Global liquidity for global development

Official development assistance declined in real terms in 2011 as a result, in part, of fiscal austerity in many donor countries. Traditional forms of funding have fallen well short of needs to finance achievement of the Millennium Development Goals, climate protection programmes and other global public goods. In the search for alternatives, there has been a reassessment of the option of using international liquidity for global development purposes.

The International Monetary Fund (IMF) was empowered in 1969 to create international liquidity for its member countries through issuance of a special multilateral asset called the special drawing right (SDR), and has done so thus far on three occasions (1970-72, 1979-81 and 2009). SDRs account for only 4 per cent of global official (non-gold) reserves, leaving much room to increase SDR allocations. Even significant increases would have minimal impact on global financial flows, while – if properly designed – they could provide substantial additional buffers of international liquidity and development finance for developing countries.

As discussed in the United Nations *World Economic and Social Survey (WESS) 2012: In Search of New Development Finance*, annual issuance of additional SDRs and/or leveraging existing idle SDRs could yield at least $100 billion annually for development and global public goods. Such proposals have been made in the past, but have encountered political obstacles. In the light of the sustainable development challenge, the time has come to give more serious consideration to this option.

Two ways in which SDRs could finance international cooperation

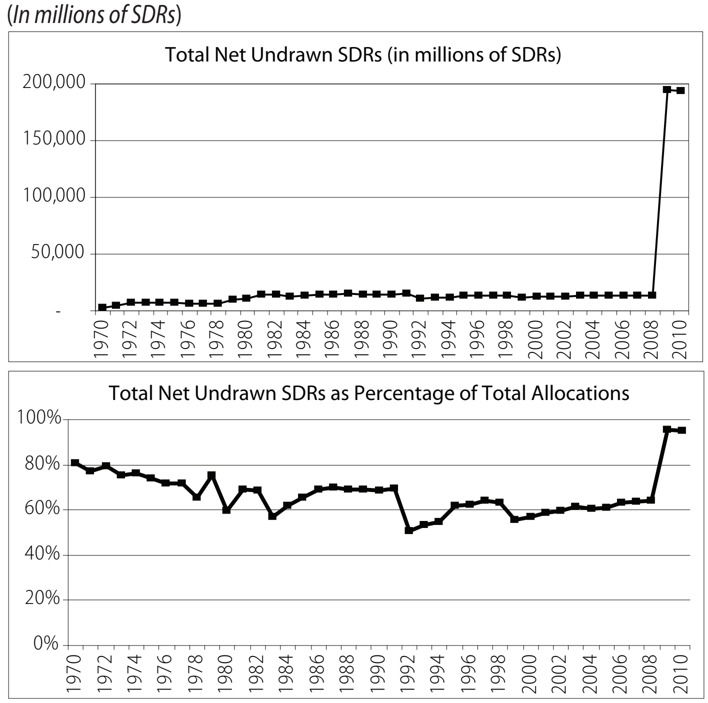
There are two types of proposals for using SDRs for development purposes presented in the Survey. The first is based on new annual issues, with the SDR allocations biased or 'tilted' toward developing countries. The second leverages developed country allocations for development financing by floating bonds backed by SDRs, rather than by spending the SDRs directly.

A. New SDR issuance favouring developing countries

This mechanism entails changing the existing formula to skew allocation in favour of developing countries, along with regular issuance of SDRs. Developing countries would obtain more international liquidity, reducing the need for their own efforts to set aside foreign-exchange earnings in reserve holdings to provide a buffer against global market shocks. Additional SDR allocations form a good alternative to borrowing on international markets or to running balance of payments surpluses to buy reserve assets such as United States Treasury bonds.

Under the current formula, which is based on the existing distribution of "quotas" (contributions and votes) in the IMF, about 60 per cent of newly issued SDRs would be allocated to developed countries, 3 per cent would accrue to low-income countries, and 2 per cent to the least developed countries. If the IMF were to each year issue, say, between SDR150 billion and SDR250 billion (about $240 billion–$400 billion) under a revised formula that would allocate, say, two thirds of the newly issued SDRs to developing countries, these countries would receive between $160 billion and $270 billion in additional reserves annually. The proposed additional collective insurance would reduce the need for developing countries to accu-

Figure: Total net unused SDRs , 1970-2011
(*In millions of SDRs*)



Source: International Financial Statistics, the IMF.

mulate reserves from their own resources, thus potentially freeing up space for enhanced developmental investments.

Note that while this mechanism should help increase global stability, it only indirectly contributes to enhancing existing pools of development finance.

B. Leveraging 'idle' SDRs of developed countries

An alternative, more direct, channel would leverage the "idle" SDR allocations held by developed and emerging economies with abundant official reserves. As shown in the figure, 'idle' SDRs jumped from approximately SDR13 billion to almost SDR200 billion ($320 billion) after the issuance of SDR250 billion in 2009.

One proposed option is to use 'idle' SDRs to buy bonds from multilateral development banks, enhancing the banks' lending capacity for investments in development and global public goods, such as climate change mitigation and adaptation. Using a conservative estimate, around $150 billion of existing idle reserves could be utilized to purchase bonds. If combined with new allocations of between 150 billion and 250 billion in SDRs every year, amounts in that order may be usable for financing long-term development on an annual basis.

It should be noted that this "development link" does not require asymmetric issuance. Instead, the resources available for development finance would be derived from unused SDRs allocated to developed and some emerging economies.

An alternative would be to create "trust funds" to leverage SDRs. In this proposal, $100 billion in "SDR equity" could be used to back issuance of $1 trillion in bonds, using a leverage ratio of 10 to 1. Assuming 10-year maturity, this would provide $100 billion for development financing per year. This could, for instance, meet the initially agreed needs for climate financing for the "Green Climate Fund". The Fund could collect market-based interest payments from at least some borrowers, which it would then use to pay its bondholders. As low-income countries might not be able to afford such loans, the Fund would also receive additional annual contributions from donors to enable it to underwrite its concessional activities. Because of the relatively high leverage ratio, this proposal would require less frequent (or smaller) issuance of SDRs.

A high leverage ratio, however, exposes bond holders to greater risk, thus raising the cost of borrowing. An additional argument against the use of such leverage is that it breaches the original purpose of SDRs, which were created solely for transactions of a purely monetary nature. Leveraging SDRs in such a way as to expose their holders to risks of illiquidity distorts the purpose for which they were created. The viability of the proposal thus depends on how much risk would be involved, and on designing the financial instrument for leveraging SDRs carefully enough to maintain its function as a reserve mechanism. For example, if considered too high, the leverage ratio could be set lower and greater SDR issuance could be considered. The risks are further limited to the extent that the proposal is restricted to using "idle" SDRs, which is similar to the existing practice of a fair number of countries of moving excess foreign currency reserves into sovereign wealth funds.

The way forward

Traditional mechanisms of official assistance are falling well short of what is required for development and global needs, such as addressing climate change. The international community must recognize that it is in the common interest to provide stable and contractual resources for these purposes. Politically, tapping revenue from global resources is difficult. In particular, new issuance of SDRs has proven to be a tall order, attested by the lack of SDR issuance for almost three decades. The latest special allocation, although already agreed in 1997, did not pass the United States Congress until 2009, when it was ratified as part of the Group of Twenty (G20) responses to the global financial crisis.

Changing the SDR allocation formula would also be a major political undertaking. It would require amendment to the IMF Articles of Agreement, which in turn requires approval from 85 per cent of member votes implying, for example, that the United States, which holds over 16 per cent of the votes, would have to give its approval. But like all political decisions taken for the next generation, this should be assessed carefully against alternative scenarios, including the very dangerous one of not confronting global challenges.

The proposed forms of SDR issuance and leveraging for development purposes are technically feasible and make economic sense both from the perspective of improving the global reserve system that is based more on collective than individual country insurance against balance of payments risks, and from the perspective of dealing with urgent development and global public objectives. They deserve serious consideration.

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