Remind Me Again Why We Organized a Neighborhood Party?

Recommitting to the Objectives of Special Drawing Rights Issuance

Center on International Cooperation
New York University

Betty N. Wainaina
Program Director
Multilateral Reform

June 2025

Center on International Cooperation

NYU | ARTS & SCIENCE

Unfair Distribution at the Neighborhood Holiday Party

Imagine it's the holiday season, and your neighborhood decides it would be nice to hold an afternoon party where all the families can come together to celebrate. There's good music, delicious food, fun and games, and time to bond as a community. A small team is organized as the neighborhood party committee. To show your commitment to the party, every household is asked to contribute a commitment fee. Conscious that not everyone has the same financial circumstances, households contribute according to their household size and income, along with their house's equity level. As the party draws near, the committee announces that they will use the pooled funds to purchase the drinks. However, they announce a potluck style contribution for the food. A list of food requirements is distributed, and households sign up to bring their dishes, with each household allowed to bring as much or as little as they are able to contribute, as long as their contribution can feed at least one person.

On the day of the party, everyone is excited! It's a full house as guests arrive with their contributions, and music is blasting through the venue. The MC takes the microphone and gets the party started. Everyone is excited, some people are dancing, drinks are being served, and everyone is mingling happily. The food station also opens, and the announcer reminds guests to scan the QR code on the wristband they were given upon arrival to use as their ticket to get their portioned food. Nothing more is said. As the line quickly forms, people get to the station, scan their wristbands, and are served their food. Some households walk up to the station: a family of four gets fifty plates of food, a family of eight gets two plates of food, a family of six gets ten plates of food, and a family of two gets one plate of food. Everyone soon becomes perplexed. What is happening?

"This is a potluck; don't we just serve ourselves based on what is available and what we like and want?" At the beginning, everyone is trying to keep the peace. But soon, a small boy breaks the ice as he wants ice cream, and his family has only been allocated one burger and nothing else. He begins to cry and is evidently very upset. The mother is flustered by all the commotion and tries to plead with the servers to see if her son can get an ice cream. However, the server remains adamant and says no. **The allocation is system-generated, and no exceptions can be made at this stage**. A few other people join the commotion and begin to demand answers as to why food is being allocated in the way it is. The committee chairperson comes to the microphone and seeks to clarify the food is allocated according to how much each household paid as a commitment fee. So, households who paid more get a bigger allocation of food, and those who paid less receive less. "This is ridiculous," most think. "We came together to have a party, to enjoy ourselves as a community. We all agreed to bring food to share; why would the sharing now be based on our contributions?" **This notion destroyed the very objective of why the party had been put together, which was to build a sense of community and oneness.**

Why We Need an Equitable Global Financial Safety Net

This fictional barbecue party draws direct parallels to how the International Monetary Fund (IMF)-issued Special Drawing Rights (SDRs) function across the world. The Global Financial Safety Net (GFSN) is a critical part of the sustainability of the global financial system, a role in which the IMF plays a very critical part. Some countries are better positioned than others because they have internal, bilateral, and regional mechanisms that act as their financial safety nets by virtue of their economic and financial standing.

When a country faces a balance of payments shock, it can turn to these mechanisms to respond to the shock. We saw this during the pandemic. Country responses to the COVID-19 pandemic provided a large-scale example of how this can play out. While high-income countries were able to provide support to their populations in the range of 24 percent of gross domestic product (GDP) in stimulus packages and social protection policies, low-income countries could only spend around 2 percent of their GDP. This is because high-income countries could use credit lines with peer countries, rely upon regional arrangements, or even print money. Low-income countries often lack access to these options and often rely on the IMF.

What are SDRs?

SDRs, which were created by the IMF in 1969, are one instrument at the IMF' disposal to provide a global financial safety net. **SDRs are a reserve asset that operates as a reserve-sharing mechanism**. They are not money in the traditional sense. Think of SDRs as a currency that can be used to buy hard currency, as well as make hard currency transactions between holders of SDRs. **They are a financial asset that can be used among sovereign nations as a medium of exchange**. The exchange is undertaken in what are called voluntary trading agreements. SDRs are also a unit of account of the IMF and other international organizations, and obligations can be denominated in SDRs.

The IMF pays interest to countries holding their SDRs and levies a charge to countries that use their SDR allocation. The rate is the same for both the interest and charge. The IMF has allocated a total of SDR 660.7 billion (approximately USD 943 billion), since 1970. The largest-ever allocation was SDR 456 billion approved (USD 650 billion), which was the fourth issuance undertaken in 2021. The IMF and its members hold SDRs through their central banks. There are an additional twenty organizations, including regional central banks, intergovernmental monetary institutions, and Multilateral Development Banks (MDBs), that are designated as prescribed holders of SDRs. Prescribed holders of SDRs do not receive an allocation of SDRs, but they can transact using SDRs.

According to IMF data, as of the close of 2024, **global hard currency reserves stood at USD 12.36 trillion**. By participating in the IMF SDR department, countries have committed to allowing USD 943 billion out of their total reserves to be available for exchange among themselves as holders of SDRs in response to liquidity needs among members where they arise. Very much like the community party. **This represents 7.6 percent of total global**

reserves. The remaining 92.4 percent is untouched within respective central banks. The general allocation of SDRs to members is based on their quota shares in the IMF.

As a consequence of this rule, high-income countries receive a higher allocation than low-income countries. Using their allocation, countries can then exchange their SDRs for freely usable currency or use them to make payments of their loans among themselves, with the IMF, or with prescribed holders. Countries can also donate or lend their SDRs to other countries. The key feature of this global liquidity mechanism is that it is based on all participating members being willing to participate and is implemented through voluntary arrangements. You need a willing buyer and a willing seller, so to speak, for the mechanism to work. However, to ensure the mechanism acts as a secure global financial safety net, the IMF could activate a mandatory designation plan. This is an obligation on countries with a strong balance of payments position to ensure the mechanism works even when there are not enough voluntary buyers.

How are SDRs Currently Used?

Transactions involving SDRs have been in existence since this mechanism was created in 1969. However, their prominence came to the fore much more forcefully following the general allocation of 2021 because this allocation was aimed at addressing a global liquidity challenge during a major global shock brought about by the COVID-19 pandemic. However, with this allocation, it became apparent that this mechanism in its current framework would still not unlock sufficient levels of liquidity for those who needed it most, namely the low-income countries that did not have sufficient or, in some instances, had exhausted their hard currency reserves due to the impact of the pandemic. This is because, by using the IMF quota share as the basis for allocation, this category of countries received only 3.3 percent of SDRs (equivalent to USD 21 billion). On the other hand, over 57 percent of the allocation ended up with high-income countries that technically did not need them and so continue to mostly sit idle and unused. This was a classic case of market failure, where resource allocation was suboptimal.

Acknowledging this allocation mismatch, the G20 countries agreed in 2021 to rechannel 100 billion of their unused SDRs to provide additional liquidity to low-income countries. This was the objective from the very beginning. High-income countries were yet again coming together to determine how to inject a correction that would ensure the objective was still met. It was agreed that this would be voluntary and could be channeled directly to the country as a donation or through the IMF concessional facilities—the Resilience and Sustainability Trust (RST) and the Poverty Reduction and Growth Trust (PRGT). 23 countries have contributed USD 47 billion worth of SDRs, and 30 countries have contributed USD 56 billion worth of SDRs to the RST and PRGT, respectively.

However, **five years later, only a total of USD 9.1 billion of the RST and USD 36 billion of the PRGT have been committed to 23 countries and 57 countries, respectively**. The main drawback of the RST has been that countries are required to have a concurrent "upper credit tranche" (UCT) IMF program, with 18 months remaining in the program, as a condition for financing. Not many low-income countries fulfill this requirement.

An Additional Proposal to Unlock SDRs' Full Potential in the Global Financial Architecture

The IMF, as a platform for correcting this misallocation, has evidently not been very effective with the instruments at its disposal. Other proposals have therefore been presented to further unlock the potential of SDRs. **MDBs, as prescribed holders, have come forward with proposals on how they, too, can utilize SDRs by designing SDR-denominated hybrid capital instruments to which countries can invest their SDRs.** The MDBs can leverage the market up to four times and make available four times the lending capacity based on each SDR dollar equivalent. The African Development Bank (AfDB) and the Inter-American Development Bank (IDB) have already put forward a full proposal for this. The proposed solution has two main components:

- An SDR-denominated hybrid capital instrument.
- A Liquidity Support Agreement (LSA) mechanism to ensure the liquidity of the hybrid capital instrument if one of the countries encounters challenges and needs liquidity to address a balance of payments need.

To operationalize, five high-income countries with high credit ratings and a strong balance of payments position need to commit to coming together and agree to invest in this hybrid capital instrument. These **five investors will be required to commit to providing liquidity** to purchase the holdings of any one of them who undergoes a balance of payment event requiring an urgent liquidity injection. An additional **three countries willing to provide guarantees to support the liquidity of the SDRs** used in the hybrid capital instrument will also be required. These categories of countries are referred to as Tier 1 and Tier 2, respectively.

Addressing the Roadblocks of Using SDRs in MDB Hybrid Capital Instruments

At face value, this sounds like a no-brainer proposal that will not only unlock additional liquidity for low-income countries by a factor of four for every dollar invested. So why has it not taken off? Various technical high walls have been erected that have hindered it.

The first was that **this had not been explicitly provided for within the SDR department regulations**. On May 10, 2024, the IMF Executive Board authorized the use of SDRs by IMF members for the acquisition of hybrid capital instruments issued by prescribed SDR holders. This new use of SDRs will be subject to a cumulative limit of SDR 15 billion.

The second barrier is the concern that **this would compromise the reserve asset status of SDRs and risk global financial stability.** This concern is grossly overstated based on the facts. First, the USD 15 billion cap instituted by the IMF is a very conservative amount that was responding to this concern. This only represents 0.12 percent of global reserves. It is inconceivable that this drop in the ocean would produce the much-dreaded tsunami of global financial crisis, for which an alarm is being raised. In addition, the AfDB/IDB proposal addresses this concern even further in a very deliberate way. How? The SDR invested by the country would technically not be spent by the MDB. It sits in the SDR account of the MDB at the IMF, serving as capital that the MDB then uses to leverage the market. What the MDB will be lending is proceeds from the leveraging. Countries will, therefore, still be able to account for these assets as reserves. When you think about it critically, i**t doesn't get any more stable than this.**

The third challenge is that **central banks are always averse to engaging in monetary financing**—meaning using monetary instruments for fiscal purposes. A critical look at the design of this SDR-denominated instrument reveals that the purchase of this investment does not violate the prohibition on monetary financing requirements of central banks. Central banks, including those in Europe as well as the European Central Bank (ECB), have been involved purchasing national and supranational bonds, even hard currency denominated bonds as a form of financing easing without violating this requirement. This hybrid instrument is very similar. **But, in this case, the distance between the monetary tool and fiscal tools is even more pronounced because the SDRs are used for leveraging purposes, not for direct spending or on-lending purposes.** In addition, in 2009, the governing council of the ECB made provision for the European Investment Bank (EIB) to become a counterparty and have access to the ECB's standing facilities, which would facilitate the EIB's ability to accommodate additional demand for its lending programs. **If this is not considered a violation of the prohibition of monetary financing, then the very expanded view of how the SDR-denominated hybrid capital violates this provision can be reconsidered.**

Other issues of macro prudence have also been factored. The **credit quality of this hybrid instrument as designed is very high**, with a "negligibly low probability of being loss absorbing." The other issue is that when members use their SDRs, they are charged an interest. Although this amount is very negligible at 0.05 percent, no one wants to incur additional costs if they can avoid them. The hybrid capital proposal, however, has factored this in. Investment in the SDR-denominated hybrid capital instrument would yield the investor a return calculated based on the sum of the SDR interest rate and a spread. If the spread is zero, the **interest paid on the portion of the SDR allocation used to invest and the interest received from the SDR-denominated hybrid capital investment would net out**. However, the expectation is that this would be a net positive proportional to the agreed- upon spread.

Financial engineering and innovation are critical for the times that we are in for unlocking financing for development. Thinking creatively about the SDRs is one such innovation. There are other ways that we could think about SDRs that have not been put forward yet but could be considered for the future engineering of SDRs. First, as mentioned earlier in this piece, the current allocation represents 7.6 percent of global reserves; if this allocation could be increased to 10 percent of global reserves, we are talking about USD 1.2 trillion made available. Now consider this, we have a USD 4 trillion shortfall for financing for development. **If this USD 1.2 trillion could be made available to MDBs in full, MDBs would be able to leverage at least four times, unleashing a lending capacity of USD 4.8 trillion into the system.** This is not an additional charge on the exchequer; it is prudently and innovatively unleashing what is otherwise latent potential of the SDRs.

Finally, I would also like to hazard another, more political proposal. High-income countries made commitments to allocate 0.7 percent of their gross national income to official development assistance (ODA). Only four countries—Norway, Luxembourg, Sweden, and Denmark, in that order, have achieved this. The vast majority are off-track. **One proposal to meet this shortfall would be for countries to use some of their SDR allocations within a framework that is feasible**—such as the proposed hybrid capital or direct donations to low-income countries. This, again, is not a charge on the exchequer and is only utilizing what already exists that is not being utilized.

Conclusion and Recommendations

Innovatively thinking about how to unlock the full potential of SDRs represents one of the single biggest wins that can be achieved by the 4th Conference on Financing for Development (FfD4). The following four points emphasize the critical need to catalyze this potential:

1. **SDRs provide the opportunity to utilize a small fraction of global reserves to address the growing, complex, and life-threatening challenges of our time**. The current situation is akin to a family that has savings of USD 1 million but lacks food, warm clothes, and a roof that is leaking—during the dead of winter. It does not make sense. No one is saying we should squander global reserves. **But** we can utilize a small fraction to address urgent needs and invest in creating the capacity that will generate additional reserves through growth and development.
2. **SDRs rechanneling through the IMF is beneficial but limited, because in practice,** it is a dollar in and less than a dollar out. In the case of the hybrid instruments by MDBs, it is a dollar in, and four dollars out. At a time when we are seeing diminishing options for financing, any proposal that extracts more out of what is available is technically a big win. Donors should be jumping to use it.
3. The SDR allocation based on the current formula is **pro-cyclical rechanneling** through the IMF. The MDBs proposal allows for SDRs to be used counter-cyclically, thereby addressing the need for liquidity where it is most needed.
4. Lastly, **donors have decried their ever-tightening fiscal positions and increasing pressure from domestic constituencies to lean in on domestic priorities**. In this situation, we are seeing not only a shrinking of ODA but also, by extension, financing for development. The recent performance of the International Development Association 21st replenishment is further evidence of how constrained this environment is. SDRs may be the only additional money on the table in realistic terms. While it is technically new money, it does not have the same fiscal constraints because it is not a charge on the exchequer. Member states need to be clear about this. There are no silver bullets, but this may very well be it for this FfD4. The constraint is no longer a technical constraint, as has been argued in this paper. However, only a high-level political push can unlock the technical holdout.

Just as the neighborhood party, let's not forget why international cooperation exists and why the global financing safety net was established in the first place. It is not to allocate more liquidity options to those who already have a lot. **The global financial safety net exists to cushion those with critical, urgent needs—and ensure that by providing countries with liquidity options when needed, they can have a fair chance of actualizing their national development priorities.**