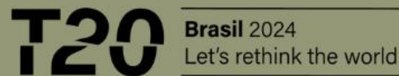
T20 Policy Brief



Task Force 03
REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE

The Economic, Social and Environmental Potential of SDRs

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TF03

Abstract

The global climate finance agenda is currently insufficient to limit climate change and foster a just transition. Too much is expected from domestic resource mobilization and blended finance. New and innovative financing mechanisms are needed.

The IMF's Special Drawing Rights (SDRs) could provide a way forward. Several proposals to rechannel unused SDRs have been tabled, predominantly via the IMF or Multilateral Development Banks (MDB's). The IMF Trusts designed for rechanneling purposes face limitations in terms of eligibility, conditionality and disbursement. Rechanneling via MDB's has significant benefits as MDB's have a development mandate and are experienced with delivering finance for development and a just transition. The African and Inter-American Development Bank have proposed a Hybrid Capital Instrument (HCI) with a leverage potential of 1:4, increasing the SDRs' clout.

This briefing examines the economic, social and environmental potential of SDRs and compares rechanneling options via the IMF and MDB's. It calls for swift effectuation of the HCI, reforms of the IMF Trusts and renewed and regular SDR issuance, with a coordinating role for the G20.

Diagnosis

Enabling all countries to invest

The world faces great challenges in terms of climate finance, necessary for a timely and just transition. The financing gap for all SDGs in developing countries, excluding China, is estimated to be between USD 3 and 4 trillion annually until 2030 (Van Tilburg et al., 2024). The promise made in 2009 to raise USD 100 billion for the global climate fund has not been realized. While USD 100 billion was pledged in 2021 for Special Drawing

Rights (SDRs) to be rechanneled to low-income countries (LICs), only four countries have received disbursements (ONE, 2024).

Meanwhile, developing countries struggle with high prices of food and energy, rising interest rates, dollar exchange rates and unprecedented debt levels. 60 per cent of LICs are at high risk of, or in, debt distress (Chamon et al., 2023). Today, 19 countries spend more on interest than on education and 45 more on interest than on health (UNCTAD, 2023a). Due to tightened global monetary and fiscal policies, developing countries have witnessed private sector capital outflows, undermining countries' economic growth. A stable climate in all countries is, however, a global common good and requires international solutions.

The current agenda is falling short

During COP28, the Independent High Level Expert Group (HLEG) on Climate Finance called for a swift implementation of its 'Grand Match finance strategy' (presented at COP27) to close the global climate finance gap. The main financial means are expected

to come from domestic resource mobilization and private (i.e., blended) finance. However, these sources currently do not deliver, and this is unlikely to change soon.

Improving domestic resource mobilisation is a difficult and lengthy process. Developing countries are renowned for administrative capacity constraints preventing them from addressing tax evasion and keeping avoidance under control. Studies on the projected development of tax-to-GDP ratios in developing countries show that their tax revenues are expected to only slightly increase (Hill et al., 2022). Blended finance initiatives tend to underdeliver. Public capital investments often lever to much lower ratios than assumed, and in 2020, total private finance constituted only around 50% of global climate finance (Prasad et al., 2022). In recent years, private investments through blended finance decreased in developing countries, from USD 150 billion in 2012 to less than USD 100 billion in 2019 (Gallagher et al., 2022).

Maximizing the impact of SDRs

SDRs are currently a modest but important source of finance. At the height of the pandemic, the IMF created USD 650 billion worth of SDRs (IMF, 2021). Only 3 percent of the issuance went to (LICs), and 30 percent went to middle-income countries (MICs). African nations received USD 33 billion in total – less than 5% of the total allocation (AfDB, n.d.). They used their SDRs to finance critical COVID 19 health expenditures, build reserves, and service debts (Mutazu et al., 2023, IMF, n.d.). In Latin America and the Caribbean region, countries experienced similar fiscal benefits and improved stability in their external accounts (Latindadd, 2023). Additionally, some of the SDRs will be used for climate resilience policies.

The G20 can make a great leap forward by supporting new SDR issuances and rechanneling while coordinating effective implementation. These proposals provide a

way forward for a socially inclusive and sustainable energy transition by reforming the global governance of IFI's, in line with the G20 priorities.

Recommendations

The potential of unused SDRs

Due to the IMF's quota system, most of the SDRs end up unused on the balance sheets of developed countries' central banks. Developing countries would benefit from rechanneling the remaining unused SDRs. In the below, a comparison is made between rechanneling through the IMF (via its Trusts) and via MDBs (particularly through the HCI), examining the track records of both institutes in terms of financing development and climate policy.

Rechanneling via the IMF Trusts and their limitations

The IMF has two rechanneling Trusts, the Poverty Reduction and Growth Trust (PRGT) and the Resilience and Sustainability Trust (RST), aimed at supporting countries with balance of payment needs.

The PRGT, established in 1999, is the IMF's primary instrument for granting concessional loans to LICs. Since the COVID-19 pandemic, the IMF has provided about USD 30 billion in interest-free loans to 56 LICs through the PRGT. Countries such as Malawi and Haiti used PRGT funds to mitigate the effects of food shocks, while Chad and Zambia have used PRGT financing to support programs involving debt restructuring (IMF, 2023).

The RST was created in 2022 to facilitate rechanneling of SDRs of rich countries (G7/G20) to LICs and MICs, targeted at climate and pandemic resilience policies. At the

end of last year, IMF member states had pledged USD 42.8 billion, of which SDR 16.7 billion usable loan resources that the RST can lend out. Already 18 countries had such loans approved (Kentikelenis et. al., 2024).

The IMF Trusts face limitations that impede the effective rechanneling of SDRs to LICs and MICs:

- Economic policy conditionality: Loan recipients must implement conditionality-carrying IMF programs before any disbursements are made, which could include cutting public expenditures, increasing taxes, removing subsidies, increasing interest rates, and reducing government debts. Such fiscal consolidation and monetary tightening measures can increase poverty and inequality in countries (Stubbs et. al., 2021).
- Eligibility criteria: Eligible countries need to be on an IMF programme and meet an income ceiling of USD 12.050 per capita GNI. Due to this exclusionary character, only six African countries managed to access the RST[1].
- Slow disbursement of the RST: Contributors' agreements totalling over five billion SDRs have been concluded with 18 countries, while only just over one billion has been disbursed (ONE, 2024). The slow disbursement could be attributed to low administrative capacity.
- Limited expertise on climate finance: Via the RST, the IMF exerts influence over countries' climate policies, while the fund has limited climate expertise (see Rwanda case in appendix for example). Program countries often lack capacity to implement certain required climate policy measures.

[1] Kenya, Morocco, Niger, Rwanda, Senegal, and Seychelles

The benefits of AfDB rechanneling

Another approach gaining traction is rechanneling via the MDB's. Countries including France, Japan, the UK, Saudi Arabia, and Canada are showing interest in a proposal by the AfDB and Inter-American Development Bank, the Hybrid Capital Instrument (HCI; Bloomberg, 2022). Hybrid capital, a combination of debt and equity, is a financing instrument widely used by private financial institutions, not yet by MDB's.

The HCI has a leverage ratio of 1 to 3-4, multiplying the resource lending capacity of an MDB. As such, the HCI complements the G20's call for a review of MDBs Capital Adequacy Frameworks to find ways of boosting their lending capacity and complement IMF trusts. The instrument has even gained an AA rating from Standard & Poor as it has limited risks due to its interest rate beyond the SDR rate (AfDB, 2023a).

An important advantage of rechanneling SDRs via MDB's such as the AfDB, is that countries gain access to the MDB's specialized knowledge and technical assistance in the design and execution of development and climate initiatives. In contrast to the IMF, MDB's have a clear development and climate mandate.

Since its inception in 1972, the AfDB has had a portfolio of 4420 projects. Between 2015 and 2020, its portfolio consisted of 764 projects. The AfDB is comprised of three entities: the African Development Bank, the African Development Fund (ADF) and the Nigeria Trust Fund (NTF).

The ADF provides 40 LICs with concessional financing amounting to USD 9.6 billion as of 2013. The Bank has increased its cumulative climate finance from around USD 500 million in 2008 to USD 30.4 billion between 2011-2022, accelerating low-carbon and climate-resilient development in Africa. It has increased projects taking account of climate change impacts from 77% in 2016 to 94% in 2022, targeting 100% before 2025.

The Bank has managed to direct 40% of all investments to climate finance and has increased climate adaptation investments up till 64% in 2022 (AfDBb, 2023).

Given its track record, the AfDB has seen growing confidence in its climate resilience investments. Exemplary is the Alliance for Green Infrastructure in Africa (AGIA), in which the Bank partners with the African Union Commission (a member of the G20) and Africa50 (an infrastructure investment platform). The AGIA is an infrastructure investment vehicle which aims to raise USD 100 million grants for project preparation and USD 400 millions of blended finance capital for project development, generating a USD 10 billion pipeline of bankable transformative green infrastructure projects at a 1:20 leverage ratio (AfDB, 2023). This collaboration, also attracting the interest of philanthropists, strengthens the case for the AfDB's HCI in which African countries with strong financing transition plans can also contribute while rechanneling their excess SDRs[2].

Legal leeway for SDR rechanneling to MDB's in EU

The EU holds over 20% of the global SDRs stock. EU countries have been amongst the first and most generous to pledge their SDRs for rechanneling purposes. However, the ECB has indicated that SDR rechanneling outside of the IMF may not be compatible with the EU's legal framework (ECB, 2021).

For most central banks, it is necessary that rechannelled SDRs preserve their reserve asset status, meeting liquidity and low credit risk criteria. Otherwise, it is considered monetary financing. Within the eurozone, article 123 of the Treaty on the Functioning of

[2] African countries highlighted by the AfDB to have strong transition plans include Botswana, Mauritius and Algeria.

the European Union (TFEU) prohibits the direct and indirect monetary financing of Member States by national central banks. However, European Council regulation 3603 states that the ECB's and national central banks' financing of "obligations falling upon the public sector vis-à-vis the IMF" is not considered as monetary financing. This includes rechanneling SDRs via the IMF Trusts or through VTAs (ECB, 2021).

According to one reading of the Council regulation, rechanneling SDRs via MDBs is therefore prohibited. Other readings of EC3603 allow for interpreting the reference to the IMF as an *example* of entities exempted from the monetary financing prohibition (Paduano, 2023). The ECB has tabled several rulings on IMF operations, despite that the IMF has been exempted. What is more, ECB rulings on IMF operations in the past have provided mixed outcomes, where Ireland's contribution under the Sudan/Somalia HIPC relief was considered as monetary financing (Paduano, 2023), whereas Italy's SDR rechanneling to the RST was not. In the latter case, reference was made to the preservation of all characteristics of reserve assets (ECB, 2022). The ECB's reasoning thus seems to boil down to the reserve asset characteristics and monetary financing prohibition, rather than the question whether the institute rechanneled to is the IMF. Additionally, the IMF itself has recently approved the use of SDRs for acquiring hybrid capital instruments by MDB's (setting a limit of 15 billion), arguing that this new SDR operation would enhance the SDRs' attractiveness as a reserve asset (IMF, 2024).

Hence, there is legal leeway for rechanneling via MDB's. The reserve asset characteristics would be equally maintained, while the purpose of rechanneling would be similar to the Trusts (mainly the RST). Article 123 of the TFEU and EC3603 can be read in such a way that the monetary financing prohibition does not apply to financing the public sector outside the EU, as with the HCI.

Recommendations:

- The G20 should support innovative financing mechanisms that accelerate climate action and promote economic resilience at the scale required across the globe. MDBs are equipped to do this with the HCI. The HCI aligns with the G20's ambition to boost the lending capacity of MDB's. Given that the IMF board has approved the use of HCI, the G20 countries should further promote its use in rechannelling across all other MDBs across the globe.
- Reform the IMF Trusts: The Trusts' strict economic policy conditionality and eligibility criteria should be reformed to provide affordable long-term financing for LICs and MICs. The IMF should obtain technical assistance from the World Bank, MDBs, and development partners about policies and climate finance. The IMF should ensure more coherence between climate-related objectives of RST programs and the concurrent IMF programs (Kentikelenis et. al., 2024). Under these conditions, the Trusts could be enhanced.
- A fundamental reform of the IMF and other International Finance Institutions (IFI's) is needed. The IMF's quota system needs to be reformed to ensure that developing countries receive a significantly larger portion of SDRs during future allocations. Additionally, a new issuance would enable countries most in need to immediately invest in development and climate policies. Calls for a regular or automated (in case of shocks or crises) allocation of SDRs should be equally supported.

Scenario's

Scenario 1: Rechanneling SDRs via MDB's

If the G20 adopts proposals related to rechanneling via MDB's, through the HCI in particular, the global position of MDB's as drivers of sustainable development is strengthened. The expertise of MDB's would be maximally used for the benefit of developing countries. Stronger MDB's contribute to the role of public capital for climate finance and increase trust in the public sector. While the HCI's maximum leverage ratio would quadruple the potential of the SDRs, it is likely to attract even more private investors.

Scenario 2: Reforming and enhancing the IMF Trusts

If the G20 adopts proposals to reform the IMF Trusts, rechannelled SDRs would become available to many more countries. Additionally, the detrimental effects of current IMF conditionalities would be mitigated, and the IMF would improve its climate expertise or collaborate with more knowledgeable institutions. As such, the Trusts could become a more effective vehicle for maximizing the impact of SDRs, and an enhancement of the Trusts could be considered. The trade-off is that there will be less incentive to push for rechanneling via MBD's, which are more apt to support effective development and climate policies.

Scenario 3: New and automated SDR issuance and quota reform

If the G20 agrees on a new SDR issuance, developing countries could directly use SDRs for development and climate policies. Reform of the quota system would ensure that countries most in need will receive (relatively) the most SDRs. Additionally, a regular

or automated issuance of SDRs would enable developing countries to mitigate the effects of economic shocks and climate disasters, contributing to a strengthened global safety net. The trade-off would be that the use of SDRs implies loans having to be repaid, instead of grants from developed countries.

TF03

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Appendix 1: Rwanda RST case study

Let's
rethink
the world