NR 7 2020

16 September

Economic Commentary

SVERIGES RIKSBANK

Special Drawing Rights – the role as a global reserve asset, the Riksbank's experience and the way forward

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Special Drawing Rights (SDR) are international reserve assets created by the IMF. SDRs constitute a *potential* claim on member states' foreign exchange reserves. SDRs are not, however, an actual currency.

SDRs are issued to IMF member countries in proportion to their quota shares in the IMF. Sweden's current allocation is SDR 2.25 billion, corresponding to SEK 30 billion at the current exchange rate.

A trading agreement for the exchange of SDRs to conventional currencies forms the basis of the SDR system, which makes access to SDR particularly important for countries whose own currencies may not be viable on the FX market.

Since 2004, the Riksbank's commitment to exchange SDRs has resulted in a marginal net inflow of foreign currency to the FX reserves, which is expected to balance out over time.

The Special Drawing Right (SDR) was originally created out of the need for a neutral reserve currency following the Second World War. The intention was to increase liquidity in the global financial system and thereby support international trade. Its role as a global reserve asset has remained limited, however, despite repeated initiatives and attempted reforms to increase its relevance and usability. In conjunction with the coronavirus pandemic, the SDR has once again come into focus with a discussion on whether a new allocation of SDR could contribute to global financial stability. With more SDRs, countries that do not have access to liquidity from other sources would be able to obtain foreign currency – above all US dollars. However, the lack of surveillance and conditionality in SDR trading makes it difficult to understand how this money is used. This is important to the Riksbank, since an expansion of the system could lead to an increase in SDR trading. If the role of the SDR is expanded, as is often proposed, the SDR system will have to be strengthened and its risks openly discussed and tackled.

Mentioning the SDR outside the narrow circle dealing with it on a daily basis would likely provoke a puzzled response. Even at the Riksbank, we can talk about the SDR and refer to different things. Many people think that the SDR is merely a unit of account used to facilitate bookkeeping for certain international organisations, but a closer look reveals a complex system that is constantly developing and whose boundaries are continuously being reassessed.

The use of SDR is based on the International Monetary Fund (IMF) approving the mutual exchange of SDRs for different currencies among member countries. This takes place via voluntary trading arrangements in which 32 countries participate, including Sweden via the Riksbank. SDR trading provides an opportunity for smaller countries, which may otherwise find it difficult to gain access to foreign currency on the regular market, to obtain currency, a mechanism which may be particularly useful in times of crisis. SDR trading takes place outside the IMF's regular lending and thus without requirements for economic reform.

The last time the Riksbank wrote an article on the SDR system was in 2003, when Anna-Karin Nedersjö provided a thorough review of how the SDR was created. This economic commentary builds on that analysis by examining how the SDR is used in practice. As there is currently a renewed discussion of a possible new allocation of SDRs, we hope to bring light on the SDR system by looking at the SDR trading system that the Riksbank participates. We also want to discuss the reasons for why the role of the SDR as a global reserve asset has remained limited and why it has been so difficult to reform the system.

We would like to thank Åsa Ekelund, Susanna Engdahl and Björn Segendorff for their constructive comments and suggestions.

The historical role of the IMF in the global financial system

The IMF was created after the Second World War in conjunction with the establishment of the Bretton Woods system and was given a central role with the task of maintaining the system of stable exchange rates. This, in turn, aimed at promoting reconstruction after the war by contributing to increased trade among countries and thereby enabling higher and more sustainable economic growth.[1]

The IMF was originally organised as a cooperative bank, where the member countries contributed with capital, known as quotas, in proportion to their share and voting rights in the organisation. As the United States was the largest economy in the Bretton-Woods system and the currencies of other countries were determined in relation to the US dollar, the dollar was also the primary means of payment for international transactions, which strengthened its role as an international reserve currency. At that time, the United States guaranteed the value of the dollar in gold, what was known as the gold standard, and other currencies were pegged to it. The exchange rate was determined by each country's central bank in agreement with the IMF. This meant that global credit growth was linked to the availability of US dollars and confidence in the convertibility of dollars to gold..

Need for a neutral reserve currency

The prevailing system of fixed exchange rates against the dollar proved unstable. Rapid growth in international trade, the dollar's position as a global reserve currency, and fixed exchange rates combined with the fact that the countries in Western Europe wanted to hold larger dollar reserves - resulted in an increasingly vulnerable global financial system.[2] Demand for a neutral reserve asset therefore emerged during the 1960s. It was in this context that the idea of special drawing rights (SDR), a global reserve asset administered by the IMF, arose. The SDR was created to meet the global economy's growing need for liquidity and at the same time reduce dependence on the US dollar. The first amendment to the IMF's Articles of Agreement in 1969 gave the organisation the right to create SDRs to meet potential liquidity needs and supplement existing global reserve assets.[3]

What are special drawing rights?

The concept of Special Drawing Rights (SDR) is, if you look closer, an overarching term covering three different concepts: the official SDR (O-SDR), the market SDR (M-SDR) and the SDR as a unit of account (U-SDR). Here we focus primarily on the O-SDR (which we refer to as "SDR" in the remainder of this article), but we will also briefly discuss the two other functions and their respective roles in the global financial system.

[1] See Segendorff and Srejber (2006), among others.
[2] As early as 1961, Robert Triffin pointed outto the US Congress that a country whose currency is used as primary global reserve currency must also be able to provide liquidity to the global financial system. This results in a current account deficit which in turn leads to the value of this currency being undermined.
[3] For a detailed description of the creation of SDRs, we refer to Nedersjö (2003) - Särskilda dragningsrätter – ett smörjmedel.

TABELL 1. SPECIAL DRAWING RIGHTS (SDR)

	Official SDR (O-SDR)	Market SDR (M-SDR)	Unit of Account (U-SDR)
MOTIVE	Created in 1969 to supplement global currency reserves. Ten years later the IMF:s Articles of Agreement were amended to specify that the role of the SDR was to become the primary reserve asset in the global financial system. As the system of fixed exchange rates was abandoned shortly after, the need for a neutral reserve asset declined, and the role of the SDR as reserve asset remained limited.	Financial instruments denominated in SDR. These are not issued by the IMF and have no connection to the SDR trading system.	The unit of account whereby the value of an SDR is calculated as a weighted average of the value of the most used international currencies, the so-called SDR basket (see below).
USE	Used by IMF members and other institutions (prescribed holders), cannot be held by private market participants.	Can be issued by state or private market participants.	The U-SDR is used by a number of international organisations and can be used as a benchmark for a country's fixed exchange rate[4].

It is worth remembering with regard to the SDR that it is neither a currency in itself nor a claim on the IMF. Its role as a reserve asset is based on the formal commitments of member countries to exchange SDR for foreign currency, primarily dollars and euro. This is done via voluntary trading arrangements (VTA) between the IMF and a number of member countries. Apart from the VTA, there is also a so called *designation mechanism* that guarantees countries in need of liquidity the possibility to exchange their SDRs for foreign currency (see Figure 1). Since it is not possible to use SDRs in the real economy, countries wishing to use their SDRs for a purpose other than IMF transactions, would have to exchange their SDRs using use the IMF's trading arrangements. In this way, the SDR represents a *potential* claim on the foreign exchange reserves of member countries, especially US dollars and euros, but there is no collateral – such as gold – as a base for the SDR.

[4] At present, Libya has a fixed exchange rate pegged to the SDR and Botswana sets its exchange rate in relation to a currency basket consisting of SDRs (55%) and South African Rand (45%).

IMF member countries are allocated SDRs in proportion to their quotas in the IMF[5]. This means that larger open economies receive the most and smaller less economically integrated countries less SDRs. An allocation of SDRs increases the size of the central bank's balance sheet, as they supplement the central bank's reserve assets and are reported as both a liability and an asset.

The first allocations were made in the early 1970s. The value of the SDR was then linked to gold, in that one SDR corresponded to one US dollar. When the convertibility of US dollars to gold was no longer possible to uphold, the link between the SDR and gold also disappeared. The gradual introduction of floating exchange rates reduced the dependence of central banks on the IMF, which had played a central role when setting the fixed exchange rates against the US dollar.

In 1974, the IMF started to value the SDR in the most important currencies in global transactions, instead of in gold. As the foreign exchange market was liberalised, industrialised countries had less need of the IMF to gain access to foreign currencies[6] and in 1978 an amendment to the Articles of Agreement was adopted, intended to strengthen the role of the SDR as a global reserve currency. However, on an increasingly free foreign exchange market, the SDR's share of global reserves remained limited. The SDR has since become the unit of account (U-SDR) used by the IMF in all of its accounting and for a large share of its transactions. While most loan disbursements take place in US dollars or euros, they are denominated in SDR, and a recipient country can always request payment in SDRs.

Figur 1 SDR DESIGNATION

If a country wishing to trade SDRs cannot find a counterparty through the VTA, the IMF's Articles of Agreement require that one or more countries buy or sell SDRs – known as the designation mechanism. It is then necessary, contrary to the case of voluntary exchanges under the trading arrangements, for the country in question to show that it does not have access to financing for international payments (a balance of payments need). There also needs to be another IMF member with sufficiently strong reserves to manage the exchange. If the IMF requires a designation from the Riksbank, it entails an SDR exchange of a maximum of 300 percent of the Riksbank's allocation, which corresponds to just over SDR 6.75 billion. It should be noted, however, that the IMF has not used the designation mechanism since the voluntary market was established in the late 1980s. The last time a designation was used was when Sweden, together with Austria, Denmark and the Netherlands, was required to sell SDRs to Mexico during the financial crisis in 1987 to a value of SDR 12.5 million.

Valuation and interest

Up until 1980, the value of the SDR was determined based on the 16 most used currencies among IMF members, including the Swedish krona[7]. The system was then simplified to a basket of currencies based on the currencies of the five member states with the largest exports during the previous five-year period. The values of the currencies in the basket are weighted to reflect their relative share of world trade and the global financial system and they are reviewed every five years[8]. Following the introduction of the euro in 1999, the currency basket consisted for a time of four currencies, until the review in 2015, when the

[5] The capital shares, known as quotas, are the capital that all IMF member countries contribute in proportion to, among other things, the size of the country's economy and financial sector, its participation in international trade and the size of its international reserves. The quotas also regulate the countries' influence within the IMF.

[6] One exception was the United Kingdom, which was forced to borrow SDR 4 billion from the IMF in 1976. At that time, this was the largest loan from the IMF and was taken to defend the value of pound sterling against the US dollar.

[7] See Boughton, Silent Revolution: The IMF 1979–1989 (2001)

[8] The way the SDR is constructed, it shares many characteristics with so-called stable coins (i.e. digital currencies backed by conventional currencies). One important difference, however, is that the value of the SDR is based on existing currencies, while the value of stable coins can be backed by other assets or algorithms governing the volume of a particular stable coin. Libra, which has been proposed by Facebook, is an example of a stable coin backed up by currency. Nevertheless, during the Libra wave there were also advocates for letting the SDR become a global digital currency, an idea of a so-called e-SDR that sometimes arises in the debate (see, for instance, Sheng & Geng in World Economic Forum 2018).

Chinese renminbi was included. China's share of global exports had then increased substantially, and the renminbi had become the fifth largest currency in global transactions. However, there was much debate preceding the inclusion of the renminbi, as China's capital controls were not considered compatible with one of the criteria for currencies in the SDR basket, namely that it should be freely usable[9].

One SDR currently corresponds to the weighted value of five currencies: US dollar (42%), euro (31%), Chinese renminbi (11%), Japanese yen (8%) and pound sterling (8%)[10]. This is what makes up the SDR basket. The exchange rate against the Swedish krona is updated daily and one SDR currently corresponds to 12,2 Swedish krona.

SDR trading also entails interest rate, which is received or paid on holdings that exceed or are less than the SDR allocation of member countries[11]. In this way, countries using SDRs to exchange reserve currency pay compensation to the countries supplying the currency. The so-called SDR interest rate is set weekly and is based on a weighted average of interest rates on short-term government debt instruments in the money markets of the SDR basket currencies, with a floor of 0.05 per cent. The interest rate is in this way linked to the SDR basket and used as a component to set the interest rate on the IMF's regular lending. When a review of the SDR is made every five years, it includes a review of which financial instruments are to be used as a base for the interest rate.

SDR as a global reserve currency and the creation of new SDRs

The SDR was originally intended to function as a global reserve currency, which would facilitate access to liquidity in foreign currency and support international trade. It is prescribed in the IMF Articles of Agreement that an allocation of SDR may only be made if it meets a long-term need for global liquidity[12]. The allocations shall also be made "in such a manner as will promote the attainment of [IMFs] purposes and will avoid economic stagnation and deflation as well as excess demand and inflation". Assuming that member countries use their allocations of SDRs responsibly, these are not considered to result in higher inflation[13].

According to the IMF Articles of Agreement, a discussion regarding a possible new SDR allocation shall be held every five years. This can be compared to how a central bank increases the money supply in its financial system, with the difference being that the aim of SDR allocations is to supplement the need for reserves in the global financial system. Up to now, only three general SDR allocations have been made. A general allocation means that all member countries receive SDRs in proportion to their quota share. After the first SDR allocation in the early 1970s, an additional general allocation was made in 1978-81. This resulted in countries joining the fund after 1981 having a proportionately smaller SDR allocation. A special allocation for new member countries was therefore decided in 1997, but could not be implemented until 2009[14]. The idea behind the special allocation was to make

[9] For a currency to be determined "freely usable" by the IMF, it has to be widely used to make payments for international transactions and widely traded in the principal exchange markets. Freely usable currencies can be used in Fund financial transactions.

[10] An SDR corresponds to around twelve Swedish kronor, for the current exchange rate, see the Riksbank's website.

[11] When the Riksbank's SDR holdings is above the allocation (that is, other countries have sold SDRs and the Riksbank has paid them in foreign currency), the Riksbank receives interest on the difference. The floor for the interest rate is currently 0.05 percent.

[12] Articles of Agreement, Article XVIII

[13] The IMF's assumption is that countries will not use their SDR to finance a higher budget deficit and that the central banks whose currencies are exchanged will not implement irresponsibly expansionary monetary policy. In this case, the SDR allocations are not considered to lead to higher inflation in the long run, see further IMF (2018) and Chito (2016).

[14] An amendment to the IMF Articles of Agreement was required to be able to implement the special allocation. Negotiations continued until September 2009.

the countries more equal with regard to their holdings of SDRs, not least as many countries in the former Soviet Union joined the IMF in the 1990s[15].

During the global financial crisis in 2008 the discussion began anew on the need for an SDR allocation to supply the financial system with liquidity at a global level. China, for example, advocated that the SDR should replace the US dollar as the global reserve currency. This provoked discussions in the United States with regard to the role of the US dollar as international reserve currency and whether an SDR allocation could reduce the need for dollars in the global economy[16]. When the financial crisis worsened at the end of 2007, the Federal Reserve offered a number of central banks the opportunity to lend dollars by entering into swap agreements.[17] The group of central bank counterparties and use of the swap agreements were then extended in 2008. However, a third general SDR allocation was finally approved in August 2009, to assist countries without access to swap agreements with liquidity.

Prior to the global financial crisis, there were SDR 21.4 billion in the global financial system, and the two new allocations resulted in a more than tenfold increase in SDRs to SDR 204 billion. New IMF member countries, that had joined after the last allocation, therefore gained access to SDRs in 2009, and almost 30 per cent of low-income and emerging market economies used at least 75 percent of their allocation to obtain currency[18].

After the allocation in 2009, the SDRs' share of the global official currency reserves increased from 0.5 to 4.3 per cent, but has since fallen to around 2 per cent in the context of a general increase in countries' reserves (annex, Diagram 3).

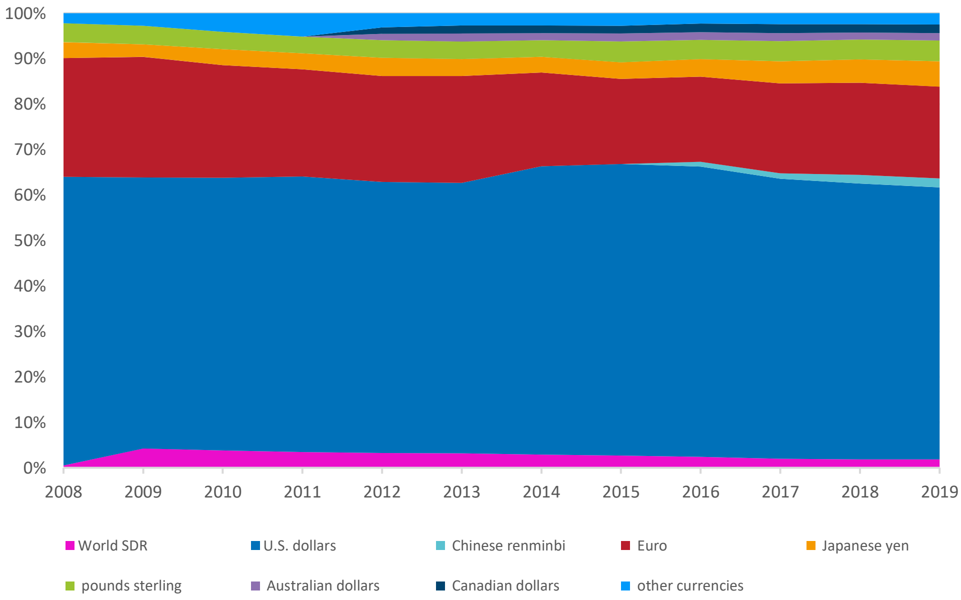
[15] Sweden and other Nordic countries also used their SDR reserves to help the Baltic countries join the IMF, by offering them intraday loans in SDR for their quota payments.

[16] *Geithner Dollar Remarks Create Panic* (2009) Atlantic Council

[17] A swap agreement involves a central bank offering its currency against collateral in another currency for a set period. There is no currency risk as the central banks exchange the currencies back at the same rate that applied at the beginning of the period. Typical examples of FX swap agreements are the Federal Reserve's standing agreement with the ECB, Bank of England, Bank of Japan and the Swiss National Bank, or its temporary agreements with, for example, the Riksbank during the coronavirus pandemic, in order to supply liquidity in US dollars. The Riksbank has also utilised FX swaps with other countries, for example during the financial crisis that broke out in 2008, when the Riksbank entered into swap agreements with Estonia, Iceland and Latvia, see also Leung (2019).

[18] IMF Financial Operations 2018, p. 91 and Role of the SDR 2018, p. 22.

Diagram 1. **Currency composition global official FX reserves (percent of total)**
Source: IMF data on composition of global official FX reserves (COFER, IMF) and data on total SDR supply



The discussion of SDR as a global reserve currency tends to be revived in situations with global liquidity stress, most recently in the onset of the corona pandemic. The low interest rate environment in recent years has led to increased capital flows to emerging market economies with higher return on investment. In spring 2020, uncertainty over the financial consequences of the corona pandemic initially led to major fluctuations on the financial markets. Fewer participants were prepared to take on risk and this resulted in large outflows of capital from emerging markets[19]. Capital outflows are particularly relevant for the IMF, as they affect countries' balance of payments – and a balance of payments need is a requirement to receive financing via the IMF.

Already at the beginning of the coronavirus pandemic, it was argued that an SDR allocation of USD 500 billion would be an effective means of injecting liquidity into the world economy, and supporting vulnerable countries with liquidity, as was done during the financial crisis in 2009[20]. International support for this proposal was expressed in an article in the Financial Times, signed by 18 global leaders, including those in Germany and France, the European Commission and leaders of several low-income countries[21]. The proposal has not been taken further, however, as the United States signalled during to the IMF Spring Meetings in 2020 that it would oppose a new allocation[22].

[19] Global Financial Stability Report, Chapter 1 and 3, IMF, April 2020
[20] Collins and Truman, IMF's special drawing rights (2020)
[21] Only victory in Africa can end the pandemic everywhere, Opinion Africa, Financial Times, 14 April, 2020
[22] The United States opposed the proposal as SDRs would primarily be allocated to larger economies (in relation to their quotas in the IMF), see further U.S. Treasury Secretary Steven T. Mnuchin's Joint IMFC and Development Committee Statement, April 2020, US Department of Treasury, Press Release. This statement ignored the alternative proposal that would have entailed low-income countries receiving a special, so-called targeted SDR allocation. However, others involved in the debate pointed out that a targeted allocation would not be compatible with the role of the SDR supplementing global reserves, i.e. that allocations should follow developments in global reserves.

The role of the SDR in the global financial system

Use of the official SDR is based on IMF Articles of Agreement that approve the exchange of SDRs for various foreign currencies both among member countries, as well as among a number of international organisations approved as prescribed holders of SDR. The IMF itself cannot participate in SDR trading but the SDR can be used for a number of different purposes such as loan disbursements or repayments to the IMF, interest payments and quota payments[23].

The voluntary trading arrangements and commitment to exchange SDRs

As SDRs cannot be used in the real economy, countries that need foreign currency can use their SDRs to obtain the currencies represented in the currency basket, i.e. US dollars, euros, Chinese renminbi, Japanese yen and pound sterling. These countries then turn to the IMF, which matches the trade request with a counterparty.

During the first ten years of the SDR system, the IMF coordinated the SDR trades of member countries without a formalised system. To ensure that the market functioned well, a system for SDR exchanges via voluntary trading arrangements, VTA, was gradually established in the 1980s. The central banks of Austria and Belgium were the first to enter into two-way agreements for SDR-trade, i.e. to both buy and sell SDR in exchange for central bank reserves in 1986. The following year the Riksbank became a member of the VTA along with Norway, Finland and Denmark. Sweden's view was that the system would improve liquidity in the global economy and hence promote stability as well as support international trade.

More countries signed up in the following years and before the outbreak of the global financial crisis in 2008, 13 countries participated in the VTA. In response to the financial crisis and to the allocations made at the time, the number of members increased further to its present number of 32 countries, including the United States and several emerging economies, including China.

The total trading volume currently available via VTAs is SDR 72 billion for the purchase of SDRs and 34 billion for the sale of SDRs (acquisition of currency)[24] This can be compared to SDR 715 billion in the IMF's total loaning capacity.

As we mentioned earlier, a designation can also be made in addition to the exchanges made within the VTA. Every autumn, the size of any designation and the countries potentially affected are communicated in a so-called designation plan. The total designation amount is currently SDR 3 billion, SDR exchanges that then are divided among 18 countries. Under the latest plan, which applies until September 2020, the Riksbank has not been designated any additional trade. It is also possible for countries to buy and sell SDRs bilaterally without the involvement of the IMF. This trading often involves only small amounts but is not unusual. Since 2014, a total of SDR 3.6 billion has been exchanged outside the VTA[25].

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[23] Although most payments take place in conventional currencies, the recipient country can always ask for a payment in SDRs. This can be advantageous if, for example, the country wishes to change one part of the disbursement into USD and another into EUR, depending on the country's specific requirements.

[24] Annual Update on SDR Trading Operations and the SDR Designation Plan for the Period October 2019–September 2020 (2019) p. 3, IMF

[25] Annual Update on SDR Trading Operations and the SDR Designation Plan for the Period October 2019–September 2020 (2019) p. 8, IMF

Being part of the VTA involves a commitment to exchange SDRs (both in and out, at the request of the IMF) – The Riksbank's arrangement involves the exchange of US dollars and euros[26]. Countries wishing to exchange their SDRs for foreign currency, or vice versa, contact the IMF, which then acts as an intermediary and coordinating party. The IMF contacts one or more participants in the VTA, who then accept the requested amount of SDR and disburse the requested currency from their foreign exchange reserves. The same procedure applies when a country wishes to obtain SDRs – for example in order to make payments to the IMF or to accumulate SDR to sell at a later date to meet an expected foreign currency need. In this case, the counterparty (the Riksbank, for example) is asked to accept foreign currency in exchange for a reduction in its SDR holdings. Members in the VTA receive interest on the SDR holdings that are in excess of their allocation and pay interest when their SDR holdings are below the allocation. The actual cost of the SDR trade is therefore the difference between the investment return on the US dollars or euros in the foreign exchange reserves, and the SDR interest rate.

SDR trading is similar to a swap agreement between central banks[27], although without specifying in advance which of the five currencies in the SDR basket are to be traded. Neither is there a requirement to provide collateral, making the system very useful in times of crisis. Furthermore, the SDR is available to all IMF member countries, in contrast to, for example, the Federal Reserve's swap agreements, which are, or are made, available in times of crisis for a limited number of central banks. These swap agreements mitigate stress on dollar markets and limit the impact on domestic borrowing costs in the United States[28]. Smaller countries, which may themselves have a large domestic demand for US dollars, but whose financial sectors are not systemically important, risk being without insurance if the cost of US dollar liquidity increases in a crisis. For these countries, the SDR system offers an opportunity to acquire foreign currency even in times of crisis.

The use of SDR today is still very much linked to member countries' transactions with the IMF. It is primarily low-income countries that initiate SDR trading – often to diversify or build up their foreign reserves in connection with difficulties in funding their international payments, while countries with access to capital markets, or that that have standing swap agreements with the Federal Reserve, often choose not to initiate trade in SDRs (other than in event of payments made to the IMF). As the IMF itself does not participate in the trading arrangements, it uses the Bank for International Settlements (BIS) as an intermediary if they need to exchange SDR for loan disbursements to program countries. This means that the Riksbank sometimes receives requests for larger SDR exchanges with BIS, to be distributed among several program countries. For low-income countries, SDR trading also means that they can acquire foreign currency at a more stable exchange rate than they otherwise could have on the FX market. There is no public information on how individual countries use the

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[26] The original agreement on voluntary arrangements are from November 1987 and included a commitment to trade SDRs within an interval from SDR 200 to SDR 300 million. The agreement also limited trade to transactions between SDRs and US dollars. In February 2000, the Riksbank agreed to reduce the lower interval limit to SDR 100 million and in August 2002, the arrangements were extended to include transactions between SDRs and euros (EUR). The interval limits were later increased in conjunction with the SDR allocation made during the financial crisis in 2009. The Riksbank currently has a commitment to trade SDRs within an interval of 50–150 percent of the allocation, which means that the Riksbank can be asked to buy a maximum of SDR 1.13 billion.

[27] A swap agreement involves a central bank offering its currency against collateral in another currency for a set period. There is no currency risk as the central banks exchange the currencies back at the same rate that applied at the beginning of the period. Typical examples of FX swap agreements are the Federal Reserve's standing agreement with the ECB, Bank of England, Bank of Japan and the Swiss National Bank, or its temporary agreements with, for example, the Riksbank during the coronavirus pandemic, in order to supply liquidity in US dollars. The Riksbank has also utilised FX swaps with other countries, for example during the financial crisis that broke out in 2008, when the Riksbank entered into swap agreements with Estonia, Iceland and Latvia, see also Leung (2019).

[28] Federal Reserve (2020)

SDRs that are exchanged via the trading arrangements, this would, however, be an interesting subject for further analysis[29].

The SDR trade falls outside the IMF conditionality

A country that wishes to utilise the IMF's regular lending facilities must be able to show that it does not have the means to finance its international payments, in IMF lingo "to have a balance of payments need". The country must also fulfil predetermined conditionality designed to resolve balance of payments problems, and ensure that national measures do not exacerbate the situation and jeopardise the return to sustainable growth. The conditionality is also set to ensure that the country can repay the IMF and other creditors. It is the country's authorities, in collaboration with IMF staff, that design the conditionality prior to the programme being approved by the IMF Executive Board. As the programme progresses, the Board approves further disbursements, provided that the country implements the agreed reforms. These reviews ensure that the country is fulfilling the conditions set at the beginning of the programme.[30]

According to the IMF's Articles of Agreement, countries that initiate SDR-sales are expected to have an underlying balance of payments need, although this is not a requirement in contrast to regular lending. The Articles do not allow SDR exchanges purely for the sake of adjusting the composition of the country's foreign exchange reserves or direct financing of the government budget. The boundary is not clear but if a country repeatedly breaches the Articles, it can be excluded from SDR trading[31].

Neither is there any conditionality linked to the trading arrangements. This is often highlighted by opponents of new SDR allocations, as this allows countries to obtain financing without undergoing detailed IMF surveillance. The lack of conditions and review in the trading arrangements is because countries that exchange SDRs are expected to exchange them back over the longer term. Prior to 1981, member countries were obliged to establish a specific level of SDR holdings (known as a reconstitution requirement). At that time, member countries had to retain a minimum of 30 per cent of their allocation over a five-year period[32]. Since then, however, there are no limits to how long a country can hold foreign currency via the trading arrangements, or requirements to maintain a certain level of SDRs on its balance sheets. It is therefore possible to say that SDR trading is unconditional as long as a country is a member of the IMF. This means that even countries that cannot currently borrow from the IMF via the regular lending facilities, such as Zimbabwe [33], can obtain foreign currency through the SDR trading arrangements. Anecdotally, if we look at Zimbwawe's SDR-trade we notice that they did not hold any SDRs for several consecutive years. The latest data show that at the end of August 2020, Zimbabwe had sold off 99 percent of their allocated SDRs in exchange for 337 million SDR in foreign currency[34].

[29] By looking at the SDR holdings and allocations of individual countries, it is possible to work out how much has been exchanged. But it would be misleading to draw incontrovertible conclusions on how this money is then used as exchanges are often made for IMF-related transactions.
[30] Financing via the Rapid Credit Facility (RCF) or Rapid Financing Instrument (RFI) is designed to meet needs that arise in a crisis situation. In such cases, the conditionality is not as strict as normal. The IMF also has preventive instruments, including the Flexible Credit Liner (FCL), which is based on strict qualification requirements rather than ex-post conditionality.
[31] IMF Articles of Agreement, Article XIX, Sections 4–5, p. 46-47
[32] Between 1979 and 1981, the requirement was lowered to 15 per cent.
[33] Zimbabwe cannot borrow from the IMF due to the debt situation in the country.
[34] IMF data: Zimbabwe: IMF SDR Allocations and Holdings as of August 31, 2020

New approaches to the SDR

Several attempts to make the SDR system more useful and relevant have been made , including in 2011 and 2018 (Table 2). During Executive Board discussions in 2018, it was assessed that it was through the use of official SDR (O-SDRs) that SDR could play a role in promoting greater global financial stability. A majority remained sceptical, however, regarding a more prominent role for the SDR. The discussion focused on targeted allocations, in which only a subset of the membership with a need to supplement their reserve assets, such as low-income countries, would receive SDRs that they could utilise via the VTA. Several Board members, including the Swedish representative, emphasised that the lack of conditionality and economic oversight could reduce the incentives for lasting economic reform. It was also discussed whether the circle allowed to hold and trade in SDRs should be expanded, and how SDRs could be given a more important role in international trade. Major changes to the SDR system would however require an amendment to the Articles of Agreement and therefore an 85-percent majority in the IMF Executive Board.[35]

Tabell 2. Latest reform proposals to strengthen the role of the SDR[36]

- Make new SDR allocations (O-SDR)
- Make targeted allocations to a group of countries, for example to low-income countries (O-SDR)
- Add conditionality for SDR trading (O-SDR)
- Reintroduce the reconstitution requirement (O-SDR)
- Make it possible for the IMF to issue SDR-denominated instruments to increase access to safe assets; this would also be an alternative source of funding for the IMF (M-SDR).
- Encourage countries to peg their currencies to the SDR (U-SDR)
- Expand the use of SDR outside of the IMF for accounting and official statistics (U-SDR)
- Strengthen its role as the unit of account in global trade (U-SDR)

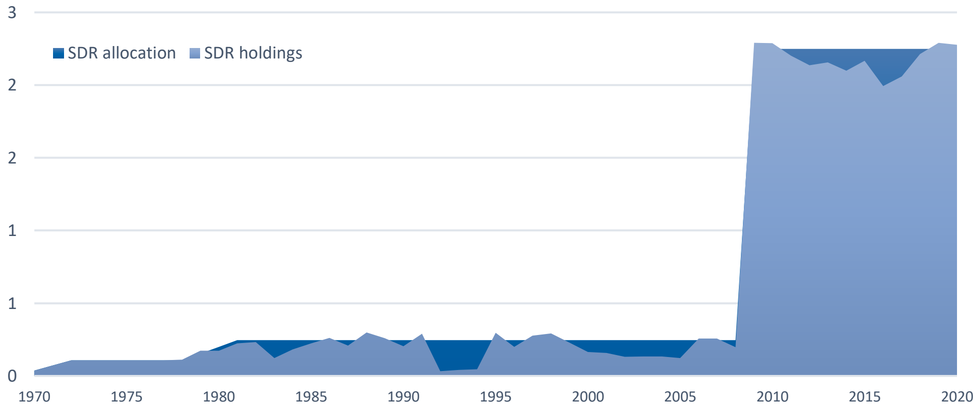
Sources: *Enhancing International Monetary Stability—A Role for the SDR?,* IMF, 2011 and *Considerations on the role of the SDR*, Policy Paper, IMF, 2018

The market-SDR (M-SDR) has been of limited significance. Compared to other financial instruments, SDR-denominated instruments offer lower currency and interest-rate risk than instruments issued in individual currencies, but there is no developed market infrastructure for SDR-trade. For example, the lack of settlement and clearing systems and difficulty to establish a yield curve for SDR-instruments. In addition, the instruments can only be issued in the currencies in the currency basket[37]. In the 1970s and 1980s, when expectations on the role of the SDR in the financial system were high, more than 560 million worth of financial instruments denominated in SDR were issued, but demand fell once the value of the dollar stabilised. In subsequent years, not much interest was shown in the instrument, but in 2016, the World Bank issued SDR-denominated bonds in China to a value of SDR 2 billion. The bonds were issued with a maturity of three years, with the aim of improving China's domestic market[38]. M-SDR trading is entirely separate from IMF activities, and takes place on the private market.

[35] An 85-percent majority is required for major decisions in the IMF Executive Board. The United States has 16.5 per cent of the voting rights in the Executive Board and *de facto* a veto.
[36] Presented prior to board discussions in 2011 and 2018
[37] See IMF staff note for the G20 – The role of the SDR – initial considerations (2016), pp. 4-9.
[38] For further information see World Bank press release (2016)

The Riksbank's experience of SDR trading

Diagram 2. **The Riksbank's SDR allocation and holdings (billion SDR)**



Source: IMF data, Sweden SDR allocations and holdings

The Riksbank's current SDR allocation is 2.3 billion, approximately SEK 30 billion. Diagram 2 shows the difference between the Riksbank's SDR holdings and allocation over time. Holdings are slightly below the allocation for most of the period. This is due in part to the SDR trading where the Riksbank mostly has sold SDRs, which adds foreign currency to the foreign reserves. Holdings are also affected when the SDR is used for other purposes, such as quota payments to the IMF. In the early 1990s, for example, the Riksbank chose to pay part of the quota increase in SDRs.

For the period 2004–2019, the average volume of the Riksbank's SDR sales has been SDR 6 million. Trading has mostly occurred in US dollars, as the IMF has been able to perform most of the euro trading with euro countries. Significantly fewer countries, including Sweden, have chosen to offer US dollars in exchange for SDRs. Since 2004, the Riksbank's participation in the VTA has resulted in a net inflow of USD 0.2 billion to the foreign exchange reserves. The addition of reserves is temporary, however, as the commitment by the Riksbank to buy SDRs in exchange for US dollars or euros could come at a few days' notice. The inflow over the period may seem puzzling, as the trading arrangements were established to facilitate currency acquisition for countries with a deficit in their balance of payments. The underlying reason for the inflow is not entirely clear, but as we know that the SDR is primarily used for transactions with the IMF, it is likely that countries have had to make repayments to the IMF during the period, and thus required SDRs. The Riksbank's SDR holdings are currently slightly above the allocation, resulting in an outflow of foreign

Figur 2 THE RIKSBANK'S TRADING ARRANGEMENTS

The agreement between the Riksbank and the IMF involves an undertaking to trade the SDR within an interval of 50–150 percent of the allocation, which means that the Riksbank can be asked to buy a maximum of SDR 1.13 billion above the allocation, and likewise sell a maximum of 1.13 billion SDR under the allocation. SDR trading under the Voluntary Trading Arrangements (VTA) make up only six per cent of Sweden's total IMF commitments on the Riksbank's balance sheet, for which there must be coverage in the FX reserves (See Annex, Diagram 4). According to the Articles of Agreement, the IMF can also oblige one or more countries to buy or sell SDRs in what is known as a designation (see Figure 1). In the Riksbank's case, this would entail an SDR exchange of up to a maximum of 300 percent of the allocation, which corresponds to just over SDR 6.75 billion. This is equal to 17 per cent of Sweden's total financial commitments to the IMF.

currency, due to recent transactions with the BIS, which acts as an intermediary for onward lending to IMF programme countries.

Transaction data since 2004 show that the frequency of trade has actually decreased; in other words, the Riksbank has received fewer enquiries to buy or sell SDRs (Annex, Diagram 6). One of the explanations for this is that the number of countries in the VTA increased at the time of the new allocation in 2009. Another factor could be larger individual purchases and sales of SDR, primarily between 2006 and 2017.

Since the allocation in 2009, trade has been within the Riksbank's approved interval limits (Annex, Diagram 5). According to the current arrangement, SDR trading is limited to a maximum of SDR 150 million per week, but the limit has only been reached once since 2004. This was in 2016 when the Riksbank was asked to exchange SDR 150 million in exchange for US dollars, likely because of a country's loan repayment to the IMF. Due to the coronavirus pandemic, the IMF temporarily requested more flexibility from member countries with regard to financing, including disregarding the maximum weekly amount. Despite this, the Riksbank has so far seen neither an increase in transaction amounts, nor the number of transactions in SDR trading in 2020.

The way forward

The role of the SDR in the global financial system has remained limited, despite the original ambitions to make it the primary global reserve currency, and the allocations in 2009 did not lead to the expected increase in SDR use. There are several explanations for this:

i) When the foreign exchange market became increasingly liberalised in the 1970s and onwards, the context for which the SDR had been created had shifted.
ii) SDRs are not allocated according to need but according to the size of countries' economies and in proportion to their quotas in the IMF.
iii) There has been a reluctance among members to give the SDR a greater role.

The aspect of the SDR system that is currently the most relevant is how the official SDR holdings of countries could be better utilised to promote financial stability, for example via targeted allocations to low-income countries.

As we have seen from the Riksbank's experience, there is still plenty of scope within the approved trading interval and no increase in trading has been observed since the beginning of the coronavirus pandemic. Based on how the SDR system is currently used, there does not seem to be a need for a new general SDR allocation. On the other hand, it is possible that the need for global liquidity could drastically increase, for example as a result of greater volatility in capital flows from emerging economies. It is then possible that countries in need of foreign currency would start exchanging their SDRs to be able to finance their international payments, assuming that they still have available SDR holdings. Since we are aware that the SDR primarily is used for IMF transactions, exchanges can also increase as a result of increased lending during the crisis.

The volume of SDR trading for the Riksbank has been small in relation to its foreign exchange reserves. The Riksbank's participation in SDR trade since 2004 has even resulted in a small net inflow of US dollars. We should remember, however, that this inflow cannot be counted as an addition to the reserves in the longer term, as the Riksbank under the VTA can be requested to buy back SDR at a few days notice, which we have also become aware of recently, as the Riksbank's SDR holdings are once again slightly above the allocation.

For developed countries with large buffers, there is no direct need for SDR as a reserve supplement, but for small countries with limited options to acquire foreign currency, increased SDR holdings can make a difference. There are, however, a number of limitations in the trading system that need to be dealt with, however – primarily the lack of surveillance and conditionality as well as the absence of a requirement for countries to retain a certain level of their SDR allocation as a buffer. The concept of "unconditional liquidity" goes contrary to the main strength of the IMF, namely the conditionality and surveillance associated with its lending. As long as the SDR continues to be used primarily within the IMF system, this is not a major problem, but if its role in the global economy is to be expanded, as is often proposed, the SDR system must be strengthened and its weaknesses openly discussed and resolved.

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Annex 1 Diagrams and tables

Diagram 3. **Currency composition global official currency reserves (USD billion)**

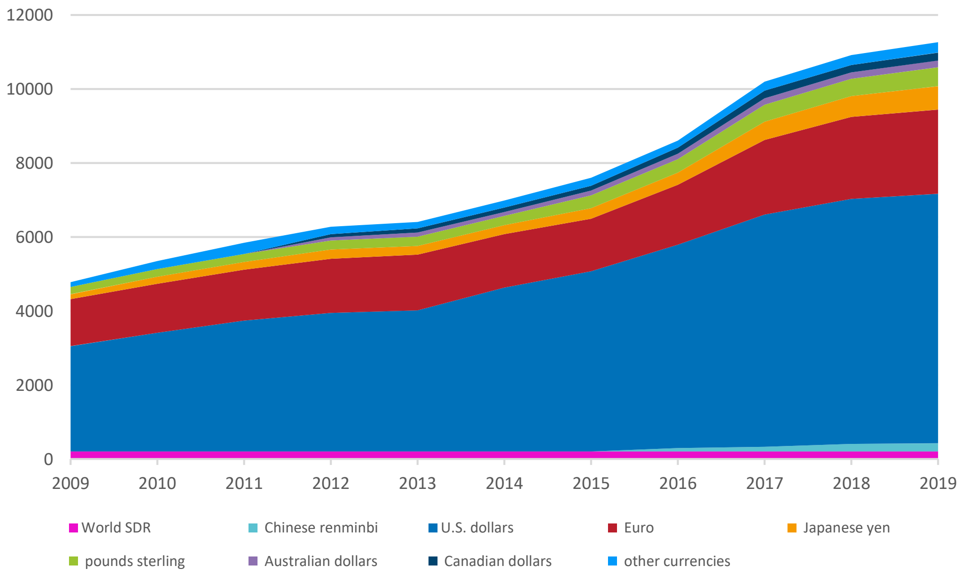
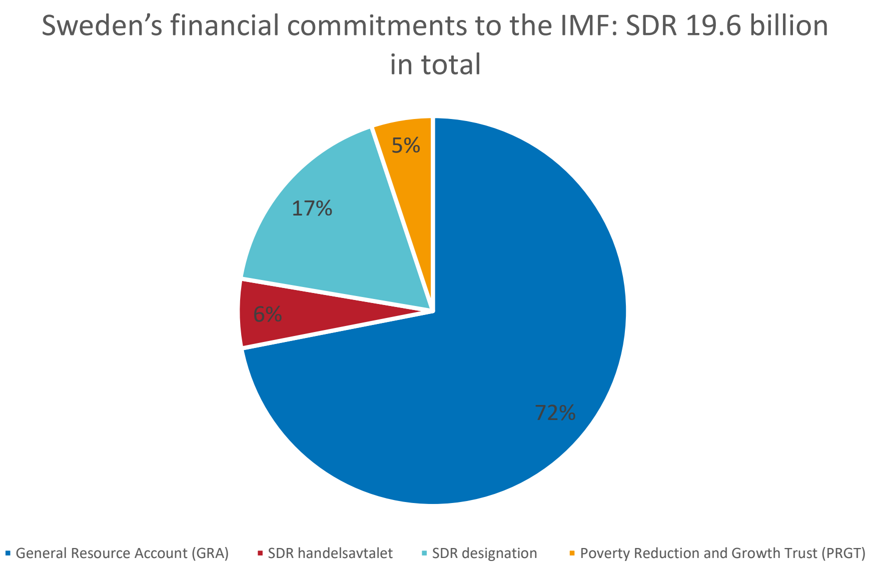


Diagram 4. **The Riksbank's voluntary trading arrangement to exchange SDR forms a small part of Sweden's IMF commitments**



Source: Riksbanken

Diagram 5. The Riksbank's trade interval and holdings (SDR billion)
Source: Riksbanken

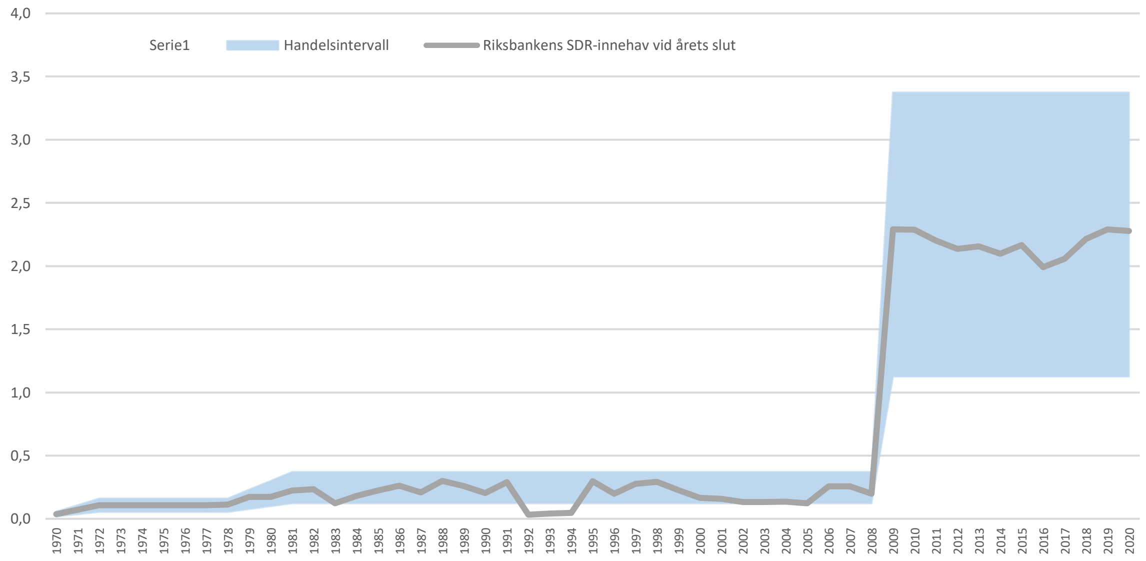


Diagram 6. Frequency number of SDR exchanges received by the Riksbank (monthly)
Source diagram 6-7: Riksbanken

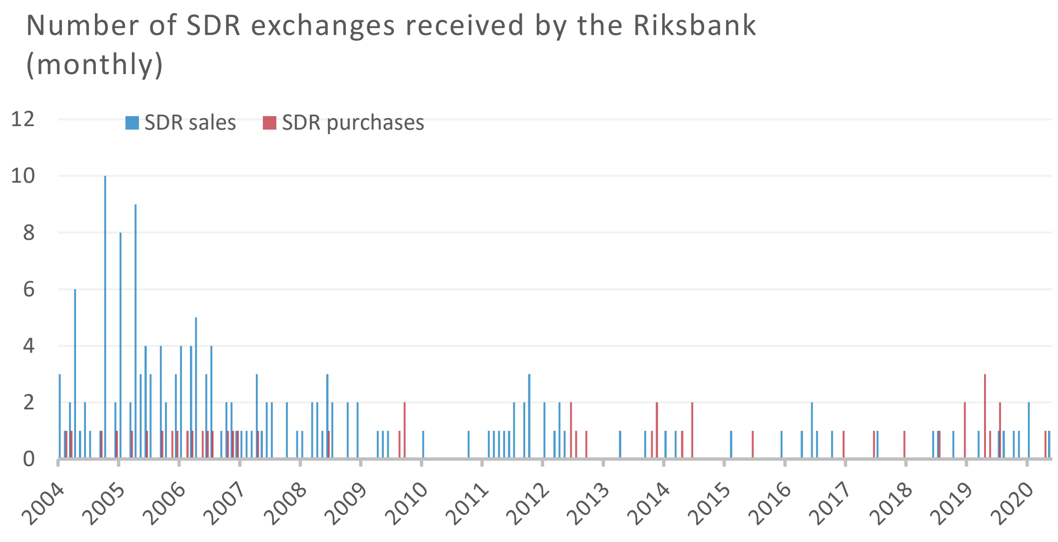


Diagram 7. A. Value of individual SDR purchases (million SDR)

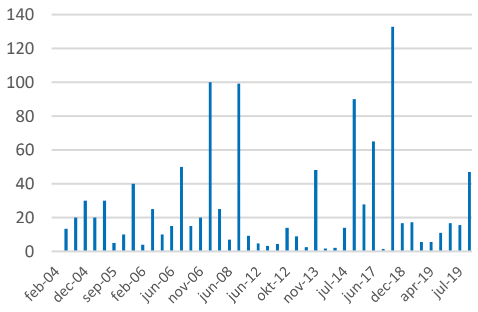


Diagram 7.B. Value of individual SDR sales (million SDR)