can support African countries to receive more SDRs, and thus more financing to support their growth and development by implementing these two interlinked recommendations:

Recommendation 1: Reallocation of SDRs to African Financial Institutions, in particular the African Development Bank's Hybrid Capital Instrument

The African Development Bank has put forward a proposal that would allow IMF member states to reallocate their unused SDRs to the Bank while maintaining the SDR's reserve asset status. IMF member states would rechannel their SDRs through the Bank's Hybrid Capital Instrument (HCI) which is designed to take SDR contributions and

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[15] "Climate related funds and initiatives at the ...", African Development Bank, 2023. https://www.afdb.org/sites/default/files/documents/publications/afdb_climate_initiatives_2023.pdf.

[16] "Africa's infrastructure: Great potential but ...", African Development Bank, 2018. https://www.afdb.org/fileadmin/uploads/afdb/Documents/Publications/2018AEO/African_Economic_Outlook_2018_-_EN_Chapter3.pdf.

leverage them **three to four times**. This would mean that if a country were to reallocate USD 1 billion, the Bank would be able to on-lend **USD 3-4 billion**.

Instead of converting SDRs to hard currency, the Bank keeps those SDRs at the IMF in the Bank's balance sheet, and with the new equity, the Bank raises funding in capital markets. The funding would be raised in hard currencies which the Bank would then on-lend to African countries in the currency of their choosing.

The HCI is designed to be as risk-free as possible for contributing countries. **First**, as high-income countries prefer to lend their SDRs as opposed to donating them, contributions to the HCI are in the form of loans to offset the difference in interest rate paid between the SDR holding and the SDR allocation. **Second**, in the event of a balance of payment issue, the HCI is designed to ensure that all contributors will have access to liquidity. **Third**, AfDB as a AAA-rated MDB can absorb greater risk on its balance sheet and is well positioned to distribute financing received through the HCI to countries, projects, and sectors that will have maximum impact. **Fourth**, the Bank has announced that financing from the HCI will primarily be for climate adaptation, mitigation, and food security with spillovers in more areas.

For the HCI to be operational, AfDB has made it clear that there needs to be at **least five SDR contributor countries** each lending at **SDR 500 million** for an initial financing of **SDR 2.5 billion**. Unfortunately, as of today, <u>no country has pledged</u> to reallocate their SDRs to the HCI.

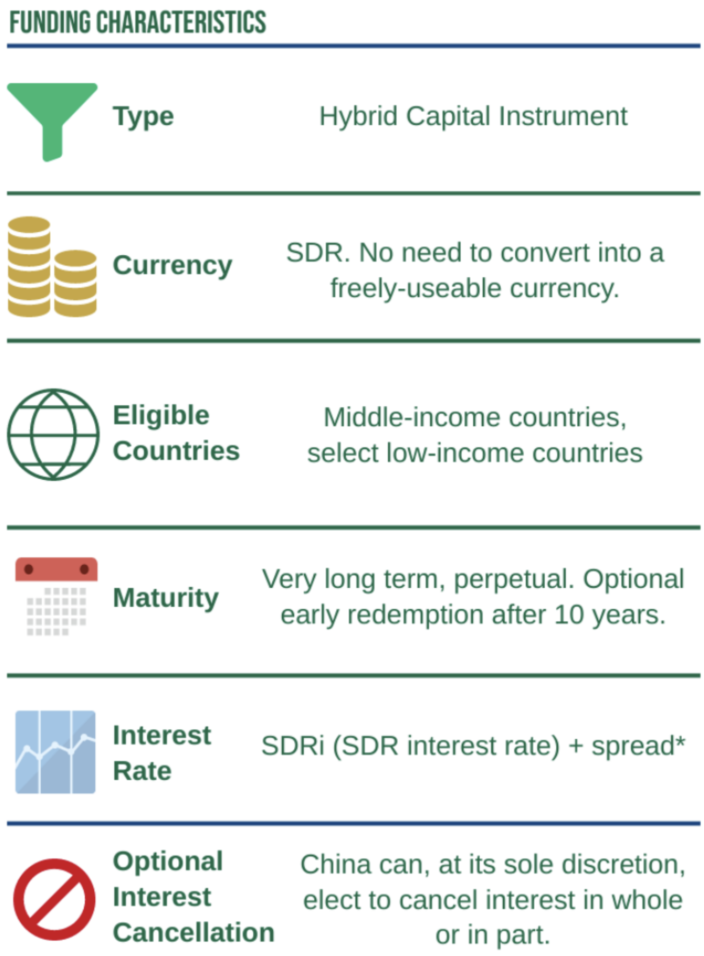

FIGURE 4. AfDB Hybrid Capital Instrument

G20 Members should commit a minimum USD 25 billion reallocation to AfDB and USD 12.5 billion to other African FIs

In March 2024, the U.S. Congress announced that the U.S. will lend up to USD 21 billion to the IMF's PRGT[17], completing the G20's USD 100 billion commitment. From the USD 100 billion, approximately **USD 81 billion** is allocated exclusively to the PGRT

[17] Shalal, Andrea. "Treasury's Yellen Says Funding Bill Allows Lending of $21 Bln To ..." Reuters, March 23, 2024. https://www.reuters.com/world/us/treasurys-yellen-says-funding-bill-allows-lending-21-bln-imf-trust-2024-03-23/.

and the RST. Although the U.S. due to its legislation cannot allocate to any other instrument apart from the PGRT, other G20 countries do not have the same constraint and can allocate to other instruments and prescribed holders. Thus, with the new U.S. commitment, G20 countries can shift their PGRT/RST commitments to a prescribed holder (AfDB for instance). Commitments often don't necessarily imply disbursements and most of the financing has not been used by these IMF instruments so far, making this shift feasible and rather simple.

With Africa accounting for **50% of extreme poverty globally,** it can be argued that **half** of the G20 commitment (**USD 50 billion**) should be reallocated to African countries where half can go to **AfDB** through its HCI, a **quarter** can be allocated to other **African FIs** and another **quarter** can be allocated to other instruments like the **RST** or **PRGT**.

TABLE 1. Overview of Commitments

	Amount Committed	Instrument	Amoung to be shifted to meet this recommendation
G20 (minus US)	USD 60 Billion	IMF's PRGT/RST	USD 37.5 billion---> AfDB and AFIs
United States	USD 21 billion	IMF's PRGT	-

Note: The USD 12.5 billion to the PRGT/RST can come from the G20 or the U.S. (PRGT only)

This distribution works well not only due to the strong disbursement capacities of African FIs and their understanding of the financing needs and priorities of different countries but also because Africa has four prescribed holders of SDRs that can hold, use, and convert SDRs.

Recommendation 2: Increase the number of African Prescribed Holders of SDRs

There are currently only four African prescribed holders of SDRs. The IMF, according to its Articles of Agreement, has the power to approve an institution's application to become a prescribed holder. More specifically, the prescription of an official entity, in this case, an African FI, requires an **Executive Board** decision and an **85% majority** of the total voting power.

As can be seen in the timeline below, several prescribed holders were approved in the 1980s. For an institution to become a prescribed holder, that institution must fulfill the criteria outlined in **Article XVII** of the IMF's Articles of Agreement.[18]

[18] "Applications To Become Holders of SDRS," International Monetary Fund, February 21, 2023. https://www.imf.org/en/Publications/Policy-Papers/Issues/2023/02/21/Applications-To-Become-Holders-of-SDRS-530055.

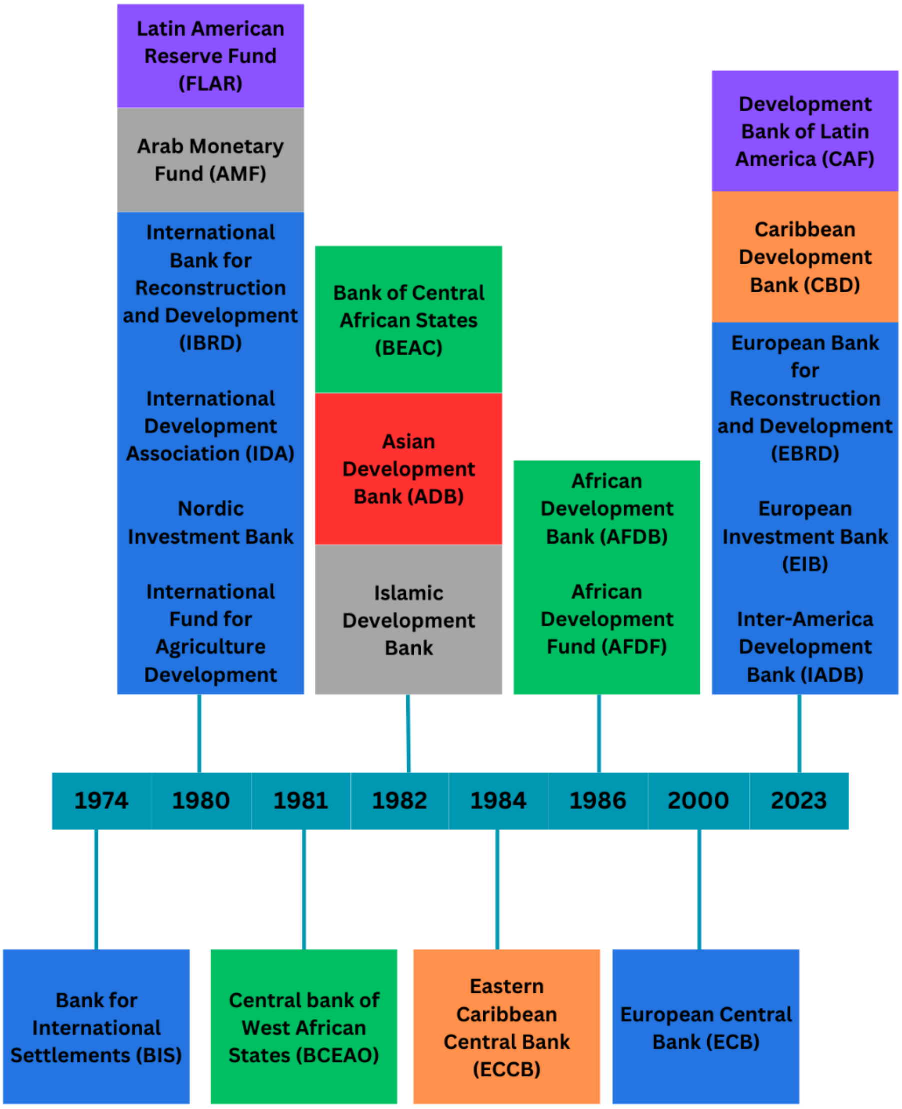

FIGURE 5. History of IMF Prescribed Holders and Year of Approval of Prescribed Holder Status[19]

In the timeline above, African institutions are colored **GREEN**, Middle Eastern institutions are GREY, Asian institutions are **RED**, Institutions based in the US/Europe

[19] "Applications To Become Holders of SDRS," International Monetary Fund, February 21, 2023. https://www.imf.org/en/Publications/Policy-Papers/Issues/2023/02/21/Applications-To-Become-Holders-of-SDRS-530055.

are BLUE, Caribbean institutions are ORANGE, and Latin American institutions are PURPLE.

It is clear from this timeline that Western institutions have much more prescribed holders of SDRs than African FIs. This lack of representation of African financial institutions vis-a-vis other regions reflects the inequalities seen in the IMF system and the urgent need for more African institutions to become prescribed holders.

Several African FIs provide critical financing and support to African countries across the continent. Institutions such as the **African Export-Import Bank** (Afrexim Bank), the **Trade Development Bank** (TDB), and the **Banque Ouest Africaine de Developpment (BOAD)** if allowed to become prescribed holders will leverage SDR reallocation to provide transformational financing to African countries.

G20 countries together are the majority shareholders of the IMF giving them the power to approve a longer list of African institutions as prescribed holders of SDRs. Expanding the list of African prescribed holders will give high-income countries that have large reserves of unused SDRs more choices to reallocate their SDRs. This will create a more risk-free and conducive environment for contributor countries. It will also foster greater innovation in the use of SDRs as seen through the AfDB's Hybrid Capital Instrument.

Conclusion

The IMF quota system is inherently flawed as it is solely based on a country's wealth and economic position in the world. The recommendations outlined above are tangible courses of action that the G20 can take given the influence, power, and decision-making capabilities of its members within the IMF.

The G20 committed in 2021 to reallocate USD 100 billion of its SDRs to vulnerable countries yet African countries are yet to reap the benefits of this commitment. The proposal by the African Development Bank allows for a risk-free reallocation of SDRs and taking that first step will open the door for more innovative and impactful ways to use SDRs. Furthermore, supporting African FIs to become prescribed holders will allow for new ideas and instruments that will give countries within the G20 and beyond more options to reallocate their financing.

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