Is There a Better Way to Use Global Reserves?

MARK PLANT

Abstract

Global reserves can serve as a global public good, facilitating the short-term global recovery from the economic impacts of the pandemic and Russian invasion of Ukraine, as well as the longer-term global transition to a sustainable and equitable economic future. Strategic allocation of Special Drawing Rights (SDRs) could facilitate sharing of global reserves with low- and middle-income countries to the mutual benefit of advanced and developing countries. This will require the development of new SDR sharing mechanisms, in which multilateral development banks could be instrumental. Other SDR reforms should also be pursued.

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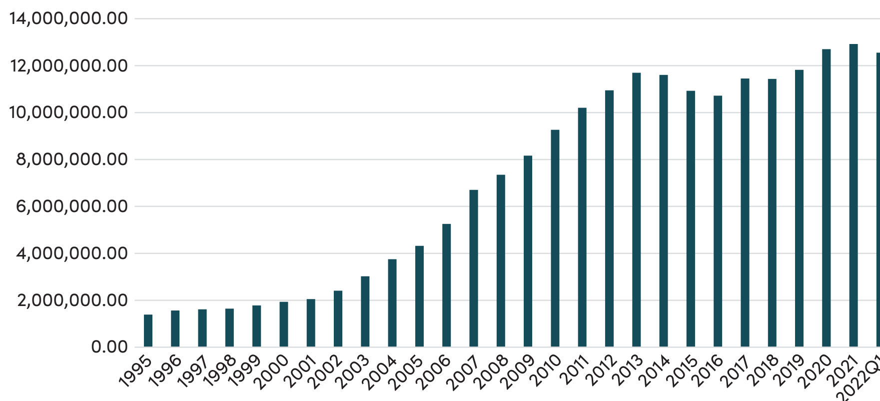
Introduction

When I ask colleagues if they think global foreign currency reserves increased or decreased during 2020 as the economic shock of the pandemic infected the global economy, the development economists usually say "decreased" and those more focused on monetary economics say "increased." Development economists reason that reserves are savings for the proverbial rainy day, and we had not seen such a dismal economic year for a long time—so those savings must have been used. Monetary economists figure that the drop in global economic activity, plus the injection of large amounts of money into the global financial system by the leading central banks, resulted in a buildup of precautionary balances by individuals, banks, and central banks, which in turn probably boosted reserves.

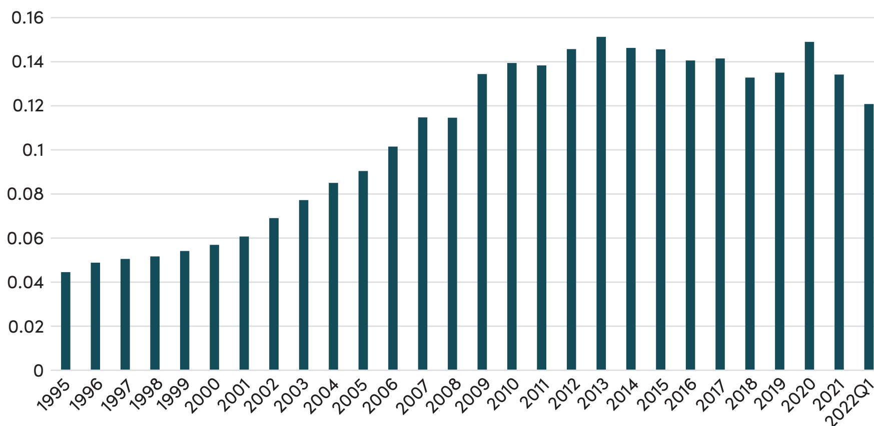
The data support the monetary economists' view. By the end of 2020, reserves had increased about 6.5 percent from end-2019 levels and stayed pretty much steady through 2021, falling a bit in the first quarter of 2022 (Figure 1).

FIGURE 1. Total foreign exchange reserves *(in millions of US dollars)*



And, since global GDP fell precipitously in 2020, reserves as a percent of GDP rose markedly, coming down again in 2021 and 2022 with the acceleration in GDP growth in 2021 and early 2022 (Figure 2).

FIGURE 2. Reserve per dollar of GDP



One argument for a special ad hoc allocation of the IMF's Special Drawing Rights (SDRs) was that, while advanced-economy countries could use stimulative monetary and fiscal policies to spend their way out of the economic hole created by the pandemic (essentially printing money), low- and middle-income countries (LMICs) had less maneuvering room. Their only choice would be to draw down reserves, which were dangerously low to begin with. So, an SDR supplement that augmented their reserves would be a "shot in the arm" that would allow them to fight back against the economic fallout of the pandemic.

But once again, this intuition is not entirely visible in the data. Many LMICs in South America lost reserves in 2020 as did those in south-central Africa. But there were big gainers too among LMICs, such as India, Mauritania, Madagascar, and Paraguay (Figure 3a), with not much change in 2021 (Figure 3b). And some advanced-economy countries lost a substantial portion of their reserves, notably Australia and New Zealand.

FIGURE 3A. Change in international reserves *(excluding gold; 2019–2020)*

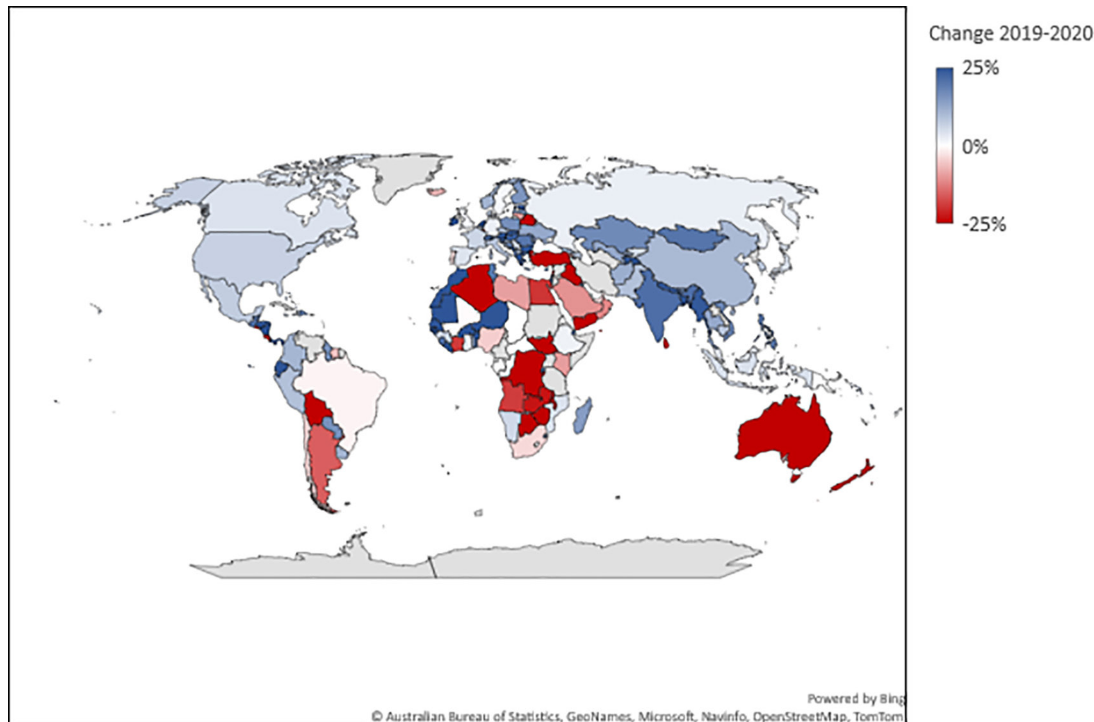
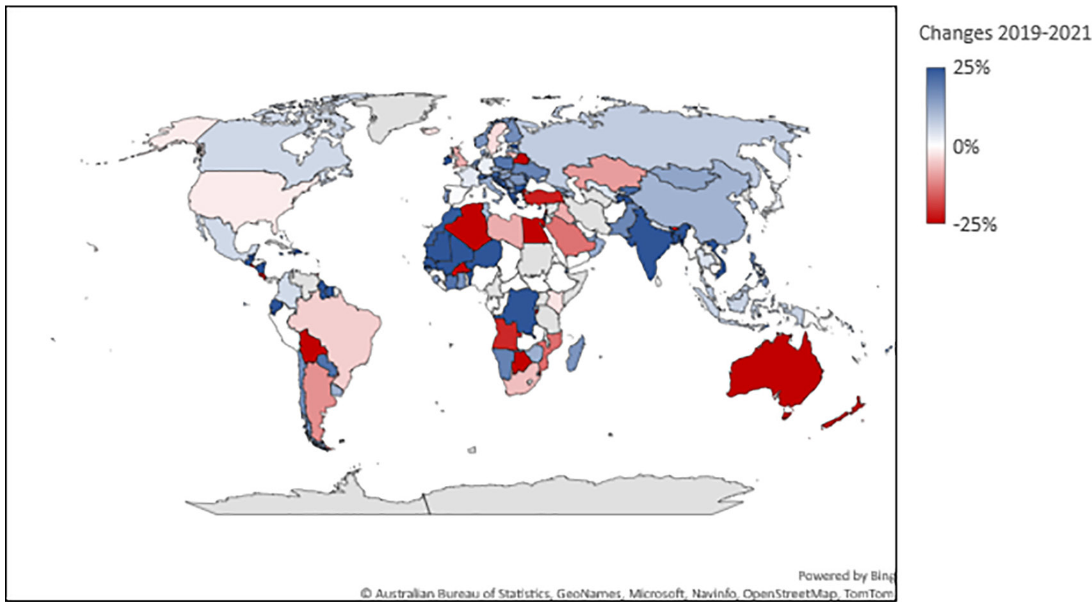
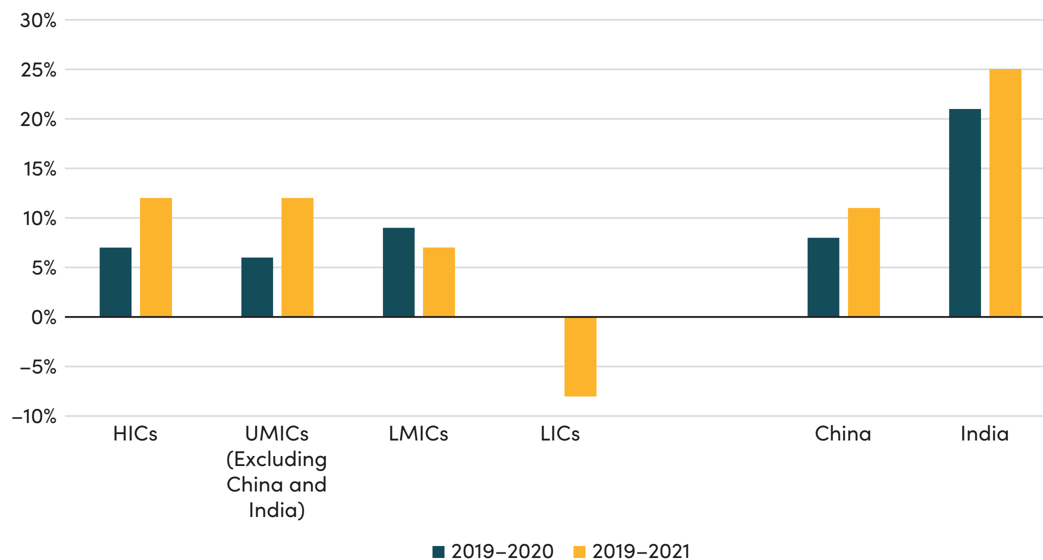


FIGURE 3B. Change in international reserves *(excluding gold; 2019–2021)*



Overall, low-income countries were the relative losers in the reserves reshuffling in 2020 (Figure 4), gaining only 1.5 percent in reserves in 2020, compared to over 15 percent gains among upper-middle-income countries (which includes India and China).

FIGURE 4. Changes in reserves, 2019–2020 & 2019–2021



These statistics broadly illustrate a common misunderstanding about reserves (that they should be used up in a crisis) and reinforce the commonly held notion that the less affluent countries were more economically challenged than the affluent ones during 2020.

And they rightly raise the question whether this global pool of resources—some $12 trillion—is being best used in the global interest. Switzerland gained $215 billion worth of reserves in 2020 and it now holds 8 percent of global reserves, up from 6.7 percent in 2019, while El Salvador and Lebanon saw their reserves shrink by 33 and 35 percent respectively and faced severe setbacks economically. *Is this a globally optimal rearrangement in the year of the largest economic dislocation in history? Might there be benefits from reserve pooling so that countries in desperate need could, at least temporarily, use the global cache of reserves to their benefit?*

To answer these questions, I first consider what the function of reserves might be, then consider how the 2021 allocation of SDRs was used to augment reserves in the aftermath of the pandemic. I then consider how those SDRs might be used to better effect through the multilateral development banks (MDBs) and briefly consider some other SDR sharing mechanisms worth exploring.

The function of reserves

The IMF outlines the following uses for foreign exchange reserves (emphasis added):

- *support and maintain confidence in the policies for monetary and exchange rate management, including the capacity to intervene in support of the national or union currency;*
- *limit external vulnerability by maintaining foreign currency liquidity* ***to absorb shocks during times of crisis*** *or when access to borrowing is curtailed, and in doing so,*
- *provide a level of confidence to markets that a country can meet its external obligation;*
- *demonstrate the backing of domestic currency by external assets;*
- *assist the government in meeting its foreign exchange needs and external debt obligations;*
- ***maintain a reserve for national disasters or emergencies***.

Judging the optimal level of reserves, globally or country-by-country, is not an easy task. There is a long-running debate in economic literature about the motives for reserve accumulation (see here for example) and the IMF has an extensive literature on evaluating reserve adequacy, along with an analytic tool and data set that assess some countries' situations. As the IMF notes, "assessing the appropriate level of reserves to hold is challenging—not just because of the multiple roles played by reserves, but also because of the complexity of quantifying external risks and vulnerabilities, and the opportunity cost each country faces." And its guidance as to how to assess reserve adequacy is detailed.

But the two bolded uses in the list above seem most pertinent to the discussion surrounding the global reaction to the COVID-19 crisis and to the balance of payments strains now being felt throughout the world from the energy and food price shocks emanating from the Russian invasion of Ukraine and the financial war being waged against Russia. These shocks have resulted in severe dislocation in many countries' balance of payments, from higher import prices (food/energy) and quantities (vaccines) and from lower export prices (raw materials) and volumes (tourism).

The question countries face is how much to dip into their reserves to fight against the shock. In many countries reserves have been or will be inadequate to the task. The recent appreciation the dollar has accelerated reserves losses, particularly for those countries with large dollar-denominated debt or dollar-denominated import dependence.

What was done, and left undone, in the crisis?

In the aftermath of the COVID19 crisis, the global community responded to the reserves strains of many LMICs by authorizing the IMF to allocate an additional $650 billion of Special Drawing Rights (SDRs) to its member countries.[1] But the allocation was not focused on those countries in need. Every central bank in the world received an extra dose of reserves amounting to 100 percent of its IMF quota.[2]

This quota-based allocation mechanism was largely designed to support liquidity needs resulting from global financial market crises, not to confront the global reserves needs brought on by a pandemic or an invasion with global consequences. The lion's share of SDRs went to advanced economies. These countries, especially those that emit reserve currencies (e.g., dollars, sterling, yen) mostly banked their extra SDRs for other reserve management purposes; the SDRs were not needed to manage the ongoing crisis. And even among low-income countries where the immediate need was acute, the allocation was uneven. For example, Liberia received an injection amounting to *9.2* percent of GDP, while Cameroon received only 1 percent of GDP in new reserves. And countries used their new allocations differently: Senegal pledged to devote its SDRs to support its healthcare system while the Republic of Congo used it to finance social spending through its budget.

Given that the allocation did not fit the need resulting from the pandemic, there were calls for a "reallocation" or "recycling" of SDRs from the outset, notably from advanced countries to LMICs that were more heavily impacted by the COVID-19 crisis and whose economic maneuvering space is more limited.[3]

The "natural" channel for recycling was through the IMF. When countries face balance of payments difficulties they turn to the IMF for assistance. And the number of low-income countries reaching out for IMF assistance was large. It quickly became clear that the IMF's trust that supports concessional lending—the Poverty Reduction and Growth Trust (PRGT)—would be severely strained by the crisis and would need more resources. SDRs had been used to fund the PRGT in the past and thus "new" SDRs could be channeled to the PRGT easily, allowing the IMF to expand its lending to low-income countries. Recognizing that middle-income countries would need patient and concessional

1 How SDRs function is explained here and here.

2 IMF quotas are explained here. The current SDR exchange rate is SDR 1 = US$1.29. In August 2021 the exchange rate was SDR1 = US$1.42.

3 See here and here for examples.

resources to address their longer-term sustainability challenges, the IMF also established the Resilience and Sustainability Trust (RST), to be funded by recycled SDRs.

However, to date, no "recycled" SDRs have made it through the IMF into the coffers of LMICs. The growing frustration with the lack of effective recycling of SDRs has led many to call for another allocation of SDRs, especially in light of the new economic challenges posed by the Russian invasion of Ukraine. But in turn this raises questions about the purpose of SDRs, when they should be used, and how they might be best exploited.

What is the real power of the SDR, and can it be used outside the IMF?

SDRs are essentially a reserves sharing mechanism – holders of SDRs can trade them with another IMF member country for hard currency, that in the end comes out of the global reserves pool. The SDR represents an important source of reserve flexibility for many LMICs, as they do not have access to the emergency financing tools offered to more developed countries. When they need hard currency, the can make use of voluntary trading arrangements at the IMF instead, converting their SDRs to a reserve currency.

The recent SDR allocation allows more access by low-income countries to the pool of global reserves than they contribute to it. Total SDRs in circulation amount to about $1 trillion, allowing for sharing of about 8 percent of the $12.77 trillion global reserves. Low-income countries' reserves comprise about 0.18 percent of total global reserves (Figure 5a—essentially invisible) but they receive 2 percent of the SDRs (right panel of Figure 5b in blue). For LMICs, the SDR share is about the same as their reserve share (Figure 5a and 5b in light grey). The real distributional difference is between the high-income countries that get significantly more SDRs than their share in global reserves at the expense of the upper-middle-income countries. This is driven mostly by China, which owns 24 percent of global reserves but whose quota at the IMF is only 6 percent. The argument for recycling SDRs is to skew this redistribution a bit more by channeling some of the high-income countries' 68-percent share to others. The argument for SDR recycling is essentially to skew this distribution further to support countries whose reserves are strained by the current economic conjuncture, making use of SDRs sitting "idle" on the central bank balance sheets of advanced countries.

FIGURE 5A. Distribution of Reserves *in 2020*

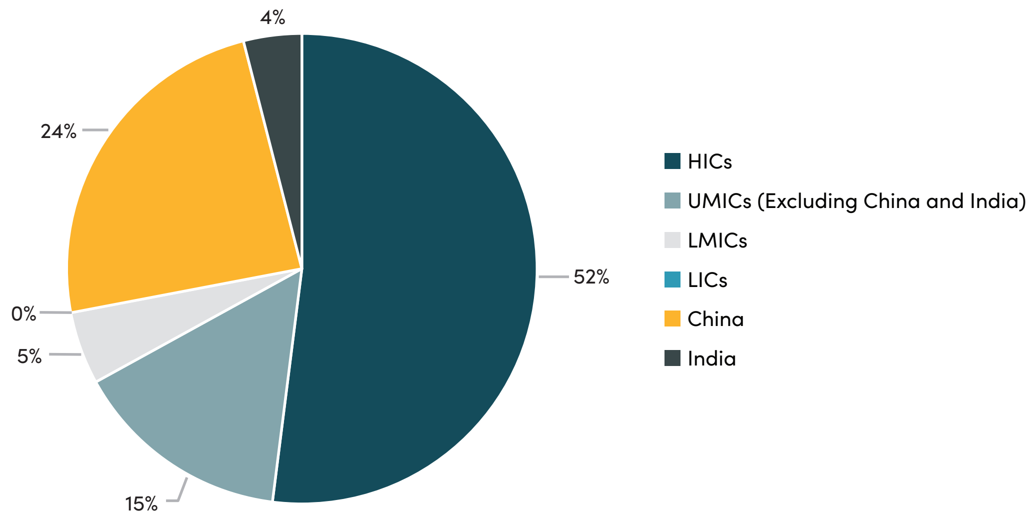
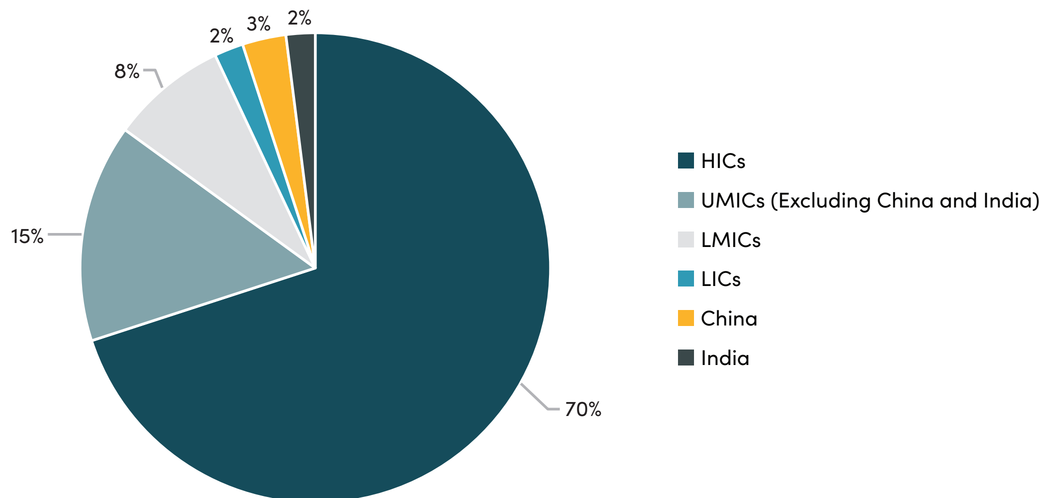


FIGURE 5B. Distribution of the SDR allocation, August 2021



The G20 has supported recycling of up to $100 billion worth of SDRs, but with an important caveat: that any recycling mechanism must retain the SDRs' "reserve asset characteristic." This has been interpreted to mean keeping the SDR risk free—SDRs cannot be permanently lost and are encashable (recycled SDRs be returned to the recycling country on demand). With some effort, these characteristics are maintained within the IMF's PRGT and RST.

But the pool of SDRs never shrinks. If a country exchanges its SDRs for hard currency, some other country (or prescribed holder) increases its holdings of SDRs. Thus, no SDR is ever spent or lost. This is its true "reserve asset characteristic"—each SDR is always there, ready to provide liquidity to its holder in case of need, whoever that holder may be.

What the G20 is really demanding is that their SDRs be recycled as a risk-free loan that can be recalled at any moment. This eliminates any permanent transfer or gifting of SDRs to others (countries, funds, or institutions) or encumbering the SDRs in a financial relationship where they cannot be quickly reclaimed. That protects each recycling country's interest, but does it empower reserve pooling to the shared global interest?

To answer that question, it is useful to step back and think about how countries use their SDRs and reserves. SDRs themselves cannot be spent—they are not a currency, but a claim on currencies. The decision by a country to "spend" SDRs, say to purchase vaccines, is a sovereign decision to trade SDRs for hard currency and transfer that hard currency from the central bank to the government. The government then purchases vaccines with the hard currency. The country's reserves are depleted, as are global reserves—some dollars have moved out of the pool of global reserves to eventually land in the pockets of the vaccine manufacturers. (Of course, the chain of monetary events doesn't end there, but let's stop there for now.)

It is a sovereign decision to cross the line between monetary and fiscal policy—the country uses central bank reserves to buy something concrete. Vaccines could be a justifiable "crossing of the line" (look again at the list of functions of reserves above)—without the vaccine the country's human capital would be depleted, endangering long-term economic and social viability. Thus, a government could conclude that investment in human capital merits depleting reserves.

Through the SDR mechanism, the world financial community is willing to allow a limited amount of "borrowing of reserves" for whatever purposes the SDR-holding country sees fit.[4] By recycling, advanced countries lend more reserves to LMICs, thus giving them more call on the global reserve pool. But the advanced countries are restricting how the SDRs can be used—risk free and encashable uses only. This restricts the recycled SDRs to be used strictly as reserves and prohibits crossing the fiscal line unless sovereigns do so, knowing that eventually the SDRs will have to be repaid.

The concrete proposals for recycling SDRs so far preserve this logic. Recycling is to instruments at the IMF: the Poverty Reduction and Growth Trust (PRGT) or the nascent Resiliency and Sustainability Trust (RST). Advanced economies lend their SDRs to the trust. The SDRs are then onlent to countries that are confronting balance of payments needs (immediate, longer-term, or prospective). The SDRs are lent from the trusts to a country's central bank. It is then a sovereign decision whether to allow the recipient country's government access to the new central bank reserves for fiscal purposes. But ultimately the central bank must repay the IMF trusts, so somehow the reserves will have to be reconstituted if they are spent by the government. And the IMF loan conditions are designed ex ante to promote policy changes that aim to reconstitute the reserves by the time the loan is due.

4 When a country exchanges its SDRs for hard currency, it incurs an opportunity cost equal to the SDR interest rate. If its SDR account at the IMF goes into deficit because of the exchange, interest charges are incurred. If it was in surplus before the exchange, it foregoes the interest it was accruing on the surplus.

There is always a (very remote) chance that a country misses its payments to the IMF, but the trusts are designed with reserve mechanisms to cover such lapses, thus protecting donors' SDRs.

Many are skeptical about whether using the IMF as an intermediary for SDR reallocation will get the resources to the countries that really need them, in the right amounts and in a timely manner. And to date, their skepticism has been justified as not a single SDR has been recycled to the benefit of any LMIC. In addition, the IMF won't be able to absorb the G20's promised $100 billion in the PRGT and RST. There will be at least $40 billion for use elsewhere? So, where and for what purpose?

Development banks as an answer for a broader use of SDRs

A national balance of payments crisis is best handled through a combination of central bank support and access to funding from the IMF. But, as the COVID crisis has demonstrated, the world is ill prepared for confronting a global balance of payments with significant spillover effects across a wide spectrum of countries. The economic aftermath of the Russian invasion of Ukraine has again demonstrated the vulnerability of an interconnected global economy. And climate change action, or inaction, is likely to present the world with more such crises. And in all these cases there is no neat line between the balance of payments needs of countries and the fiscal demands imposed globally and locally.

Sharing access to global reserves seems like it would be an important component of the response to any such crisis, confirmed by the fact that the only truly global financial response to the current crisis was the issuance of SDRs. But the current structures surrounding SDRs, including the insistence on retaining their reserve asset characteristic, make them a clumsy tool, especially when the balance of payments crisis rooted in severe unforeseen fiscal needs.

The IMF's new facility, the RST, demonstrates the clumsiness well. The global community has decided that SDRs should be used to support countries' transition to a more resilient and sustainable economic structure. This puts the IMF in the position of adjudicating the financing needs for each country's transition and their impact on the balance of payments—something well beyond the IMF's current expertise. Others have argued that the IMF's support from the RST needs to be part of a broader structure that brings the needed expertise to bear. But are there not better institutions to be the transition support lender?

The world has a set of financial institutions designed, in principle, to make such investments: the multilateral development banks (MDBs), such as the World Bank, the African Development Bank, the Asian Development Bank, and many others. Their global governance structures, prudent financial management, ability to leverage their capital to mobilize private sector financing, and, most critically, their expertise place them in an ideal position to intermediate between the assets held

by the global financial system and LMICs in short- and long-term distress. SDRs could provide the needed link between the financial power of global reserves and the investment acumen of the MDBs.

If SDRs (or some part of them) were envisaged not just as a monetary instrument, but as a financial instrument as well, the MDBs could provide a sound way to intermediate between the global pool of reserves and the global pool of capital.[5] Currently central banks purchase MDB bonds as part of their asset management strategies. In addition, central banks' SDRs could be held as part of the MDB capital base, allowing the MDBs to leverage them through their balance sheets to access private capital and increase their investment lending. Given current leverage ratios, SDRs used as capital could allow the MDBs to increase their lending portfolio by three-to-five times the SDRs' value.

In any use of SDRs, central banks will seek assurances that reserves remain safe and accessible. Given the prudent financial management policies of the MDBs, the risk that SDRs would be converted to hard calls on global reserves would be small, and the risk would be shared across the global financial system rather than by one country or group of countries.

While there are technical challenges of recycling SDRs to MDBs, stemming predominantly from the requirement to retain their reserve asset characteristic, there are ways of structuring any SDRs lent to MDBs both to count as MDB capital and to maintain their reserve asset characteristic, with ideas currently being investigated by several MDBs.[6] Others have argued convincingly that prudent investment of SDRs in MDBs is no more risky than investing in the IMF's PRGT and less risky than other investments central banks are already making, including buying MDB bonds.

Many of my colleagues have argued for the MDBs to step up their financial support of a sustainable transition. But doing so, while maintaining their poverty reduction objectives, will likely require more capital in due course. But given the current fiscal constraints of advanced economies, the likelihood of a large capital injection supported by advanced countries' budgets is small. Use of central bank SDRs is a viable alternative that is relatively low risk and potentially high return. Using SDRs through the MDBs would allow them to help countries deal with the enormous fiscal pressures of the economic transition while leaving the IMF to focus on the balance of payments needs.

5 Many thanks to Serge Ekué, President of the BOAD, for noting the needed re-envisaging of SDRs as a financial, not solely monetary instrument.

6 The other challenge for some MDBs, and certainly for regional or national development banks, is that they are not on the list of prescribed holders of SDRs, and thus any SDRs that reallocating countries might give would have to be converted to a useable currency. The IMF must approve any potential prescribed holder with an 85 percent majority, which will be politically difficult to attain. For development banks with multiple shareholders and potential SDR donors, the easier path would be for the reallocating country to give hard currency to the bank, rather than SDRs, either exchanging the SDRs for that currency in advance or invoking the fungibility of assets within the central bank balance sheet.

Thinking beyond the MDBs

In the view of the central bank guardians of the world's stock of international reserves, the use of SDRs to bolster the balance sheets and lending power of MDBs is a radical idea. For example, the European Central Bank has forbidden its member countries from recycling SDRs to MDBs.

For promoters of development finance, recycling SDRs through the IMF and the MDBs seems at best a modest step. Many had hoped to use SDRs for a host of development purposes—vaccines, social expenditure, green investment. But routing SDRs through the international financial institutions (IFIs) has proved to be a difficult, almost impossible, task. And those who do not have much faith in the IFIs to begin with are looking for other avenues.

Here are a few ideas as to how to exploit the power of the SDR as a financial asset that merit further consideration:

Think locally. A country's SDRs could be used to buttress the balance sheet of its own national development bank. In an era where development banks are re-emerging as an important tool for economic transformation, marshaling some of the country's monetary assets to the benefit of needed investment might make good fiscal and monetary sense. Diversifying the portfolio of monetary reserves assets to spur local investment is an idea worth pursuing. The critical question will be how to ensure that the development bank uses the SDRs in a sound manner to expand its balance sheet and does not just spend the SDRs.

Think regionally. Regional monetary institutions, like the Fondo Latinoamericano de Reservas (FLAR) or the Arab Monetary Fund, buttress the reserves positions of their member countries and promote regional development. Some have the advantage of being prescribed holders of SDRs and thus member countries can transfer excess SDRs to the institutions, which can in turn use them for regional support and development. One idea that has been mooted is that the regional funds could use any recycled SDRs to bolster their portfolio, freeing other reserves to be more aggressively invested and any excess returns on investment could be used to fund development or green projects.

Wider access to liquidity lines. Liquidity lines from the US Federal Reserve system are used to help countries with short-term foreign exchange shortages, but they are available to a limited number of countries (a primer can be found here). SDRs could provide a similar function, as they allow countries to access hard currency easily through a voluntary trading arrangement administered by the IMF, but the market is nontransparent and inactive. Pooled SDRs could be used to encourage more active currency exchange with and among LMICs. Also reform of IMF instruments to allow swifter, less costly access, is needed.

Undertake a wider reform of the SDR. The SDR as an instrument to facilitate global adjustment has limitations beyond those cited in this paper. In a provocative paper[7] (with an excellent annex on the history of the SDR), Ted Truman outlines four reforms that would make the SDR a better instrument to fit into the toolkit of global liquidity: (i) raise the SDR interest rate; (ii) expand the list of freely useable currencies for use in voluntary trading arrangements; (iii) re-assess the reserve asset theology of the SDR; (iv) increase the quota share of low-income IMF member countries. These would facilitate the uses proposed above and represent an important enhancement of the SDR as a global financial instrument.

Use the SDR as an international currency. Warren Coats, among others, advocates expanding the SDR to become an alternative to the dollar in transborder settlements. This would require fundamental reforms in the functioning of the international monetary system, but given the sclerosis in the system, at least from the standpoint of LMICs, these are ideas worth pursuing.

Conclusion

Global reserves provide an important service in ensuring the smooth functioning of the world's financial system. But these $12.7 trillion of resources remain largely unshared—some portion is under the control of each country's central bank. While the advanced countries have recognized the merit of sharing reserves in times of individual crises, LMICs have largely been left out of this process. To get help in times of crisis, LMICs need to come to the IMF to supplement their reserves. While current IMF support instruments may be appropriate to country-specific external policy shocks, the two seismic global economic shocks have illustrated the weakness of these instruments in providing broad-based and immediate support.

The SDR allocation was a blunt means of providing LMICs access to global reserves, but it was not enough. Measures to recycle excess SDRs have fallen short, at least in terms of rapidity. But they fall short in another dimension as well: helping LMICs mobilize the financing needed to confront the impacts of climate change and transform their economies. Using SDRs to bolster the resources of the MDBs is feasible and represents a minimal-risk way of investing some small portion of global reserves to this end: 5 percent (just under $1 trillion) safely loaned in reasonably liquid form to MDBs could increase their lending by $3–5 trillion.

More works also needs to be done to extend the usefulness of SDRs as a reserve-sharing mechanism. Rather than retreating into reserves nationalism, the international financial community should find ways to use global reserves to support the global transition to a sustainable, resilient, and equitable future.

7 "Promoting the Special Drawing Right" Edwin M. Truman, Harvard Kennedy School, manuscript.