Reforming the interest rate system for special drawing rights to incentivize reallocation

Key messages

• The current dual interest rate system for special drawing rights (SDRs) provides little incentive for developed countries to reallocate their unused SDRs, because the developed countries will irrevocably lose their SDRs and the associated interest.

• Although there are obstacles to the reform of the interest rate system, such as the requirement that it be supported by 70 per cent of the total voting power of International Monetary Fund (IMF) members, the procedure for the reform is not as complicated as it is for other types of reform.

• IMF should consider the disaggregation of the interest rate system for SDRs to facilitate their use without causing disruption to other operations.

• Broad political consensus on rechannelling SDRs and increasing development financing is still needed to help developing countries to recover from recent shocks and achieve the Sustainable Development Goals.

Introduction

SDRs are an international reserve asset issued by IMF and allocated to its member countries to help to supplement their official reserves. IMF unconditionally allocates SDRs to all or some of its membership when it determines that there is a need to boost global liquidity. Since its creation in 1969, the SDR has been the unit of account of IMF and several other multilateral organizations, such as the African Development Bank.

SDRs are not money but are a reserve asset. They cannot be used to purchase anything but can be exchanged for freely usable currency. In addition, SDRs belong to individual countries, not to IMF. Any decision to reallocate or transfer SDRs must be made by the countries concerned. IMF plays no direct role, other than accounting, in any allocation that takes place between members. Furthermore, there is a cost for countries to use their allocated SDRs, which is the SDR interest rate.

Under its Articles of Agreement, IMF is entitled to proceed with allocations of SDRs when it determines that there is a long-term global need to supplement the official reserves of countries. An allocation of SDRs does not add to the public debt burden of any country. To date, nearly $1 trillion of SDRs have been allocated by IMF, including the unprecedented SDR 456 billion, which was equivalent to $650 billion, that were approved for allocation in August 2021 to help countries to cope with the impact of the coronavirus disease (COVID-19). On the basis of the current share of quotas held by African countries,¹ that allocation provided no more than SDR 33.3 billion, or just 5 per cent of the total allocation, in additional resources to Africa, which was barely adequate to meet the financing needs of the continent, as reported by the Economic

¹ Quotas are used by IMF to determine the financial resources a member must provide to IMF, its voting power, the loans it can obtain from IMF under normal access and its share of a general allocation of SDRs. They reflect the relative position of IMF members in the global economy and are a function of gross domestic product, openness and reserves.
Commission for Africa (ECA) in 2021. In comparison, the United States of America received $113 billion, or 17 per cent of the total allocation (African Development Bank, n.d.). Advanced countries with ample fiscal space hold large balances of SDRs that they do not actively use. Low-income and vulnerable countries with liquidity constraints, on the other hand, receive lower amounts of SDRs, which are far from enough to meet their financial needs.

Various discussions are currently focused on how to recycle SDRs and rechannel them to low-income countries, such as by realocating them to multilateral development banks and using them for onward lending through IMF facilities, such as the Poverty Reduction and Growth Trust and the Resilience and Sustainability Trust. Less attention is being paid, however, to a direct rechannelling mechanism, and to whether countries can transfer and trade SDRs among themselves, through IMF, which may be a more efficient way of directing resources to countries in need. IMF created the system of voluntary trading arrangements for SDRs in 1987, but very few African countries have participated in it, and there have been few voluntary donations of SDRs (Andrews, 2020). One of the main reasons for the underuse of the system lies in the current interest rate system for SDRs. IMF operates a dual interest rate system for SDRs, in which countries earn interest for holding SDRs and pay interest for using them. When countries reallocate their SDRs to other countries, they lose the SDRs and the associated interest. Recipient countries do not want to pay the interest that donor countries forego upon donation. The present policy brief is aimed at providing an overview of the current interest rate system for SDRs and provides recommendations for the reform of that system to encourage their use and rechannelling.

**Special-drawing-right interest rate**

The SDR interest rate provides the basis for calculating the interest charged to members on non-concessional IMF loans from the general resources of IMF, the interest paid to IMF members on their remunerated creditor positions in IMF, including reserve tranche positions and claims under borrowing agreements, the interest paid to members on their holdings of SDRs and the interest charged on their allocation of SDRs.

The SDR valuation basket currently includes five currencies, namely the United States dollar, the euro, the yuan, the yen and the pound sterling. The composition of the basket is subject to a review by the IMF Executive Board at least once a year.

### Special-drawing-right interest rate for the week from 22 May to 28 May 2023

<table>
<thead>
<tr>
<th>Currency unit</th>
<th>Currency amount under Rule O-1a (A)</th>
<th>Exchange rate against the SDR (B)</th>
<th>Interest rateb (C)</th>
<th>Product (A) x (B) x (C)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yuan</td>
<td>1.0993</td>
<td>0.106593</td>
<td>1.900300</td>
<td>0.2227</td>
</tr>
<tr>
<td>Euro</td>
<td>0.37379</td>
<td>0.80903</td>
<td>3.149725</td>
<td>0.9525</td>
</tr>
<tr>
<td>Yen</td>
<td>13.452</td>
<td>0.00541053</td>
<td>-0.171000</td>
<td>-0.0124</td>
</tr>
<tr>
<td>Pound sterling</td>
<td>0.080870</td>
<td>0.930369</td>
<td>4.605302</td>
<td>0.3465</td>
</tr>
<tr>
<td>United States dollar</td>
<td>0.57813</td>
<td>0.748547</td>
<td>5.270000</td>
<td>2.2806</td>
</tr>
</tbody>
</table>

| Total                       |                                    |                                   | 3.7899             |                       |
| Floorc                      |                                    |                                   | 0.050              |                       |
| SDR interest rate           |                                    |                                   | 3.790              |                       |


*a* Rule O-1 of the IMF By-Laws, Rules and Regulations provides that the value of SDR 1 shall be the sum of the values of 0.57813 United States dollars, 0.37379 euros, 1.0993 yuan, 13.452 yen and 0.080870 pounds sterling.

*b* The interest rate on the following financial instruments of each component currency in the valuation basket, expressed as an equivalent annual bond yield: three-month benchmark yield for Chinese treasury bonds, as published by China Central Depository and Clearing Co; three-month spot rate for euro area central government bonds with a rating of AA and above, published by the European Central Bank; three-month Japanese treasury discount bills; three-month British treasury bills; and three-month American treasury bills.

*c* Since 2014, IMF has set a floor on the rate that determines the interest it pays to creditor countries for lending money, and the cost for borrowing countries to access emergency IMF loans. IMF will pay lenders at least 0.05 per cent, even if the rates that comprise the benchmark become negative, as has happened in Japan and some eurozone countries.
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Reforming the interest rate system for special drawing rights to incentivize reallocation every five years. The SDR interest rate is the sum of the products of the currency amounts in the valuation basket, the interest rate on the financial instrument of each currency in the basket and the exchange rate for each currency against the SDR. An example of the calculation of the interest rate is shown in the table.

Until the first quarter of 2022, the SDR interest rate remained approximately at its floor level of 0.05 per cent per year, owing to low international interest rates. With the recent wave of rate increases, however, it has been revised upwards significantly, as shown in the figure.

The current SDR interest rate system is a dual system. The Special Drawing Rights Department of IMF pays interest on holdings of SDRs to each member and levies charges on allocations of SDRs against each member at the same rate (the SDR interest rate). Thus, an allocation of SDRs is cost-free because interest charges and earnings net to zero if a country does not use its allocation. The use of SDRs, however, is not cost-free. When using their SDRs, countries are charged the interest rate on the difference between their cumulative allocation and their remaining holding. As a result, when members use their SDRs in any way and their holdings drop below the level of their allocation, they must make interest payments to IMF. With an interest rate of 3.79 per cent, which is significantly higher than the floor rate, as shown in the table, countries will need to make interest payments in freely usable currency, which is likely to be in short supply for countries that are obliged to use their SDRs in the first place, to cover the difference between their allocation and their remaining holding.

When rechanneling SDRs, there is uncertainty under the current system about which country pays the interest costs. Conventionally, the end users of the SDRs, the low-income and middle-income countries, are penalized, because they must cover those interest costs. For example, if France gives SDR 20 million permanently to Côte d’Ivoire, France would be charged SDR 758,000 per year in interest, at the current interest rate, and Côte d’Ivoire would earn SDR 758,000 per year in interest. If France did not want to lose the interest, Côte d’Ivoire would be required to pay to France that interest cost. Furthermore, the annual cost continues in perpetuity. Donor countries, therefore, expect recipient countries to bear the interest cost.

Some countries choose to lend their SDRs instead of donating them. If countries lend their SDRs, the SDRs remain the asset of the lending country. As with any lending, SDRs may earn interest, but the lender incurs some risk of non-repayment. Donating SDRs to another country, on the other hand, is a permanent transfer, and the SDRs are no longer an asset of the donating country. For most countries, donations are a budgetary transfer, requiring the approval of parliament (Plant, 2021).

Since 1987, IMF has implemented its voluntary trading arrangement system, which is a bilateral arrangement between IMF and SDR participants, in which the members agree to buy and sell SDRs within certain limits. Cumulatively, between January 2017 and August 2022, SDR 34.1 billion were sold (IMF, 2022). Until recently, however, most countries that participated in the system were from Europe, Asia and the Pacific or the Western Hemisphere. The only African countries that have participated in the system are Algeria and Mauritius (IMF, 2022), which are upper-middle-income countries. No African low-income country has participated in the system. The burden of the SDR interest rate is one of the obstacles that hinders the participation of those countries. Instead of paying interest of 3.79 per cent from the trading

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**Special-drawing-right interest rate, 2000-2023 (Percentage)**

![Special-drawing-right interest rate, 2000-2023 (Percentage)](image)

of SDRs with other countries, it is cheaper to borrow from the Poverty Reduction and Growth Trust of IMF with zero interest or through facilities managed by other institutions at similarly lower interest rates.

The current interest rate system for SDRs is penalizing their use, in particular for low-income countries, which use SDRs more than other countries (ECA, 2023). According to ECA and the Economic Commission for Latin America and the Caribbean (2022), the countries of the Group of Seven use SDRs at an average rate of 5.90 per cent. The rate for European countries is 7.79 per cent, and for African countries it is 52.37 per cent. That sharp contrast represents the structural imbalance in the SDR system: developing countries, which have a smaller share of SDRs and need additional liquidity, use SDRs more and incur greater interest payments. In contrast, developed countries, which have larger shares of SDRs and fewer liquidity needs, typically entrust their SDRs to IMF, where they remain unused.

Recommendations

SDRs belong to individual countries, not to IMF. Any decision to reallocate or transfer them must be made by the countries concerned. There does not seem to be a global political consensus that there is an urgent need for wealthy countries and some middle-income countries with adequate reserves to transfer their unused SDRs to vulnerable countries (Plant, 2021), and the current SDR interest rate system provides little incentive for redistribution. The world must, therefore, now address the issue of establishing a mechanism to redistribute unused SDRs in a cost-free or cost-effective manner.

Although there are obstacles to the reform of the interest rate system, the procedure to achieve it is not as complicated as for other types of reform, such as that of the quota system. Reforming the quota system, for example, would require an amendment to the Articles of Agreement of IMF and the support of 85 per cent of total voting power.2 In accordance with section 3 of article XX of the Articles of Agreement, however, the SDR interest rate can be adjusted by a 70 per cent majority of total voting power. Critically, the current formula that underlies the SDR interest rate is not set out in the Articles of Agreement, and, thus, the Articles of Agreement does not need to be amended in order to reform the interest rate. There is merit, therefore, in prioritizing proposals for the reallocation of SDRs that can be implemented quickly (Paduano, 2022).

Discussions are ongoing regarding the replacement of the dual interest rate system with a single interest rate system, in which members pay a single interest rate for holding SDRs, in order to promote the use of SDRs, or the simple elimination of the interest rate completely. The SDR interest rate system has implications not only for allocations of SDRs, but also for IMF operations in general, given that SDRs are, in essence, reserve assets and not an unconditional subsidy. More importantly, if a single interest rate system is applied, the majority of the IMF membership will oppose the allocation of SDRs because of the associated interest cost. Given that the average rate at which SDRs are used by the countries of the Group of Seven is only 5.90 per cent (ECA and Economic Commission for Latin America and the Caribbean, 2022), which indicates that developed countries do not use much of their allocation, such countries will oppose the allocation of SDRs if it means that they would pay interest simply for holding SDRs. In addition, replacing the dual interest rates with a single interest rate would require a majority vote of 85 per cent, pursuant to the Articles of Agreement.

IMF should consider further methods to disaggregate the SDR interest rate system in ways that facilitate the use of SDRs without disrupting other IMF operations. For instance, under the current system, interest can be earned on holdings of SDRs. That interest rate could be lowered, however, if the SDRs are idle for a given length of time, such as for more than five years. There could be another incrementally decreasing interest rate mechanism that operates in parallel with the current, universal SDR interest rate system to promote the use of SDRs. For example, if the SDR interest rate is similar to the current rate of 3.79 per cent, SDRs that are not used for more than 5 years could attract the floor interest rate (0.05 per cent), and SDRs that are not used for more than 10 years could attract a zero interest rate. If any SDRs held by a country earn zero interest, the country would be encouraged either to use them or lend them onwards, which could earn interest.

The recent interest rate hikes by central banks around the world have led to an increase in the SDR interest rate, which is resulting in higher interest charges on IMF loans from the General Resources Account and the Resilience
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and Sustainability Trust. IMF should consider capping the SDR interest rate for lending from the Resilience and Sustainability Trust, in particular for low-income countries (ECA, 2023). The Resilience and Sustainability Trust has a tiered interest-rate structure, but even Group A countries, the most vulnerable low-income countries, will now pay more than 4 per cent in interest on loans from that Trust. IMF has already proposed a cap of 2.25 per cent on interest for Group A countries accessing the Trust, but the proposal is still awaiting approval (IMF, 2023). That interest cap should be applied immediately, given the current elevated level of interest rates globally. IMF could also consider an interest rate cap for Group B countries, which would extend support to middle-income countries.\(^3\)

IMF must promote transparency in the SDR market so that the public, policymakers and other stakeholders can hold countries accountable for their pledges to rechannel SDRs to help beneficiary countries access much needed funds (ECA, 2022). IMF could also consider a special allocation of SDRs to all low-income countries to help to address the problems caused by the accumulation of debt in response to economic shocks.

In conclusion, rechannelling some $1 trillion of idle SDRs for development purposes is a fiscal and sovereign decision that must be made by countries, and fiscal decisions are closely integrated into political processes. IMF should explore options to facilitate the mobilization of unused SDRs. More important, however, a broader political consensus needs to be built to increase development financing, which should not be limited to SDRs.

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\(^3\) Group A countries are eligible to access loans from the Poverty Reduction and Growth Trust at a 55-basis-point margin. In addition, they pay no service charges on top of the SDR interest rate for borrowing from the Resilience and Sustainability Trust.

\(^4\) Group B countries are not eligible for loans from the Poverty Reduction and Growth Trust and have a per capita gross national income of less than 10 times the operational cut-off for eligibility for support from the International Development Association.
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References


International Monetary Fund (2021). Questions and answers on special drawing rights. 23 August.


