I. Special Drawing Rights: advantages, limitations, and innovative uses[1]

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Introduction

Special Drawing Rights (SDRs) were created by the International Monetary Fund (IMF) in 1969 at a time of international reserve scarcity to supplement the reserve assets of IMF member countries. SDRs are not money per se but rather a potential claim on freely usable currencies of member countries. SDRs can be traded for these currencies at a variable but very low rate of interest. SDRs are a source of liquidity that can be particularly useful to small and financially constrained economies. In times of financial distress, SDRs offer a source of finance that is significantly cheaper than those available through the international capital market. Nations can use SDRs for a wide range of operations including: accumulating international reserves; payments of loans and financial obligations with the IMF and its members; and bolstering their fiscal budget in times of need.

When an allocation takes place, countries receive SDRs in proportion to their IMF quota which is largely determined by their GDP. This means that the lion's share of the assets (roughly 64%) are allocated to developed countries. For large economies like the United States, China or the United Kingdom, countries with national currencies that serve as an international reserve asset, the influx of new SDRs is of low significance relative to their total reserves. In advanced economies these assets seldom account for more than 5% of their total international reserves. SDRs can also be held by certain designated official entities termed prescribed holders, like multilateral development banks and international/regional monetary institutions.

[1] This document is based partly on ECLAC (2021).
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Since their inception, there have been five allocations of SDRs. The largest allocation took place in 2021 as the COVID pandemic placed a particular strain on international liquidity. "This new SDR allocation featured three core objectives: 1/ offer additional reserve assets to countries with fragile balance of payments; 2/ relax countries' budget constraints during the COVID pandemic, for instance to purchase vaccines; and 3/ help countries address longer-term climate challenges and digital transformation" (Lazard, 2022). Despite these intentions, only about one third of the new SDRs allocated were assigned to developing countries, the ones most gravely in need of international reserves. Since then, several large economies through the G20 have pledged to recycle their new SDRs to low- and vulnerable middle-income economies.

Three options stand out as possible ways in which these new assets could be recycled to countries in need. SDRs could be channeled to the Poverty Reduction and Growth Trust (PRGT) or the Resilience and Sustainability Trust (RST), both of which operate under the management of the IMF. These trusts do not hold SDRs directly but rather facilitate subsidized loans to countries in need while ensuring the asset's high liquidity and zero risk properties through an encashment regime. The PRGT and RST model could be used by prescribed holders such as multilateral development banks, provided they maintain a similar encashment mechanism. A third option consists of allowing prescribed holders to use SDRs as leverage for loans from the financial market. This would require solving the issue of whether SDRs could remain on the recipient's balance sheet while maintaining its properties as a reserve asset.

Amidst these options, the SDRs' prescribed properties of being a zero risk and highly liquid asset remain the major arguments against reallocation between countries and the use of them as capital to leverage resources. In practice, the use of encashment regimes guarantees the contingent liquidity of the asset. Considering that SDRs make up a marginal portion of developed countries' reserves and that several of these large economies issue reserve currencies, the financial stability of potential lender is unlikely to be compromised. The willingness of developed economies to follow through with the promises of facilitating their SDR reserves will largely determine the degree to which the IMF's three objectives regarding the most recent allocation will be fulfilled.

The remainder of this chapter is organized as follows. Section I outlines SDRs' advantages and shortcomings. Section II describes the mechanisms by which SDRs could be recycled to countries in need. Section III concludes with a brief discussion of the inherent contradictions in the use of SDRs.

A. Special Drawing Rights (SDRs) and their limitations

SDRs can be held and used only by participants in the SDR department,[3] by the IMF through its General Resources Account (GRA), and by the fifteen existing prescribed SDR holders.[4] Latin America and the Caribbean have two prescribed holders: the Latin American Reserve Fund (FLAR) and the Eastern Caribbean Central Bank (ECCB). SDRs are not money in the traditional sense of the term. Rather, they are a claim on freely convertible currency. That is those currencies that play a pivotal role in international trade and financial transactions: the United States dollar, the British Pound, the Euro, the Japanese Yen, and the Chinese Renminbi.

3 All IMF members are also members of the SDR department.

4 Prescribed holders include three central banks: European Central Bank, Bank of Central African States, Central Bank of West African States; two intergovernmental monetary institutions: Bank for International Settlements, and the Arab Monetary Fund; and eight development finance institutions: African Development Bank, African Development Fund, Asian Development Bank, International Bank for Reconstruction and Development and the International Development Association, Islamic Development Bank, Nordic Investment Bank, and International Fund for Agricultural Development. https://www.imf.org/en/About/FAQ/special-drawing-right. August 21, 2021.

1. SDRs and Their Advantages

Despite their limitations, SDRs have several advantages over other liquidity facilities provided by the IMF. First, SDRs can be granted on an automatic basis to the members of the IMF SDR department. Their issue does not need any backing of any asset whatsoever and they are created literally at the 'stroke of a pen'.

Second, SDRs are a loan without any obligation to repay the principal. Third, the use of SDRs, that is the exchange of SDRs for freely convertible currencies entails the payment of a concessional interest rate, currently set at 0.005%.

Fourth, the holdings of SDRs increases international reserves and thus can contribute to maintain external financial stability and improve a country's risk perception.

Fifth, SDRs do not have a prescribed use and have proven to be a versatile and flexible financial instrument that can be used for several purposes other than that of accumulating international reserves. These include official-debt repayment, debt restructuring and fiscal expenditure (see table I.1 below).

Table I.1
Fiscal use of the 2021 SDR allocation in Latin America and the Caribbean
(Millions of dollars)

IMF Member	2021 SDR allocation	Fiscal use	Fiscal uses *(Percentages of allocation)*
Antigua and Barbuda	27	27	100
Argentina	4 351	8 554	197
Colombia	2 791	2 743	98
Ecuador	952	840	88
Guyana	248	242	98
Haiti	224	110	49
Honduras	341	336	99
Mexico	12 167	7	58
Panama	514	506	98
Paraguay	275	270	98

Source: Prepared by the authors based on Arauz et al. (2022) & IMF (2021a).

2. The inherent limitations and contradictions of SDRs

SDRs were created at a time when the biggest problem at the international level was the actual and perceived scarcity of international reserves. The SDR was created with two objectives. The first was to transform the SDR into the main international reserve asset. The second consisted in the use of the SDR to manage aggregate demand to avoid situations of inflation and deflation and to ensure the full use of existing resources.

The SDR has never lived up to its promise. SDRs account for roughly 4% of the total stock of international reserves which is minimal when compared with the 64% that is held in United States dollars. Also, the SDR is not used often as means to settle official transactions. It performs the function of unit of account for minor operations within the private sector (see Introduction to this volume).

The use of SDRs is limited by restrictive provisions which include the fact that they cannot be used by the private sector other than as a unit of account and by strict regulations regarding its issuance. Any issue of SDRs up to 100% of the quota of all IMF members (which represents roughly US$ 650 billion dollars) requires the approval of 85% of the IMF's executive board members which implies that it must count with the approval of the United States Congress.

SDRs have never been issued on a recurrent basis. There have been four general SDR allocations (9.2 SDR billion in 1970-72; 12.1 SDR billion in 1979-1981; 161.2 billion in 2009; 465.5 SDR billion in 2021). Despite the increase in the value of the SDR issues over time their amount remains small in comparison to the growth in global financial assets especially since the 1990s.

Also, they do not have a "life on their own": they are an unconditional right to obtain hard currencies and they are complex instruments, and not a transfer of net wealth. For example, they come with an obligation to send them back to the IMF should its members vote to cancel them (at an 85% supermajority)" (Lazard, 2022).

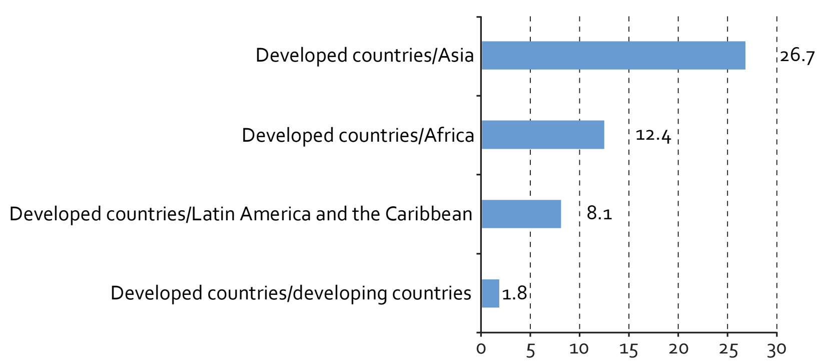
Furthermore, SDR issuance tends to favour developed country since country shares are determined by the IMF quota system which relies to a large extent on GDP. Developed countries have without exception received the bulk of the SDR. In 2021, developed countries received 64.4% of the allocation of SDR and developing countries the remaining 35.6%. Figure I.1 exemplifies this point by showing the General allocation of SDRs (August 2021) of developed countries relative to developing countries and to selected developing regions.

Yet at the same time, developed countries have a much lower use of SDRs than developing countries. The available evidence shows that the SDR mean utilization rates as a proportion of IMF quota reached 6% for developed countries and 20% for developing countries. Also, the SDR utilization gap tends to increase during crises as shown by the example of the Global Financial Crisis and the COVID-19 Pandemic.

The low usage of SDRs by developed countries can be explained by simple fact that most developed countries issue international reserve currencies and thus do not need SDR, either to boost their reserves, or to obtain liquidity by exchanging SDR for freely convertible currencies which is the exactly the case of developing countries. Thus, the countries that need SDRs the most are the ones that receive the smaller share.

Moreover, developed countries have the policy space and autonomy to undertake expansionary and full employment policies without excessive regard to their financial conditions and exchange rate parities. The opposite is the norm for developing countries. As shown in table I.2 a significant number of developing economies have non-floating exchange rate regimes. The opposite is the case of high-income countries.

Figure I.1
General allocation of SDRs (August 2021) of developed countries relative to developing countries and to selected developing regions



Source: Prepared by the authors, on the basis of International Monetary Fund (IMF), "IMF Finances", Washington, D.C. [online] https://www.imf.org/external/np/fin/tad/query.aspx.

Quantitative easing policies in the United States, the Euro Zone and Japan have increased their assets central bank assets by more than 3.5 times (US$14.5 in November 2019 compared with US$4 trillion before the Global Financial Crisis).

Developing countries including those of Latin America and the Caribbean face important restrictions at the financial and real economy levels, including most importantly the external constraint, to achieve the full use of their productive potential.

This has important social and economic costs. This asymmetry implies that counter cyclical policy is always an available policy option for developed countries (even if they do not take full advantage of such a prerogative, especially with regards to fiscal policy). In contrast, in the case of developing countries it is a policy option under very specific and limited circumstances.

Table I.2
General allocation of SDR classified by type of exchange rate regime and income category

Exchange rate regime/ income categories	High-income	Upper middle-income	Lower middle-income	Low-income
Floating	391 162	71 607	31 393	1 329
In percentage of total	62	11	5	0
Non-floating	33 590	61 868	32 177	7 235
In percentage of total	5	10	5	1

Source: Prepared by the authors based on Lazard (2022).

Another facet of this situation is the asymmetry of adjustment between debtor and creditor countries. Latin America and the Caribbean are historical witnesses to this malaise. Indeed, the contractionary bias built into debtor countries typical short-term adjustment policy stance has remained a pervasive weakness of the global financial architecture and a stumbling block to global growth and full employment, as well as to the development of developing countries.

When developing countries are debtors the adjustment is compulsory. The onus of adjustment is always placed on the debtor country, which is generally the weaker and the smaller economy. Also, the economic and social strains required by the restoration of equilibrium tends to be out of proportion to the burden of the debt. When developed countries are the debtors (the United States prior to the Global Financial Crisis) they are not forced to adjust. The adjustment is voluntary.

In summary, the adjustment is always 'forced in the direction most disruptive to social and economic order and growth, and to throw the burden on the countries least able to support it, making the poor and poorer and preventing the development of the whole economy.' [5]

B. The recycling of SDRs

The above analysis provides the basis to justify the recycling of SDRs from developed to developing countries. In October 2021, the G20 pledged to recycle $100 billion worth of SDRs from members to vulnerable countries. To date, pledges appear to amount to about $59.5 billion, not including $21 billion from the United States, which failed to get congressional approval (Plant 2022; Sebany et al, 2022) (table I.2).

Table I.3
SDR allocation and pledges for recycling by country

Country	SDR Allocation *(Billions of dollars)*	Pledged *(Billions of dollars)*	Pledged *(Percentages)*
Australia	8.32	1.66	20
Canada	13.95	3.63	26
China	38.57	15.20	34

[5] See Keynes (1980).

Country	SDR Allocation *(Billions of dollars)*	Pledged *(Billions of dollars)*	Pledged *(Percentages)*
France	25.50	7.65	30
Germany	33.70	9.94	29
Italy	19.06	3.81	20
Japan	38.99	7.80	20
Netherlands	11.05	2.90	26
Saudi Arabia	12.65	0.66	5
South Korea	10.86	0.59	5
Spain	12.06	3.41	28
United Kingdom	25.50	5.10	20
Total	250.22	60.36	24

Source: Prepared by the authors based on Plant (2022) and Sebany et al. (2022).

1. Recycling SDRs through the Poverty Reduction and Growth Trust Fund

There are currently two on-lending mechanisms through which developed countries recycle SDRs to developing countries: the Poverty Reduction and Growth Trust (PRGT) and the Resilience and Sustainability Trust (RST).

The PRGT is an instrument of the IMF that provides concessional support to low- and middle-income countries that are deemed to be in debt distress. Thirty-four out of a total of fifty low-income countries (representing 68% of the total) are PRGT-eligible countries. Ten upper middle-income countries in debt distress are also PRGT-eligible countries (Dominica, Grenada, Guyana, Maldives, Marshall Islands, Samoa, St Lucia, St. Vincent and the Grenadines, Tonga and Tuvalu).[6]

The PRGT financial architecture consists of *Subsidy*, *Loan*, and *Reserve* accounts. The loans borrowed from countries at market interest rates are lent out through the Loan account to borrowers at low rates, often subsidized from the Subsidy accounts. The Subsidy account largely finance the subsidy costs through its balances, while the Reserve account provides collateral to lenders since its funds can be used to pay back loans in the case of late payment. Also, the investment revenue obtained from this account may be used to cover the costs of the subsidies. The PRGT is not an SDR-prescribed holder even though it receives SDRs from contributing countries. When loans are provided under the bilateral agreements, the lender earns SDR interest rate on the SDR-denominated loans.

In response to the pandemic, and as part of the fast-track loan mobilization effort, the PRGT provided US$ 24 billion in funding to PRGT-eligible countries, out of which 63% was financed with lending of SDRs.[7]

There are two benefits of channelling SDRs through the PRGT. First, the lending country's assets are protected through the IMF's policy conditionalities and the Reserve Account. The Reserve Account provides collateral to lenders since its funds can be used to meet obligations in the event of delayed payments or default by PRGT borrowers. The Reserve Account was originally financed by the profits of gold sales in the late 1970s, reflows of the Trust Fund and Structural Adjustment Facility (SAF) repayments, as well as investment returns on balances held in it. The policy conditionalities provide another layer of safeguards by strengthening a country's macroeconomic fundamentals, as stated in the IMF's guidelines embedded in the PRGT. The PRGT loan resources including in the form of SDRs come from bilateral agreements with IMF members which earn an interest based on the prevailing SDR rate (Andrews, 2021a).

[6] See IMF (2020). In all there are 69 countries eligible for PRGT funding (IMF, 2021a). Guyana has met the PRGT graduation criteria and is set to graduate from PRGT status.

[7] See IMF (2021b). The developed countries that through bilateral agreements provided funding through SDRs include Japan, France, United Kingdom, Italy, Australia, and the Netherlands. The use of PRGF was facilitated by the increase in the annual access limit in the PRGT from 100 to 150 percent of quota. More recently the IMF (July 2021c) approved: (i) a 45 percent increase in the normal limits on access to concessional financing; (ii) the elimination of hard limits on access for the poorest countries and (iii) a two-stage funding strategy for the PRGT consisting in securing SDR 2.8 billion in subsidy resources and an additional SDR 12.6 billion in loan resources. The SDR 12.6 billion could be provided by loaning of SDRs from developed countries.

Secondly, PRGT eligible countries currently pay no interest on borrowed funds even though the IMF secures these loans at prevailing SDR interest rates. The difference is financed through the PRGT's Subsidy account which is funded by bilateral contributions from members and, the Fund's own resources, and returns from the investment of their balances.

Thus, based on its current configuration, reallocating SDRs through the PRGT would benefit both lenders and the borrowers. The lenders would have their assets secured and earn interest, while borrowers would be able access loans at no costs. However, increased lending through the PRGT requires corresponding increases in the Subsidy and Reserve accounts to subsidize the loans and to safeguard lenders from the possibility of default. These resources will have to be in the form of grants or earned income not loans.

Furthermore, reallocating SDRs using the PRGT platform would currently only benefit PRGT-eligible countries thereby excluding middle and low-income countries that are not PRGT-eligible but have urgent financial needs. Currently, only 39 countries, which represent 72 per cent of African countries, are listed as PRGT-eligible countries.

The PRGT has three important drawbacks. First, PRGT funding is subject to negotiated IMF programs which are subject to conditionality. Second, all SDR on-lending by developed countries is subject to an encashment regime. The encashment regime consists of a bilateral agreement between the lender country and the PRGT, whereby the PRGT commits itself to return the SDR in case the country in question is faced with balance-of-payments difficulties. As stated in the PRGT report for 2020, the encashment regime refers to "the right to seek early repayment of outstanding claims on the Trust in case of balance of payments and reserve needs and authorizes drawings by the Trustee to fund such encashment requests of other participating creditors to any of the Loan Accounts of the Trust" (IMF, October 2020, p. 5).

Third, the loan resources of the PRGT are small. According to the IMF, in 2020 which was an unusual year in terms of funding requirements "the PRGT lending commitments were projected to reach SDR 21 billion during the pandemic period under a Baseline scenario, more than four times the historical average on an annualized basis" (IMF 2021a, p. 2).

2. Recycling SDRs through the Resilience and Sustainability Trust

The second option consists of channelling the SDRs through the Resilience and Sustainability Trust (RST). The RST, which is managed by the IMF, was established on April 13th 2022 and became operational on May 1st. The capital of the RST was set at SDR 33 billion or US$ 45 billion dollars.

The mandate of the RST is to help "...low-income and vulnerable middle-income countries build resilience to external shocks and ensure sustainable growth, contributing to their longer-term balance of payments stability. It complements the IMF's existing lending toolkit by providing longer-term affordable financing to address longer-term structural challenges, including climate change and pandemic preparedness" (IMF, 2022a). RST-eligible countries include all low-income countries, all developing and vulnerable small states, and lower middle-income countries. Loan resources have a cap of 150% of quota or SDR 1 billion depending on whichever is lower. Loans are provided with a 20-year maturity period and 10 year and a half grace period a rate of interest slightly above the SDR three-month rate.

The RST governance and financial structure like that of the PRGT. This means that loans are provided with conditionalities, and that it is subject to an encashment regime. Barbados and Costa Rica have accessed funding (equivalent to US$ 183 and 710 million dollars respectively) from the RST (IMF, 2022b; Shalal and Lawder, 2022).

3. Recycling SDRs through multilateral development banks

A third option that has been put on the table to recycle SDRs is through multilateral development banks (MDBs). MDBs are considered natural candidates for the recycling of SDRs since they support development and supply global public goods in line with the SDGs. They also provide financing at affordable or concessional rates, and act countercyclically. Moreover, some MDBs are already prescribed holders of SDRs which would facilitate recycling of SDRs through these institutions.

SDRs cannot be donated for two reasons. First, a donation is equivalent to a liability by the donating country as, in this case, interest on allocations is not offset by interest earned on holdings. Also, the donation of SDRs precludes their use as international reserves which 'violates the principles set out by the G20 and G7 for the recycling of SDRs' (Mansour, A., & Sembene, 2021).

However, SDRs can be on-lent to prescribed holders. To maintain the SDR property of an international reserve asset, the approach would have to resemble that followed by the PRGT or the RST. That is, it would have to include some type of encashment regime. The PRGT makes the encashment regime operational by maintaining a liquidity buffer equal to 20% of the amounts committed by lenders participating in the encashment regime. Similarly, the RST includes a 20% encashment buffer in its loan account.

As explained by the IMF (2022b, p. 42): "loan account (LA) contributors' commitments will include an encashment buffer available for drawings in the event that another contributor requests early repayment of its LA claims by representing that its balance of payments or reserve position justify it". Besides requiring risk mitigation measures and ensuring the liquidity of the asset, lending countries may also require a cap on the length of the loan. As things stand, the maximum maturity of the loans is established at 10 and 20 years for the PRGT and the RST (Andrews, 2021b).

An alternative use of SDRs is to provide additional resources to leverage operations, rather than substituting for existing sources of funding as in the case of direct on-lending. The use of SDRs to leverage resources would have to solve the problematic issue of whether this instrument could remain on the recipient's balance sheet without undermining its properties as a reserve asset: low risk and high liquidity.

When countries (normally high income who don't use them) lend their SDRs to the IMF, they want to be sure that IMF maintains the asset's characteristics. That same encashabilty must stay true in hands of the MDB. That is a hard thing to do. At the same time, rating agencies which look at the capital structure of the MDB, must be convinced that this SDRs are in fact capital. So there exist a tension between what donors want, and what MDBs need regarding capital. This is not only a technical problem, but a political one. There are reserve currencies for 14.7 trillion dollars in central banks' balance sheet to face the crisis, which might be exchanged for SDRs. It's going to take political will to move central banks and technicians of the world to figure the way this work.

Another important issue is whether multilateral development banks are sufficiently capitalized and in fact do not need SDRs to leverage additional resources. The consensus seems to indicate that multilateral development banks and some regional development banks have obtained significant capital increases which allowed them to significantly increase their finance in 2020. The World Bank Group claims to have provided the largest financial support in fiscal year 2021 (July 1, 2020-June 30, 2021) to fight the pandemic equivalent to over US$ 157 billion dollars, and that this was made possible by the 2018 IBRD and IFC General Capital Increases and the IDA19 Replenishment.[8] In 2018, the World Bank Group approved an increase of US$ 13 billion dollars for both the IBRD and the IFC and a US$ 52.6 billion dollar increase in callable capital for the IBRD.

For its part, in 2020 the IDB provided the largest financial support to Latin America and the Caribbean. Between the end of 2019 and that of 2021, the IDB's balance sheet expanded to reach US$ 15 billion dollars and its board of governors mandated a capital increase to benefit the investment arm of the IDB (IDB invest). For its part, the Latin American Development Bank (CAF) approved a capital increase of US$ 7 billion dollars, the largest in its history and the Central American Bank for Economic Integration approved a 40% increase in its capital base during the pandemic.

There are other issues that constraint the lending capacity of development banks that are perhaps more pressing than the use of SDRs. These include a financial model based on high credit ratings, strict lending criteria and conservative management of how they leverage their equity.

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8 See Mansour, A., & Sembene (2021) and Fleiss (2021).

At the IDB, as at the World Bank, the available capital could also be used more effectively by reducing the equity-to-loan ratio to a level on par with that of commercial banks. Multilateral development banks take a conservative approach to equity levels: major banks have an equity-to-loan ratio of between 20% and 60%, which is higher than that of most commercial banks (10%–15%) (Humphrey, 2020). In other words, multilateral development banks hold US$ 2–US$ 6 in equity for every US$ 10 in outstanding loans, whereas commercial banks hold only US$ 1–US$ 1.50 per US$ 10 in outstanding loans. The equity-to-loan ratios of the World Bank and IDB stand at 22.6% and 38.2%, respectively.[9]

A recent study focused on the World Bank, the Asian Development Bank, the Inter-American Development Bank, and the African Development Bank shows that by adopting more flexible criteria for lending and increasing their leverage, these banks could collectively triple their lending capacity from US$ 415 billion to US$ 1.3 trillion. The findings showed that the increase in leverage and risk would have minimal effect on these banks' credit ratings. In July 2021, G20 drafted terms of reference for an independent review of the capital adequacy frameworks of multilateral development banks (Settimo (2019), Maasdoorp (2021), G20 (2021) and ECA/ECLAC (2021)).

Some of these considerations have led to the proposal of An Action Plan to reform Multilateral Development Bank Capital Adequacy. The plan recognizes that credit rating agencies have 'considerable influence in determining risk tolerance de facto embedding rating agency methodologies into internal policies, and that credit rating agencies should refine their methodology to better reflect the reality of development banks.' It also proposes a more efficient and flexible use of callable capital (G20, 2022).

C. Conclusion

SDRs were initially created to aid the international financial system by providing liquidity to IMF member countries. They were intended to function as the central asset for regulating international aggregate demand and as the main way of controlling world reserves. As shown by the use given by countries to the most recent allocation of SDRs, they remain a highly versatile tool that is nonetheless constrained by the restrictions placed on its properties and on the number of entities allowed to hold them.

The asset is largely unknown to the private financial market, not being permissible for trade, and only serving as unit of account in specific and minor transactions. It is of little economic relevance to developed countries, where it receives only sporadic use. The highest potential for the asset remains in the relief it can provide to highly constrained economies that are having difficulties in accessing financial markets. Allocations in proportion to country quotas is insufficient, as it disproportionately benefits nations that make a low use of SDRs rather than those in need who use them readily.

Following the most recent allocation in 2021, there have been requests and pledges in favour of reallocating SDRs to low- and vulnerable middle-income economies. The use of an encashment mechanism like the one used by the PRGT and the RST is a viable option to provide international liquidity without significantly affecting the asset's characteristics. Recycling SDRs through these trusts or through prescribed holders using similar mechanisms is a potential path forward to fulfill the reallocation. SDRs could also be channelled to multilateral development banks and be used as capital to leverage loans from the financial market, however this would entail a large change to the way SDRs currently function.

The fact that as a reserve asset holdings and transaction of SDRs must be highly liquid and present no risks is the main argument against recycling SDRs between countries, for including liquidity buffers in the PRGT and the RST and for opposing its use as equity and capital to leverage resources.

In practice the asset reserve nature of the SDR is guaranteed through an encashment regime as exemplified by the PRGT and the RST. This implies that the lending country can under balance of payments

9 Equity includes paid-in capital and accumulated reserves. Loans include loans, guarantees and capital investments for development purposes.

problems reclaim its SDRs. The encashment regime guarantees contingent liquidity rather than absolute liquidity. Moreover, this scenario is unlikely since the lending countries are often the countries that issue a reserve currency. In essence, it does not make economic sense for lending countries to hold SDRs since they contribute very little to the financial stability of these economies. This is perhaps the reason why the SDRs in the United States form part of the Exchange Equalization Account which is under the authority of the executive power and not under that of the Federal Reserve.

A revision of the SDRs properties and restrictions is required for the asset to achieve its full potential as a tool for international liquidity and financial stress relief. Allowing the asset to be traded in the public financial market would facilitate the leveraging of resources for post-COVID recovery. For this to be possible, a fundamental shift on the way SDRs are presently defined and the rules that govern them is necessary.

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