INTERNATIONAL MONETARY FUND

Proposal for a General Allocation of SDRs

Prepared by the Finance, Legal, and Strategy, Policy, and Review Departments

(In collaboration with the Research Department)

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Contents Page

I. INTRODUCTION[1]

1. **Faced with a global crisis of exceptional magnitude, the membership of the IMF has called for ambitious steps to strengthen the global financial safety net**. These include, alongside efforts to strengthen the Fund's lending capacity, an allocation of SDRs equivalent to US$250 billion to become effective well before the 2009 Annual Meetings.[2] This call recognized that an SDR allocation is a prime example of cooperative monetary response to a global predicament. As such it would build confidence by adding to other concrete evidence of the international community's commitment to a collaborative response to the crisis. This paper follows up on the IMFC's request, in its Spring 2009 communiqué, for the IMF to put forward a concrete proposal assessing the case for such a US$250 billion allocation and describing how it could be implemented.

2. **The current circumstances contrast sharply with those prevailing ahead of the ninth basic period**, when—in June 2006—the Managing Director declined to propose a general allocation. That conclusion was driven by the lack of evidence of broad support among the membership; and by the recent and projected economic outlook—strong growth, ample global liquidity, and rapid reserve growth with sustained compression of borrowing spreads and improved access to capital markets. The Managing Director made clear at the time that this did not preclude his making SDR allocation proposals at any time during the ninth basic period if warranted.

3. **The paper argues that the case for a prompt, one-step, general allocation in an amount equivalent to US$250 billion is now strong**. Given the current depressed global economic conditions and grim medium-term outlook, the allocation would be timely—smoothing the need for adjustment and allowing scope for expansionary policies in the face of deflation risks, by providing significant unconditional financial resources to liquidity constrained countries. Over the longer run, additional reserve assets needs are projected to be very large compared to their pre-crisis levels, and the proposed SDR allocation—while covering only a fraction of those needs—would help meet them in ways that are more conducive to systemic stability than some of the alternatives. Overall, therefore, the proposed allocation would help to meet a long-term global need for reserve assets and also generally further the Fund's purposes, while "avoiding economic stagnation and deflation as well as excess demand and inflation in the world," consistent with the criteria laid down in the Articles of Agreement (see Box 1).

4. Should Executive Directors support this assessment, a Managing Director's report to the Board of Governors including a proposal for a general allocation of SDRs equivalent to

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[2] See Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund, April 25, 2009–http://www.imf.org/external/np/cm/2009/042509.htm.

US$250 billion would be promptly prepared for the formal concurrence of the Executive Board around mid-July, to be followed by transmittal to the Board of Governors for approval. On this basis the allocation could be made by end-August.

5. The remainder of the paper is organized as follows: Section II assesses the case for an SDR allocation at the current juncture, including its macroeconomic implications; Section III outlines the key features of the proposed allocation; Section IV discusses post allocation operational issues; and Section V contains issues for discussion. Annexes provide background on various aspects.

II. The Case for a General SDR Allocation

A. Global Context: A Sharp Economic Contraction

6. **The current global outlook points to a deep recession and slow recovery, and risks are weighing to the downside** (Figure 1). In particular, recovery from financial crises tends to be protracted. Further, given the global nature of the crisis, exports are unlikely to provide substantial support to growth. This has important implications for reserves, increasing the need for a buffer given the size of the crisis, but restricting availability of external financing.

7. **The current level of reserves has been put to the test in many emerging market and developing countries (EMDCs), as they experienced a drying-up of external financing.** The crisis has resulted in a sudden stop in capital flows to several countries, capital outflows from many, and dramatic declines in trade. Net private capital inflows to EMDCs are projected to be negative by US$100 billion for 2009. Although there has been a recovery of capital flows to some countries recently, many parts of the global financial system remain strained with insufficient foreign currency liquidity. Renewed bouts of risk aversion could exacerbate capital flight and lead to sharp domestic adjustments and falling demand. Risks to capital flows are likely to remain until financial stability is restored, which may take time.

8. **Policy responses to the crisis have often drained international reserves substantially.** Several countries have sold reserves to boost foreign currency liquidity, while others have provided foreign exchange facilities to the private sector, including commercial banks with reduced or more expensive market access and to support trade finance. Where room was limited for the use of reserves, countries have had to undertake sharp domestic adjustments.

9. **As a result, countries have attempted to protect or augment reserves, through:** market borrowing, which has become much more costly with limited amount of access; official swap arrangements; and borrowing from international financial institutions—the commitments for use of Fund resources have jumped to about US$150 billion. And while protectionist reactions have been contained, the threat remains.

B. Evidence of a Long-Term Global Need

The long-term global need for reserves is estimated using standard metrics of reserves coverage (imports, short-term external debt, and broad money) as well as recent models of optimal reserves. For EMDCs excluding China and fuel exporters, this need is estimated at US$400 billion – US$900 billion over the next 5 years and at US$1.3 trillion – US$2 trillion over the next 10 years.

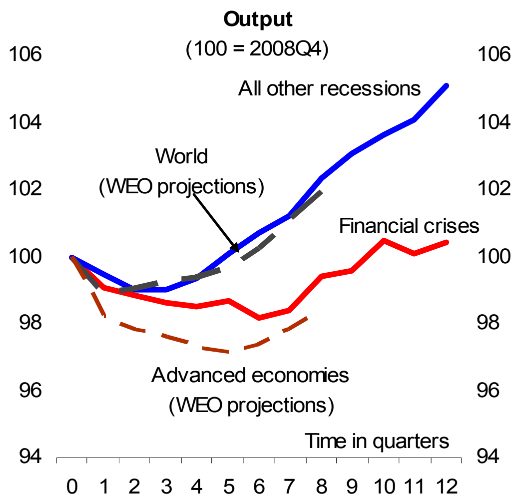
10. **Estimates of the future need for reserve assets are large.** These estimates are computed using standard metrics of reserve coverage for EMDCs excluding China and fuel exporters—a sample comprising 118 countries. The focus is on EMDCs since they do not issue reserve currencies and may at times have difficulties accessing needed amounts of reserve currencies. China and fuel exporters are excluded since, in light of these countries' very large reserve holdings, the benchmarks would be artificially inflated; moreover, as these countries' reserves are not readily available to meet other countries' reserves needs, netting them out would not be appropriate. Advanced economies are also excluded since many of them have already access to freely usable currency. This focus is consistent with past assessments of global need, for example, "SDR Allocation in the Eighth Basic Period—Basic Considerations" (http://www.imf.org/external/np/tre/2001/111601.pdf).

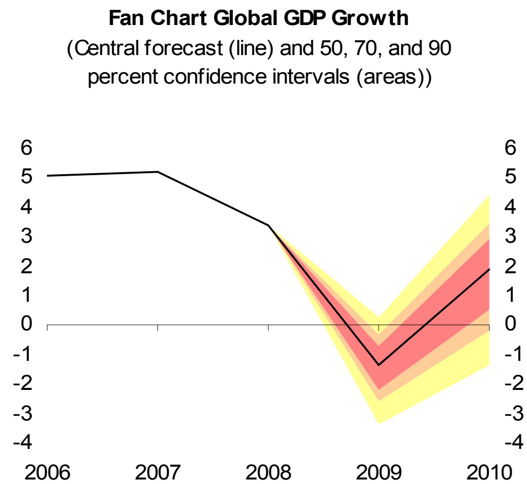
11. **Specifically, the amount of reserves required to maintain the pre-crisis coverage ratios of imports, short-term debt, and broad money is calculated**. The paths for imports, short-term debt, and broad money through 2014 are taken from the WEO, and the reserves need is calculated country by country for EMDCs, excluding China and fuel exporters. Estimates beyond 2014 are computed by extending the WEO projections through 2019, assuming a constant share of GDP of each of the variables from 2014 onward. Table 1 summarizes.

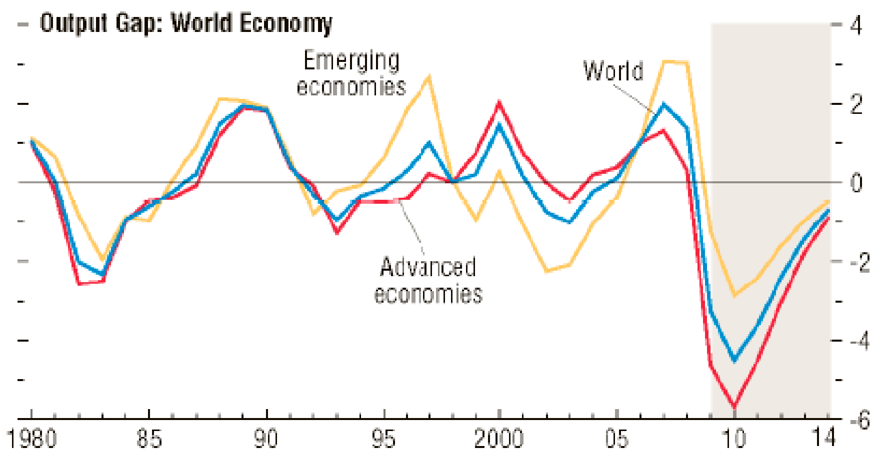
- *Reserve coverage of imports*: this measure reflects coverage of real obligations. In 2007, reserve coverage of imports was 6.1 months. Using this benchmark, an additional US$709 billion of reserves is needed over the next 5 years, which increases to US$1.76 trillion over the next 10 years. Using the 2004–07 benchmark of 5.5 months yields a reserves need of US$482 billion over the next 5 years and US$1.42 trillion over the next 10 years.

Figure 1. Global Economic Outlook: Sharp and Prolonged Contraction, with Downside Risks

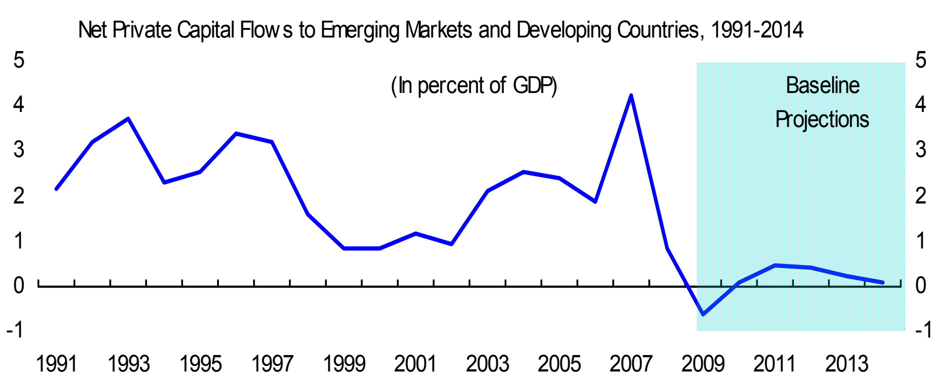
The global economy is experiencing its most severe crisis in decades. Recoveries from financial crises are typically very slow (3 years on average). The outlook is exceptionally uncertain for the current recession, with risks to the forecast still weighing to the downside and support from external demand missing in a global recession.







These risks are compounded by a sharp and sustained projected decline in capital flows to EMDCs.



BOX 1. FRAMEWORK FOR CONSIDERING GENERAL ALLOCATIONS

The framework for considering a general allocation of SDRs revolves around whether there is a long-term global need to supplement reserve assets, whether a general allocation would meet this need in a manner that avoids economic stagnation and deflation as well as excess demand and inflation, and whether there is broad support among the membership for such a proposal.

The basis for considering a general allocation of SDRs is Article XVIII. Section 1(a) states: "In all its decisions with respect to the allocation and cancellation of SDRs the Fund shall seek to *meet the long-term global need*, as and when it arises, to *supplement existing reserve assets* in such a manner as will promote the attainment of its purposes and will avoid economic stagnation and deflation as well as excess demand and inflation in the world." In addition, before making a proposal, the Managing Director is required to "conduct such consultations as will enable him to ascertain that there is broad support among participants for the proposal" (Article XVIII, Section 4(b)).

The Articles do not specify how the long-term global need requirement is to be met. Moreover, the fundamental changes that have taken place in the international monetary system since 1969 when the SDR mechanism was established have made the overall issue somewhat more complicated. In practice, the Fund has followed a two-step process in considering a general allocation of SDRs: first, the demand for reserves to hold is projected and, second, a judgment is made about the extent to which this demand could or should be met through an allocation of SDRs.

Legislative history and past experiences provide guidance on the interpretation of the concept of long-term global need:[1]

- ***Global need***. A global need does not require all or even most IMF members to experience an inadequacy of reserves, but reflects a broad assessment that the projected level of global reserves, in the absence of supplementation, would be inadequate or would result in a suboptimal performance of the global economy.[2] This can occur as long as the group of countries facing the reserves need accounts for a significant share of the world economy.
- ***Long-term need***. The focus is to address a "long term" global demand rather than a cyclical or short-term one. The five-year horizon of the normal basic periods for considering SDR allocations provides guidance, including on the horizon for assessing risks of global deflation and inflation. However, current conditions do influence the assessment of a long-term global need by providing the starting point (e.g., current level of reserves).

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[1] IMF, 2001, "SDR Allocation in the Eighth Basic Period—Basic Considerations," (http://www.imf.org/external/np/tre/2001/111601.pdf). In addition, based on legislative history the "objective of making the SDR the principal reserve asset", introduced in Articles VIII, Section 7 and XXII by the Second Amendment, is not relevant for the Fund's decisions on allocations. While this objective was a consideration in the Managing Director's proposal for an allocation of SDRs for the third basic period, the discussions that led to such proposal show that the objective was found relevant for a decision to allocate but only once a finding of need had been made.

[2] For instance, the previous two instances of SDR allocation (1970-72) and 1979-81) were strongly motivated by the need to replenish global reserves on the grounds that these had not kept pace with world trade (Box 2).

- *Reserve coverage of short-term debt*: this measure reflects coverage of short-term financial obligations. In 2007, reserve coverage was about 200 percent. Using this benchmark, an additional US$800 billion of reserves is needed over the next 5 years, which increases to US$1.88 trillion over the next 10 years. The 2004–07 benchmark of 165 percent points to a need for reserves of US$396 billion over 5 years and US$1.28 trillion over 10 years.

- *Reserve coverage of broad money*: this measure proxies for potential speculative pressures from domestic residents. In 2007, reserve coverage was 28.3 percent. Using this benchmark, an additional US$892 billion of reserves is needed over the next 5 years, which increases to over US$2 trillion in 10 years. The 2004–07 benchmark of 26.6 percent, on the other hand, yields a reserves need of US$745 billion in 5 years and US$1.83 trillion in 10 years.

Table 1. Estimated Long-Term Need for Reserves: EMDCs Excluding China and Fuel Exporters[3]

Reserve coverage of:	***2007 as benchmark*** ***(2004-07)***	***Additional reserves needed over 5 years*** 1/	***Additional reserves needed over 10 years*** 1/
Imports	6.1 months (5.5 months)	US$709 billion (US$482 billion)	US$1.76 trillion (US$1.42 trillion)
Short-term external debt	200 percent (165 percent)	US$800 billion (US$396 billion)	US$1.88 trillion (US$1.28 trillion)
Broad money	28.3 percent (26.6 percent)	US$892 billion (US$745 billion)	US$2.05 trillion (US$1.83 trillion)
Summary		**US$700 b - US$900 b** **(US$400 b-US$750 b)**	**US$1.8 tr - US$2 tr** **(US$1.3 tr - US$1.8 tr)**

1/ "Additional" reserves are defined as reserves needed over and above the level of reserves projected for 2009 in the WEO.

12. **There is potential for even greater future demand for reserves than estimated above**. The calculations provided above assume that there is no further hemorrhaging of

[3] Taking a longer time period as reference, i.e., 1998–2007, estimates of reserves needs are slightly lower, reflecting lower benchmarks: 5.1 months of imports, 130 percent coverage of short-term external debt, and 24.5 percent coverage of broad money. These benchmarks yield estimates of reserves needs of US$700 billion to US$1,600 billion over 10 years. However, this longer timeframe does not take into account structural changes, such as a greater desire for self-insurance in the wake of the emerging market crises of the late 1990s, that have led to more substantial accumulation of reserves in recent years.

reserves beyond 2009,[4] and further that the pre-crisis coverage ratios are the right benchmark. Coming out of the crisis, many countries may in fact desire to have even more reserves buffers and protection, not least because crises are recurring events. Moreover, in the long run, greater capital market integration, including of low income countries (LICs), could also further increase the precautionary demand for reserves. Indeed, countries with relatively higher reserves have tended to face lower borrowing costs and lower volatility of key macroeconomic variables such as real exchange rates (controlling for other factors).

13. **Recent models of optimal reserves can be used to assess the impact of higher risk aversion or higher crisis probabilities and costs**.[5] These models balance the trade-off between the cost of a sudden stop and the opportunity cost of holding reserves. The resulting level of optimal reserves depends critically on the degree of risk aversion of investors or borrowers as well as factors affecting the probability and the cost of crises.

- A generalized increase in both investor and borrower risk aversion, which is possible in the aftermath of the current crisis, has an ambiguous impact on the optimal level of reserves. While an increase in the borrowing country's risk aversion would raise its precautionary demand for reserves, greater risk aversion on the part of international investors raises the opportunity cost of holding reserves. However, the partial effect of the higher borrowing cost resulting from the investor risk aversion unambiguously increases the likelihood of a crisis, both by raising general debt servicing costs of EMDCs and by choking off the demand for precautionary reserves.
- The current crisis may also lead to a re-evaluation of the likelihood or cost of crises and therefore raise the precautionary demand for reserves.[6] Under plausible calibrations, the models discussed above suggest that the additional demand for reserves resulting from such a re-evaluation of crisis costs could imply that the estimates in Table 1 would be around 10 percent greater.[7]

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[4] The April 2009 WEO projected a drain on reserves of over US$270 billion in 2009 for EMDCs, excluding China (http://www.imf.org/external/pubs/ft/weo/2009/01/).

[5] The older literature on demand for reserves stressed the "transactions demand" motive (see, e.g., Flanders 1971, and Frenkel and Jovanovic, Gandolfo 2002), with a more modern variant being that trade typically requires short-term credits, and countries should hold reserves to cover short-term debt. The more recent literature has examined (see Berg, Borensztein and Pattillo, 2005, and Frankel and Wei, 2005, for reviews): (i) the effects of reserves on sudden stops (see Caballero and Panageas, 2007, Calvo, Izquierdo and Mejia, 2004, Durdu et. al., 2008, Cavallo and Frankel, 2008, Ghosh et al., 2008, Jeanne and Rancière, 2009, Jeanne, 2007, and Kim, 2009); (ii) the effects of reserves on currency crises (Chang and Velasco, 2000, and Morris and Shin, 1998); (iii) the relationship between reserves and sovereign spreads (Duffie, Pedersen and Singleton, 2003, Hauner, 2006, and Levy-Yeyati, 2008); and (iv) the role of reserves in reducing the exchange rate volatility (Aizenman et al., 2007, and Hviding, Nowak, and Ricci, 2004). For the calculations in this paper, the models of Jeanne and Rancière (2009) and Kim (2009) are used.

[6] See World Economic Outlook, April 2009, chapter III for a discussion of the output costs of global crises.

[7] The calibration is based on Jeanne and Rancière (2009). Key parameters for the baseline scenario are the probability of a sudden stop (10 percent); the magnitude of the financial account reversal (11 percent of GDP);

(continued…)

C. Role of an SDR Allocation in Meeting the Long-Term Global Need

There are several advantages of a US$250 billion general SDR allocation in helping to meet the long-term global reserves need. Besides immediate benefits in helping to alleviate foreign exchange pressures, it could over the longer term reduce the need for pursuing destabilizing and costly reserve accumulation policies. Of the US$250 billion, nearly US$100 billion would go to EMDCs, including LICs.

14. **There are several sources to meet the long-term global need for reserves**. All these sources have a role to play in meeting the reserves need. Besides an SDR allocation, the sources include:

- ***Net private capital inflows***: to EMDCs excluding China and fuel exporters are projected to decline from over US$500 billion in 2007 (about 6 percent of GDP; the average was about 4 percent of GDP during 2004-07) to about US$150 billion in 2010. Inflows are projected to recover in 2011 to about US$250 billion and then rise to US$360 billion in 2014 (about 3 percent of GDP). These inflows would contribute about US$475 billion to reserves over the next 5 years, leaving a gap of about US$225 billion–US$425 billion. In addition, there are downside risks to the projections. Past episodes of financial stress in advanced economies resulted in net outflows from EMDCs for several years (April 2009 WEO, Chapter 4).

- ***Self-insurance***: through current account surpluses or market borrowing.

- ***Official support***: through a significant further expansion and continued rolling over of bilateral swaps and increased bilateral and multilateral loans—including under the Fund's new Flexible Credit Line and High Access Precautionary Arrangements. For LICs, aid flows are an important source of foreign exchange, although the impact on reserves tends to more limited as they are often used to finance additional imports.

15. **A relatively large SDR allocation would have several benefits, some immediate, others over the longer term**. Each of these benefits would contribute to promoting the Fund's purposes as outlined in Article I, including to promote international monetary cooperation, facilitate the expansion and balanced growth of international trade, shorten the

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and the output cost of a crisis (6.5 percent of GDP)—all of which are calibrated based on sudden stops in a sample of 34 middle-income countries over the period 1975–2003 (see Jeanne and Rancière, 2009). The remaining parameter, the assumed risk aversion, is set to match the model's implied optimal reserve holdings to actual reserves-to-GDP ratios during the period 2004–07. The alternative scenario, in which the perceived cost of crises increases following the current global crisis, the output cost of crisis is raised from 6.5 percent of GDP to 8 percent of GDP (which corresponds to the upper 90 percent confidence interval for the estimated output cost of crises in the sample panel). With this higher cost of crises, the optimal reserves-to-GDP ratio increases from 15 percent of GDP in the baseline to 16.3 percent of GDP—i.e., about a 10 percent increase in the level of reserves. (In fact, given the model's parameters, the optimal reserve holdings is approximately linear in the output cost of crises, though this is not true in general.)

duration and lessen the degree of disequilibrium in the balance of payments of members, and maintain orderly exchange arrangements:

- ***Distribution*****:** an allocation in an amount equivalent to US$250 billion would achieve a significant boost in the reserves of countries with the greatest needs. An amount equivalent to about US$100 billion would go to EMDCs, including LICs. Of this, about US$37 billion would be allocated for EMDCs excluding China, fuel exporters and LICs, an average increase of 7¼ percent in reserves (EMDCs as a group excluding LICs would get about US$80 billion). LICs, excluding fuel exporters, would receive an amount equivalent to about US$15 billion, an average increase of 19 percent in reserves.

- ***Crisis response***: a large immediate SDR allocation would help buffer the sharp contraction in external financing and thereby help forestall further downward pressures on demand, especially for the relatively healthy but hard currency constrained economies. It is fast and does not involve policy conditionality, which is particularly appropriate when/to the extent there is systemic contagion.

- ***Crisis prevention***:

    - ***Low cost buffer***: For most countries, borrowing, particularly from markets, would be significantly more expensive and access less reliable. As an upfront reserve buffer, SDR holdings reduce downside risks to capital inflows, thereby facilitating recourse to other sources of meeting long-term needs, such as market borrowing; by adding to reserves buffers and containing the cost of holding reserves, an allocation would contribute to improved confidence and lower spreads, which would in turn reduce the likelihood of crises.

    - ***Global imbalances***: by providing an additional buffer, an SDR allocation helps limit the need for reserve accumulation policies, such as running persistently large current account surpluses, that can be destabilizing at the systemic level by contributing to global imbalances. Not all countries can pursue such a policy, nor should they.

    - ***More efficient risk sharing***: global risk sharing is more efficient than bilateral or regional swaps.

Box 2. The Case for a General Allocation in the First and Second SDR Allocations

This box summarizes the cases made for the first and second SDR allocations.

The first allocation—SDR 9.3 billion, allocated in broadly equal installments on January 1, 1970, 1971, and 1972—followed the establishment of the SDR mechanism, in the first basic period.

- Evidence of long-term global need: Based on the marked decline in world reserves (gold and U.S. dollars) in absolute terms and relative to world trade since the mid-1960s. Other factors included the heavier reliance on trade restrictions, growing recourse to IFIs to finance payments deficits, and increased use of capital controls.
- The decision also took into account "the attainment of a better balance of payments equilibrium, as well as the likelihood of a better working of the adjustment process in the future" (as required for the first allocation by Article XVIII, Section 1(b)).
- The size of the allocation was based on the projected trend in the need for reserves compared to the prospective growth in reserves. The estimate of reserve needs was broad, from about US$3.5 billion to US$6 billion a year.
  - ✓ Recognizing substantial uncertainties in the estimates, the future rate of reserve growth was calculated under different assumptions, in line with (i) past long-term import growth, and (ii) past average ratio of annual reserve increase to level of imports.
  - ✓ To assess the need for reserve supplementation, the growth of gold and currency reserves was also estimated, assuming an unchanged external position for the U.S.

The second SDR allocation—SDR 12.1 billion was allocated in three similar annual installments on January 1, 1979, 1980, and 1981—took place in the third basic period (1978–81).

- Case for the allocation: consideration of the major changes in the international monetary system since the inception of the SDR (emergence of international capital markets and more flexible exchange rates) served as the basis for the assessment of the long-term global need:[1]
  - ✓ The demand for reserves had increased with the level of international transactions, and was expected to continue to do so even with greater exchange rate flexibility;
  - ✓ A decision to allocate did not depend on a finding that long-term global need could be met only by SDRs, which in any event were not subject to the refinancing problems that were characteristic of reserves borrowed from the market.
- The size of the SDR allocation was based on the projected growth of world reserves relative to world trade, assuming that imports and reserves would grow in the same proportion. Given the variability around this assumption, the increase in reserves was projected between SDR 100–200 billion.
- In the prevailing inflationary environment, a modest allocation (relative to the estimated need) was proposed, notably to take into account possible effects on expectations.

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[1] On the objective of making the SDR the principal reserve asset, as and how this objective was considered for in the Managing Director's proposal for an allocation for the third basic period, see footnote 1 in Box 1 above.

D. Macroeconomic Implications of an Allocation of SDRs

A general allocation in an amount equivalent to US$250 billion would be consistent with "avoiding economic stagnation and deflation as well as excess demand and inflation in the world". It would help alleviate foreign currency constraints in several countries, thereby helping to prevent sharp domestic contractions. Its small size relative to global GDP, trade and reserves suggests that any quantitative effect on global inflation would be limited. Impact on debt sustainability likewise would be minimal in most cases.

Money supply and inflation

16. **The creation of SDRs does not generate money supply per se.** Indeed, their use is likely to be associated mainly with changes in the currency composition and geographical allocation of global money supply (see Box 3). For countries that hold on to their allocation, and generally for shares of the allocation that are not spent, no impact on the money supply would be expected. For allocations that are spent, the ultimate monetary impact would also depend on the extent to which central banks decide to sterilize the transactions and the effect on policymakers' incentives. More generally, the long-run behavior of price levels is a reflection of domestic monetary policies rather than the supply of an outside reserve asset.

- First, if countries selling SDRs use the acquired reserve currency to intervene and sterilize the foreign exchange sales more than reserve currency countries sterilize new issuance, global money supply would increase.
- Second, the SDR allocation might induce more expansionary policies. In countries that face external financing constraint, it could help the country to avoid unduly contractionary policies at times of adverse shocks. Indeed, this is one objective of the allocation. In this case, inflation may be higher—or deflation lower—than otherwise, although this would be welfare enhancing rather than a source of concern. In some other countries, increased availability of external financing may allow greater flexibility to conduct monetary and fiscal policies, and the resulting inflationary pressures may in part be exported to other countries—which is a form of moral hazard. Sterilization on the part of reserve currency countries may, however, offset in part or in full such inflationary pressures.

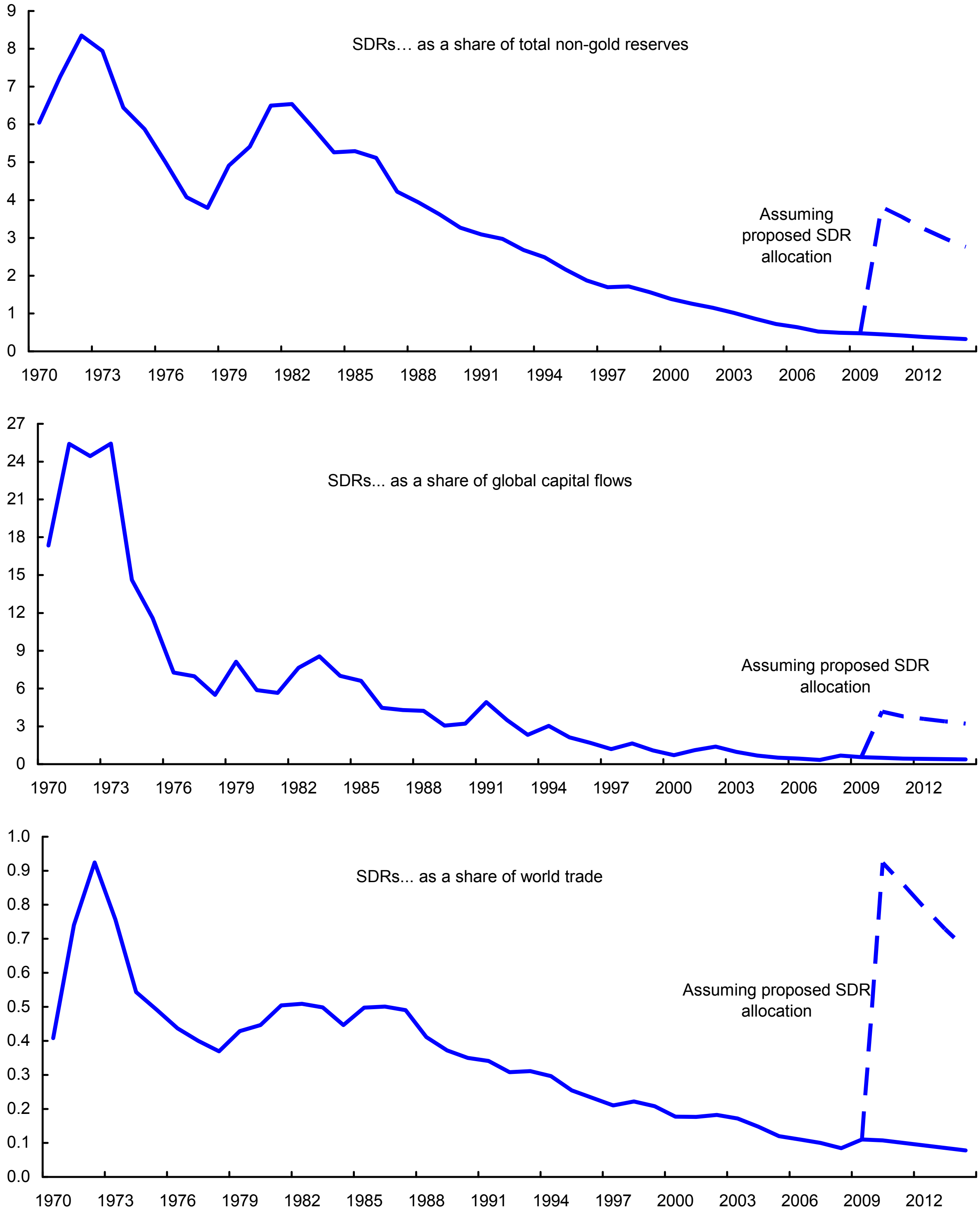
17. **In any event, the impact of the SDR allocation on global money supply and inflation is unlikely to be sizeable**:

- A US$250 billion general SDR allocation amounts to only about ⅓ of 1 percent of global GDP and about 3 percent of global reserves. As a share of global trade, it is similar to the 1972 allocation, at less than 1 percent. And it is only about 3½ percent of global cross-border capital flows, down from 25 percent in 1971–73 (Figure 2).

Figure 2. A Long-Term Perspective on the SDR, 1970 - 2014

(in percent)

The proposed SDR allocation is small compared to global reserves, international capital flows, and global trade. As a share of these, the allocation would be similar or smaller to the 1972 allocation.



Sources: IFS, WEO.

Box 3. Implications of General SDR Allocation for the Central Bank Balance Sheets and Money Creation

This box discusses the implications for central banks' balance sheets, reserves, and global money supply,[1] of various scenarios related to the use of SDRs. A general SDR allocation would increase reserves, but would not per se affect the global money supply. Accounting considerations are discussed in Annex III.

Net international reserves would increase for every participating country. SDR holdings are classified as assets in central banks' balance sheets, while SDR allocations are treated as long-term liabilities[2] that are not netted out against the reserve assets. Hence, a general SDR allocation would normally increase both gross and net reserves of all countries receiving the allocation, and global reserves would go up by the full amount of the allocation.

The central bank of the country that sells its SDR holdings in exchange for a reserve currency (say, country A) would experience a change in the composition of its reserves. On the asset side of the central bank's balance sheet, the amount of SDR holdings decreases while that of the reserve currency increases. On the liability side, SDR allocations remain unchanged. Domestic and global money supply remain unaffected (until the seller central bank spends the reserve currency, see below).

The central bank balance sheet implications for the country buying SDRs (say, country B) would depend on whether or not it issues the reserve currency.[3] If country B does not issue the reserve currency, holdings of SDR would increase while those of the reserve currency would decrease, implying a shift in the composition of reserves. Domestic and global money supply would remain unchanged. However, for a country issuing the reserve currency, SDR holdings (assets) and foreign liabilities would increase. As the liability is toward a foreign central bank, again domestic and global money supply would remain unchanged.[4]

It is natural to conceive that country A would use the reserve currency to intervene in the market, then the amount of the reserve currency in circulation would increase globally, while that of the local currency would decline.[5] For example, the authorities may want to resist pressure on the exchange rate in the face of a speculative attack or balance of payment needs. Global money supply would remain unchanged—unless there is an exchange rate effect—but its composition would have changed.

The market participant that acquired the reserve currency might use such currency to import goods or buy assets from residents of country B. In this case, the world will end up not only with a change in composition of money supply (less of currency of country A and more of the one of B) but also with a geographic reallocation (more money in country A and less in B).

Countries may choose to sterilize their change in domestic money supply, as country A (B) may fear deflationary (inflationary) pressures. If both countries sterilize in the same amount, global money supply remains unchanged, and the initial composition is restored. To the extent that countries differ in the extent of sterilization, global money supply would change.

Overall, the creation and use of SDR are likely to have a neutral effect on global money supply. Some effects may arise from asymmetric sterilization policies or from a change in the policy incentives induced by the availability of additional reserves, especially for countries facing binding constraints on external financing.

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[1] The analysis in this Box reflects the fact that many members' SDR positions are shown in their central bank's balance sheets. Global money supply here refers to the liabilities of the global banking system (that is, all central and commercial banks).

[2] See the *Balance of Payments and International Investment Position Manual*, sixth edition.

[3] There are several possible ways in which the buyer country can provide liquidity to the seller country, each of which may have different implications for money supply in the buyer country. For simplicity, here we assume that the buyer central bank creates a credit line for the seller central bank, so the effect on global money supply is unchanged.

[4] According to the *Monetary and Financial Statistics Manual*, money holders are "usually defined to include all resident sectors except depository corporations and the central government."

[5] While waiting to use the reserve currency for intervention, country A may choose to invest it in the assets of country B in order to gain interest. During this period and depending from which sector in country B the assets are purchased, money supply in country B, as well as global money supply may increase. This would be reversed when country A sells the assets or if country B sterilizes the increase.

- It is also small in relation to other forms of liquidity creation at the current time: from mid-2007 to March 2009, base money in the U.S. increased by about US$900 billion (more than doubling the central bank's balance sheet); while base money in the Euro area increased by about US$300 billion. In stock terms, a balance of payments related upper bound of projected usage (SDR30 billion, see below) would represent about 1 percent of the total base money of reserve currency issuers, suggesting the relevant central banks could sterilize the associated liquidity creation without difficulty.

- Moreover, despite recent discussions of green shoots, history points to the risks of a deep recession and slow recovery, and the economic outlook for the coming years appears bleak. As discussed earlier, the median recovery period of output during financial crises is around 3 years, compared with about 1 year for all other recessions with very slow recovery of credit. These past recoveries, however, were export-led, which is unlikely in a global recession. Indeed, the WEO projects a global output gap to persist through 2014, by which point any expansionary impact of early spending of the SDR allocation should have dissipated.

As such, the allocation seems unlikely to generate global inflationary pressures.

Debt sustainability

18. **The increased debt service burden associated with the use of the SDR allocation will have a bearing on members' debt sustainability indicators.** Specifically, in the context of the Bank-Fund LIC Debt Sustainability Framework (DSF), the interest payment obligations stemming from members' use of their SDR holdings will increase the present value of public and publicly guaranteed external debt and thus its ratios to GDP, exports and revenue—key indicators to assess debt sustainability in LICs.[8] The ratios of public and publicly guaranteed external debt service to exports and revenue, the other key debt sustainability indicators in the DSF, will also increase. For middle income countries (MICs), debt service ratios will also be affected. Country practice, however, varies as regards the inclusion of SDR allocations in nominal debt stocks, and it is recommended that debt sustainability analyses be explicit about the recording convention used.

19. **At current interest rates, the impact on debt sustainability indicators of using the new allocation would be limited for nearly all Fund members**.

- SDR allocations constitute a relatively limited share of GDP and exports in most LICs, and even more so in MICs (Figure 3). In a small number of LICs, however, these shares are sizeable and use of the full SDR allocation could have non-negligible implications for debt sustainability.

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[8] Since external debt in LICs is often contracted on highly concessional terms, debt sustainability analyses under the LIC DSF are not based on the nominal debt stock.

- At current low SDR interest rates, the debt service obligations generated by use of SDR allocations would be very small and, hence, the impact on debt service indicators (or present value of debt) would be practically negligible for most countries.[9]

20. **Use of the SDR allocation would expose LIC members to interest rate variability, an important concern in at least a few LICs (Figure 3).** The current SDR interest rate of 0.4 percent is at a very low level by historical standards—over the last thirty years, it has averaged about 5.5 percent. Interest obligations will increase as SDR interest rates rise, although the associated debt service burden would remain manageable for most members even if they drew the full amount of the allocation. Particular attention should be paid to the interest risk in those LICs where the SDR allocation is sizeable as a share of key macroeconomic aggregates. More generally, the SDR allocation should not be seen as a substitute for PRGF resources, which do not raise such risks and are less costly in most circumstances.

E. Summary: The Case for a US$250 Billion General SDR Allocation

21. **The proposed amount—equivalent to US$250 billion—cannot be derived directly from the overall needs estimates, but seems a sensible order of magnitude:**

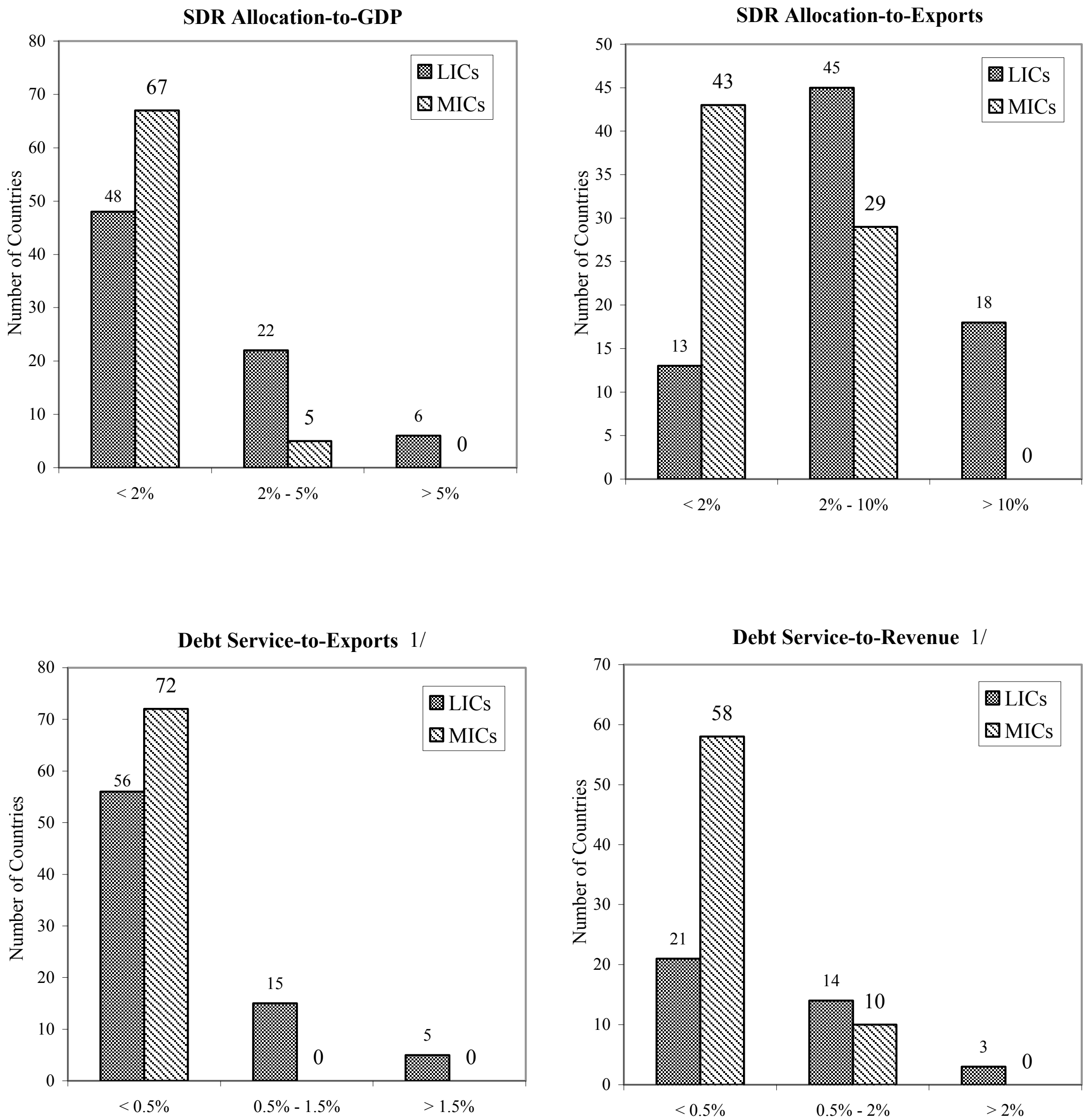
- Using various benchmarks and model estimates, and despite some uncertainty, future needs for additional reserve assets are expected to be large—ranging from US$400 billion – US$900 billion in the next 5 years to about US$1¼ trillion – US$2 trillion in the next 10 years. Moreover, there is upside potential to these estimates.

- While other sources are available to meet at least a significant portion of these needs, meeting them in part through a general SDR allocation has clear advantages in terms of both immediate crisis response and longer-term crisis prevention.

- Crucially, a general allocation equal to US$250 billion is a level that is likely to garner broad support from the membership.

[9] In only one LIC would the use of the entire allocation cause a member to breach any of its policy dependent DSF thresholds in the baseline scenario, with possible implications for a downgrading of the rating to high risk.

Figure 3. SDR Allocation and Debt Service for Low and Middle Income Countries



Source: WEO and most recent LIC DSAs.

1/ Debt service is calculated based on the 30-year historical average SDR interest rate of 5.5%.

III. Key Features of the Allocation: Legal Aspects

This section discusses key legal aspects of the proposed SDR allocation, including the decision making framework, the context and distribution of the allocation, and its implications for certain classes of members and vis-à-vis the proposed Fourth Amendment for a special one-time allocation of SDRs.

A. Decision-Making Process

22. Under the Articles of Agreement, decisions on allocations (and cancellations) of special drawing rights "shall be made by the Board of Governors on the basis of proposals of the Managing Director concurred in by the Executive Board" (Article XVIII, Section 4(a)). Before making a proposal to allocate SDRs, the Managing Director must: (a) satisfy himself that such an allocation would be consistent with the relevant economic criterion (i.e., as discussed above, it would satisfy a long-term global need to supplement reserve assets in a manner that would avoid stagnation, deflation, excess demand and inflation) and (b) conduct such consultations as will enable him to determine that there is broad support among participants for the proposal.

23. Adoption of the Board of Governor's resolution to allocate SDRs requires an 85 percent majority of the total voting power of members that are participants in the Special Drawing Rights Department (Article XVIII, Section 4(d)). Adoption of the Executive Board's decision to concur in the Managing Director's proposal requires a majority of the votes cast.

24. In light of the above, and to the extent that Executive Board's discussion of the proposal set forth in this paper reveals broad support for the proposed SDR allocation, the Managing Director intends to submit for Executive Board consideration a report to the Board of Governors containing his formal proposal for a general allocation of SDRs in an amount equivalent to $250 billion, which will include a draft Board of Governors' resolution. If the Executive Board concurs with the Managing Director's proposal, the Managing Director's report will be submitted to the Governors with a request for a vote without meeting on the proposed resolution pursuant to Section 13 of the By-Laws. Members who are participants in the SDR Department whose voting rights are suspended pursuant to Article XXVI, Section 2(b) cannot participate in the adoption of the Executive Board decision to concur in the Managing Director's proposal or in the Board of Governor's resolution on the proposed general allocation.[10]

[10] Under the Articles, "the number of votes allotted to the member [whose voting rights have been suspended] shall not be cast in any organ of the Fund. They shall not be included in the calculation of the total voting power, except for purposes of the acceptance of a proposed amendment pertaining exclusively to the SDR Department" (Schedule L, paragraph 2). No similar exception exists for votes related to decisions on general allocations of SDRs.

B. Determining the Period and Distribution of the Allocation

(a) Basic Period for the Allocation

25. Under the Articles, the general provisions require that (i) decisions of the Fund to allocate shall be made for "basic periods" which shall be five years in duration and (ii) allocations shall take place at yearly intervals within each basic period. Notwithstanding these general provisions, however, the Articles also provide for considerable flexibility. Specifically, when making a decision for a basic period, the Fund may decide, inter alia, that the relevant basic period shall be less than five years and that the SDR allocation shall take place at other than yearly intervals (Article XVIII, Section 2(c)). Moreover, even if no decision has been taken to allocate SDRs at the beginning of a basic period, the Articles give the Managing Director the authority to propose an allocation whenever he determines that the conditions summarized in paragraph 22 above have been satisfied (Article XVIII, Section 4(c)(ii)).

26. The current basic period, the ninth, began on January 1, 2007 and, as noted in introduction, no decision to allocate SDRs was made at that time. Taking advantage of the flexibility provided for under the Articles, described above, it is proposed that an allocation of SDRs be made under Article XVIII for the current ninth basic period and that the full amount of the allocation take place 21 days after the decision to allocate, i.e., 21 days after the adoption by the Board of Governors of the relevant resolution. Since it is envisaged that the Board of Governors resolution would be adopted in early August 2009, this would mean that the allocation would be made by end-August.[11]

27. Current circumstances call for a one-step rather than staggered allocation. As discussed above, with large output gaps and an immediate need for liquidity, the allocation would be consistent with "avoiding economic stagnation and deflation as well as excess demand and inflation in the world". Compared to the first two allocations, when the growth and inflationary environment, respectively justified a staggered approach, a one-step approach appears more adequate today, given the large output gap and the need for removal of the policy stimulus over the medium-term.

(b) Distribution of Allocation

28. Under the Articles, the general provision requires that "the rates at which allocations are to be made shall be expressed as percentages of quotas on the date of each decision to allocate" and that "the percentages shall be the same for all participants". However, the Articles also provide that, when making the decision to allocate, the basis for allocation may be the quotas of participants on dates other than the date of the decision to allocate (Article XVIII, Section 2(c)).

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[11] Similar to the present case, the general allocation of SDRs for the third basic period was proposed by the Managing Director pursuant to Article XVIII, Section 4(c)(ii) after the third basic period had begun as an "empty" period.

29. In light of the fact that, as discussed above, it is proposed to allocate the full amount of SDRs 21 days after the decision to allocate, the allocation will be based on participants' existing quotas. While an allocation that takes into account the second round ad hoc quota increases envisaged for a number of members under Resolution No. 63-2, would be feasible, it would require the allocation decision to provide for the actual allocations to take place at a later date or dates, i.e., when all the relevant increases had come into effect. (It would not be possible for the allocation decision to provide that the allocation will take place on the basis of proposed quotas, since these quotas may never enter into effect). This was the approach taken in the third basic period, when the allocation was phased over time and took account of increases in quota that came into effect after the initial decision (but before the relevant annual allocations). However, such a delay would undermine the rationale for the existing proposal, which rests importantly—alongside evidence of a long-term need for reserve assets—on the depressed current and medium-term outlook. The latter elements provide comfort that, as required by Article XVIII, the proposed allocation would avoid economic stagnation and deflation as well as excess demand and inflation in the world. Moreover, a delay to allow the effectiveness of the second round of ad hoc increases could be significant as Resolution No. 63-2 specifies that no quota increase may become effective until the proposed amendments regarding an increase in basic votes and the appointment of a second Alternate Executive Director have also entered into effect.

30. In light of the above analysis, the rate for the general allocation of SDRs for the ninth basic period would be approximately 74.27 percent of eligible participants' quotas on the date of the adoption of the Board of Governor's resolution on the SDR allocation, taking into account certain assumptions regarding eligibility and opting-out, discussed further below. This rate is the percentage, rounded to the nearest one hundredth of one percentage point, that results from dividing an amount of SDRs equivalent to US$ 250 billion (based on exchange rates as of end-May 2009) by the total of quotas of those participants. For the actual allocation calculations, it is proposed that the USD/SDR exchange rate to be used for purposes of converting the US$250 billion proposal would be that of the date of the summing up of the Board discussion of the current paper.

(c) Eligibility and Opting Out

31. The rate of allocation specified above assumes that all Fund members that are participants in the SDRs Department would receive allocations made under the Managing Director's proposal (see list of participants and proposed allocations attached in Annex I). For purposes of this assumption, the following should be noted.

(i) ***New Participants***

32. Under the Articles, a member that becomes a participant after the commencement of a basic period, will only be able to receive allocations made during that basic period if the Fund decides that it may do so. Such decision may be adopted by the Executive Board by a majority of the votes cast.

33. It is assumed that the Executive Board would adopt such a decision for the benefit of all members that have become SDR Department participants since the commencement of the ninth basic period, consistent with the approach that has been followed in previous

allocations. This would include the Republic of Montenegro, which became a participant on January 18, 2007. The calculations underlying the rate of allocation discussed above also assume that Kosovo would be eligible for the allocation.[12]

(ii) ***Opting Out***

34. Under the Articles, a member that was a participant at the beginning of the relevant basic period shall receive an allocation unless (a) the Governor for the participant did not vote in favor of the decision *and* (b) the participant has notified the Fund in writing prior to the first allocation of special drawing rights under that decision that it is does not wish special drawing rights to be allocate to it under the decision (Article XVIII, Section 2(e)). The rate of allocation identified above assumes that no participant will opt out of the allocation.

(iii) ***Participants with Suspended Voting Rights***

35. Participants whose voting right has been suspended may not participate in the voting process with respect to either (a) the concurrence of the Executive Board or (b) the adoption of the Board of Governors' resolution. However, unless a participant whose voting rights have been suspended also notifies the Fund that it wishes to opt out of the allocation (see above), it will receive its allocation on the same basis as other participants.

(iv) ***Participants with Overdue Obligations to the Fund***

36. Participants in the SDR Department that are in arrears to the Fund in either the General Department, the SDR Department or to the Fund as trustee, are eligible to receive the SDRs allocated to them for the ninth basic period on the same basis as all other participants**.** However, under Article XX, Section 5, the SDRs allocated to participants with overdue charges in the SDR Department shall be immediately applied against such unpaid charges and cancelled (up to the extent of such charges). In contrast, the Fund is precluded under the Articles from automatically eliminating overdue obligations resulting from the use of Fund resources in the General Resources Account or to the Fund as trustee with SDRs received by the participant under the general allocation (see Box 4).

C. Relationship with Proposed Fourth Amendment of the Articles of Agreement

37. SDRs allocated to participants in the SDR Department under the proposed general allocation will be separate and additional to any SDRs that could be allocated to such participants under the proposed Fourth Amendment of the Articles of Agreement.[13] While

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[12] The Republic of Kosovo applied for membership in the Fund on July 10, 2008. By Resolution No. 64-2, effective May 5, 2009, the Board of Governor's offered to Kosovo membership in the Fund. Pursuant to this resolution Kosovo may accept membership within six months from the effective date of the resolution (i.e., by November 4, 2009).

[13] As specified in the text of proposed Schedule M, current participants in the SDR Department will receive their special allocation on the 30th day following the effective date of the Fourth Amendment.

general allocations under Article XVIII are based on the finding of a long-term global need to supplement existing reserve assets, the special allocation under the proposed Fourth Amendment is based on equity considerations (see box II.1 in Annex II on the proposed Fourth Amendment).[14]

38. The proposed general allocation would have limited effects on the size of the special allocation of SDRs that participants could receive under the Fourth Amendment. Specifically, such effects would be limited to the size of any future special allocations made under the Fourth Amendment to countries that may become Fund members and SDR Department participants after the general allocation for the ninth basic period.

IV. Post Allocation Operational Issues

This section discusses the significant operational implications of the proposed SDR allocation. It provides estimates of the potential volume of future SDR transactions; highlights the need for modifying and expanding the existing two-way arrangements; discusses the role of the designation mechanism; and briefly touches upon other post-allocation issues.

A. SDR Allocation and Conversion of SDRs into Freely Usable Currencies

39. **As discussed above, it is proposed that the general allocation of SDRs would be made soon after its approval by the Board of Governors** (see paragraph 26). The allocation would be reflected in a simultaneous increase of (i) the SDR holdings and, (ii) the cumulative SDR allocation, of each participant in the SDR department by the same percentage of each participant's quota.[15] Table I.1 in Annex I provides illustrative figures for an allocation of 74.27 percent of quota, equivalent to US$250 billion as of May 29, 2009.[16] Global reserves would rise by the amount of the allocation.

[14] In addition, while general allocations under Article XVIII are made as a percentage of quotas, with all participants receiving the same percentage, allocations under the Proposed Fourth Amendment would not be made in proportion to quotas but rather pursuant to a methodology that would bring participants' net cumulative allocations-to-quota ratio to a specific common benchmark, as provided for in Schedule M of the proposed Fourth Amendment.

[15] SDR holdings are reserve assets created by the Fund and equivalent to liquid balances in convertible currencies in nearly every respect (See Annex III on statistical treatment of SDR holdings and allocations). As discussed above, all current participants will receive part of a general SDR allocation unless (i) the Governor for the participant did not vote in favor of the decision, and (ii) the participant has notified the Fund in writing prior to the first allocation under a decision that it does not wish SDRs to be allocated to it under the decision. As also discussed above, for members with arrears in the SDR Department, holdings would increase less up to the extent of those arrears.

[16] The May 29 USD/SDR rate is used here for illustration. The actual rate will be as noted in paragraph 29.

Box 4. General Allocation of SDRs to Participants with Overdue Financial Obligations to the Fund

Pursuant to Article XVIII, Section 2(e), "A participant [in the SDR Department] *shall* receive allocations of special drawing rights made pursuant to any decision to allocate, unless (i) the Governor for the participant did not vote in favor of the decision; and (ii) the participant has notified the Fund in writing prior to the first allocation of special drawing rights under that decision that it does not wish special drawing rights to be allocated to it under the decision…". This provision establishes a mandatory regime pursuant to which each SDR Department participant *must* receive its share of a general SDR allocation unless it meets the specific opt-out requirements specified in the provision. Consequently, there is no basis upon which the Fund could exclude a participant—including one with overdue financial obligations to the General Department, the SDR Department, or the Fund as trustee—from receiving SDRs in a general allocation under the Articles. The Articles, however, do require the Fund to automatically apply the SDRs subsequently acquired by a participant with overdue charges, including SDRs acquired in a general allocation, against the overdue charges and to subsequently cancel these SDRs (Article XX, Section 5).

The above-mentioned mandatory regime for SDR allocations reflects the virtually complete separation between the Fund's General and SDR Departments in accordance with Article XVI, Section 2,[1] and between each of these Departments and the Trusts administered by the Fund in accordance with Article V, Section 2(b).[2] Certain additional important consequences arise from the above-referred principle of separation, including (i) a participant's right to use SDRs cannot be suspended on account of arrears to the General Department or to the Fund as Trustee (in contrast, the Fund may suspend a participant's right to use SDRs following its failure to fulfill any obligation with respect to SDRs; and (ii) a participant's voting and related rights in the Fund cannot be suspended on account of its failure to fulfill any obligations with respect to SDRs.

The proposed Fourth Amendment provides for a limited exception to this principle of separation that, by its terms, applies only to the allocation under that Amendment. Under this exception, the SDRs allocated under the proposed Fourth Amendment to a participant with overdue repurchases and charges in the GRA, overdue principal and interest on loans in the SDA, overdue charges and assessments in the SDR Department and overdue liabilities to the Fund as trustee would not be made available to the participant, but rather would be deposited and held in an escrow account in the SDR Department; these SDRs would be released to the participant only upon the discharge of all such overdue obligations to the Fund.

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[1] Article XVI, Section 2 provides that any assets or property held by the Fund in one department shall not be available to discharge or meet the liabilities, obligations or losses incurred by the Fund in the conduct of the operations and transactions of the other department; it allows a specific exception only for the expenses incurred by the Fund in conducting the business of the SDR Department

[2] Article V, Section 2(b) specifies that operations involved in the Fund's performance of services for such trusts shall not be on account of the Fund, and the Commentary to the Second Amendment clarifies further that "…assets in the Accounts of the General Department or any assets in the Special Drawing Rights Department would not be available to meet obligations or liabilities incurred in the course of these services." (See *Commentary* contained in *Proposed Second Amendment to the Articles of Agreement, A Report by the Executive Directors to the Board of Governors,* Washington, D.C. (March 1976), page 19.)

40. **Participants can use their SDR holdings to obtain freely usable currencies either through transactions by agreement or through the designation mechanism**. Transactions by agreement can be conducted bilaterally between participants, but are typically mediated by the Fund through the system of voluntary arrangements (Annex IV). If the volume of SDR transactions exceeds the absorption capacity of this system, the designation plan would be activated to preserve the liquidity of the SDR, by ensuring that those participants with a balance of payments need can exchange SDRs for freely usable currency (Annex V). If needed, such transactions by designation would be met by members with an external position sufficiently strong to be included in the designation plan—currently 51 members accounting for 82 percent of quota and also of the general SDR allocation. Exchanges of SDRs for freely usable currencies have averaged about SDR 2.2 billion per annum in recent years and, since August 1987, all transactions have been effected through voluntary arrangements without recourse to the designation mechanism.

B. Potential SDR Transactions after a General SDR Allocation

Balance of payments projections and portfolio considerations offer some perspective on the potential use of SDRs after an allocation. However, with the proposed allocation a multiple of earlier allocations and amid a highly uncertain global outlook, such projections entail a large degree of uncertainty. Available estimates suggest upper bounds for potential SDR transactions, well in excess of the recent volume of activity in the SDR Department.

41. **Countries can use SDRs to finance their balance of payments needs or to acquire other assets as part of their reserve management**. A country with a need to sell SDRs for balance of payments purposes is able to obtain the requisite freely usable currency without delay through voluntary transaction or the designation mechanism. While some central banks treat SDR holdings passively, with net usage depending on transactional needs for SDRs, others manage their SDR holdings more actively and may choose to convert them into other assets according to their reserve management strategy, even in the absence of balance of payments need (through voluntary transactions).

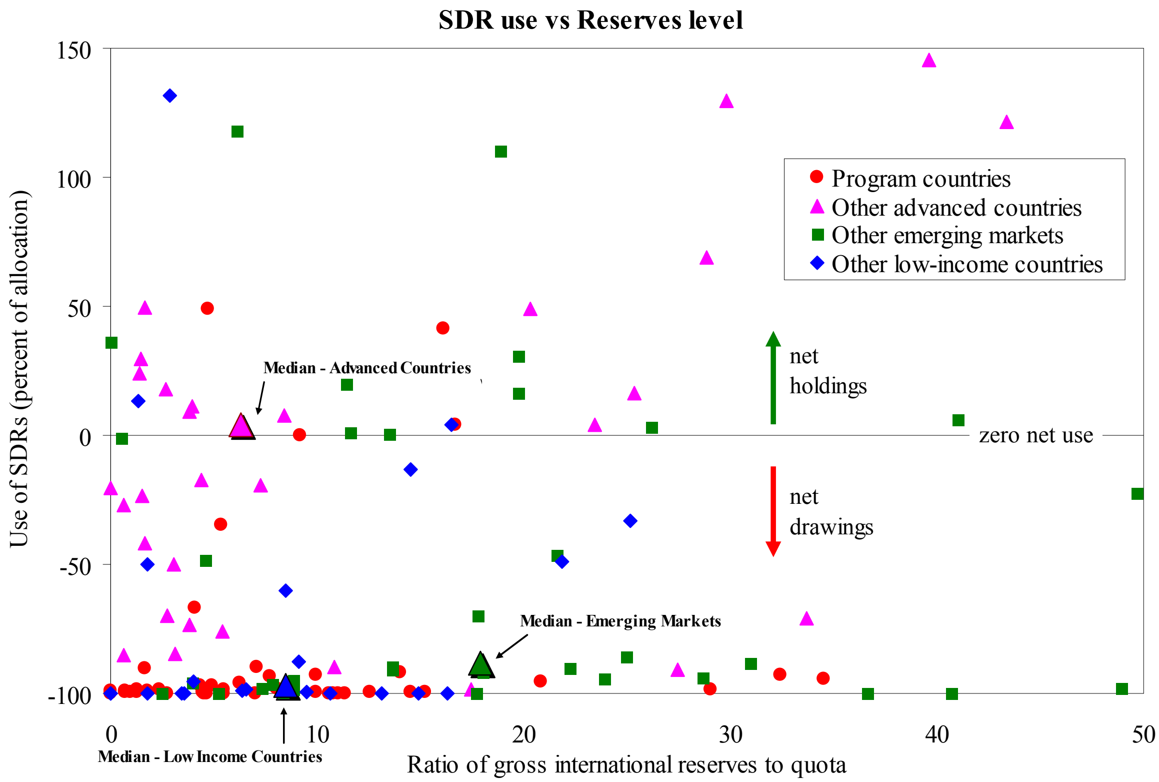
42. **SDR holdings relative to allocations vary widely across countries.** In recent years, members have used their SDRs for three main purposes: (i) balance of payments needs; (ii) transactions involving the Fund; and (iii) portfolio choices as part of reserves management. This has resulted in a wide range of usage patterns, even across countries with apparent similarities.[17] Figure 4 shows that there is very little correlation between the level of reserves and the use of SDRs.[18] Data points near the bottom left corner of the chart may represent use for balance of payments need, while those towards the lower center and right

[17] For example, the United Kingdom and India hold very little of their allocations, while Germany and China hold SDRs substantially in excess of their allocations.

[18] The chart shows March 2009 data for countries which have received allocations, and excludes eight outliers: five with very high reserves and very high SDR holdings, two with very high reserves and very low SDR holdings, and one with low reserves and high SDR holdings.

may represent portfolio choices (or possibly past usage for balance of payments need that has not subsequently been replenished).

Figure 4: Relationship between SDR usage and reserves, 2008



43. **Nevertheless, some general patterns emerge** (Table 2):

- *Advanced economies'* holdings of SDRs vary widely relative to allocations, but are close to allocation on average.

- Holdings of *emerging market countries* (EMs) declined substantially below their allocation in the late 1980s and early 1990s, with much of the decline occurring around the time of the second allocation, which coincided with the Latin American debt crisis. Since then, there has been a significant accumulation of SDRs, to about three-quarters of the allocation of this group, partly reflecting the accumulation of SDRs by new members that have not received an allocation.

- *Low income countries* typically hold SDRs well below their original allocations, as they used most of their SDRs received in earlier allocations and have not replenished their holdings.

- *Program countries* (whether LICs or EM) mostly fully draw down their allocations: over 80 percent of program countries are using more than 90 percent of their allocations, with an average usage of almost 85 percent. To an important extent, countries in these groups have elected to repay program-related obligations to the Fund in SDRs, and to a lesser extent to use their SDR allocations for other needs.

Table 2. Median SDR Holdings of Selected Groups of Countries 1/
(In percent of cumulative allocations)

		Sub-Samples			
		First Allocation	Second Allocation	High Use of Fund Credit	Recent Turmoil
	Whole Sample	1970-75	1979-83	1994-2003	2007-09
Advanced economies	101.6	105.7	81.1	103.0	93.9
excl. FTP members	3.6	74.3	12.0	1.9	8.6
Emerging and developing economies	58.1	61.0	56.4	60.4	73.6
excl. FTP members	42.9	52.5	47.0	43.6	41.4
PRGF-eligible	17.8	58.0	36.3	16.2	14.1
excl. FTP members	21.0	50.0	21.1	20.1	20.7

Source: Finance Department.

1/ As in the 2008 Quota and Voice Reform, emerging and developing economies include Korea and Singapore and all countries that are not classified as advanced economies. The 26 advanced economies are: Australia, Austria, Belgium, Canada, Cyprus, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Israel, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, San Marino, Spain, Sweden, Switzerland, United Kingdom, and the United States.

44. **There is considerable uncertainty over the extent to which members will choose to use their increased SDR holdings and how quickly.** Historical holdings do not appear to be subject to clear empirical determinants, and in any case there is the likelihood of structural breaks in holding patterns in the context of the present global crisis and taking account of the large scale of the proposed SDR increase relative to the existing stock. Given the uncertainties involved, the following estimates should be viewed as illustrative of potential use rather than predictions.

45. **Upper bounds on SDR usage can be estimated on the basis of existing and potential balance of payments needs and of past portfolio patterns:**

- **Transactions would reach about SDR 10 billion in a scenario where countries with identified balance of payment needs fully use their SDR allocations.** This universe is proxied by countries that have or are currently negotiating a Fund-supported program. Actual SDR transactions may well fall short of this level. In particular, financing needs are typically met under programs by a combination of financing and macroeconomic adjustment, and Fund programs may require the additional liquidity from the SDR allocation to be retained in reserves.[19]

- **Under a second, adverse global crisis scenario, additional SDR transactions could amount to about SDR 20 billion—bringing the total to SDR 30 billion**. This

[19] Scope for SDR usage in Fund-supported programs will have to be assessed on a country-specific basis. Annex VI presents a discussion of the impact of SDR allocations on program design.

scenario—drawing on the internal vulnerability exercise—is defined as a "sudden-stop" with further declines in rollover rates of capital flows to emerging market countries, and partial use of reserves until they reach 100 percent coverage of short-term external debt. The amount of SDR transactions by a member is assumed to be the lower of the resulting financing gap and the additional allocation: emerging market countries with financing gaps are assumed to use the full amount of additional allocation until the gap is filled. Full use of the additional allocation is assumed for all low-income countries, where no estimate of the BOP gap is available, since many of them face binding financing constraints that would be relaxed by the additional allocation.

- **A third scenario adds to balance-of-payments related sales those related to portfolio preferences, which could reach possibly up to SDR 25 billion**. Several countries not covered in the two scenarios above currently hold SDRs well below their cumulative allocations. If these countries were seeking to sell SDRs after the proposed allocation to move their actual holdings again in line with historical patterns, this would imply a sizable additional supply of SDRs. It is important to note, however, that this is likely to present an upper bound (and probably by a wide margin) of potential sales: holdings below allocation by these countries often reflected SDR sales for quota increases rather than pure portfolio considerations; and some of these countries may also opt to use the proposed SDR allocation for other purposes (for example to support Fund financing for development, see below) that would not add to bilateral sales among members.

46. **These illustrative scenarios underscore that gauging the potential size of SDR transactions is a difficult exercise subject to considerable uncertainty**. While keeping this in mind, the illustrations presented in this section, though probably overestimating the likely use of SDRs, can offer some guidance of the potential impact on the SDR market of the proposed general allocation.

C. Absorption Capacity of Voluntary Standing Arrangements

In view of the size of the proposed SDR allocation and of potential post-allocation transactions, there is a need to revisit existing voluntary arrangements and to expand the group of participants in these arrangements.

47. **Exchanges between SDRs and freely usable currency have been conducted solely through transactions by agreement for more than two decades**. Thirteen participants and one prescribed SDR holder have cooperated voluntarily with the Fund by making standing arrangements to buy and sell SDRs. As further discussed in Annex IV, the Fund facilitates transactions between members seeking to sell or buy SDRs and these counterparties to the voluntary agreements. The present capacity of the system can handle about SDR 1.4 billion in sales and some SDR 2.8 billion in purchases.

48. **Given the size of the proposed SDR allocation, most counterparties under the existing voluntary arrangements would not stand ready to buy any further SDRs under the existing arrangements**. Each of these arrangements is subject to minimum and maximum SDR holdings, which together put an overall upper limit on the capacity of this system to absorb SDR sales and purchases. The proposed size of the SDR allocation would put the SDR holdings of most counterparties with voluntary agreements above their

maximum limits under such agreements. Accordingly, without modifications to existing arrangements, these counterparties would no longer stand ready to purchase SDRs. Sales by SDR holders above the remaining limits of the agreements would then have to be transacted under the designation mechanism, and would be subject to a balance of payments need (see below).

49. **Voluntary standing arrangements have greatly facilitated transactions in SDRs and staff proposes to explore several avenues to preserve and strengthen the role of these arrangements**. Possible steps include:

- *Expanding the role of existing two-way arrangements*. This could involve (i) realigning the levels of maximum and minimum SDR holdings, as specified in each arrangement, to be consistent with the new, higher SDR allocation; and (ii) exploring the room for expanding the volume of SDR holdings acceptable to counterparties under the voluntary agreements.

- *Expanding the group of countries participating in two-way arrangements*. Countries that have not so far established voluntary two-way arrangements may wish to do so, including members interested in holding a higher level of SDRs as part of their reserves. In the first instance, staff would propose to approach those participants in the Financial Transactions Plan (FTP) that have not yet entered into two-way arrangements to gauge their interest in establishing two-way arrangements. Given the size of the proposed allocation and the potential use of SDRs, as outlined above, increasing the number of participants in two-way arrangements will be important to reduce the potential need for recourse to the designation mechanism.

D. Designation—Implications and Approaches

The existing designation mechanism could, if needed, be called upon to handle a sizable amount of SDR transactions, subject to a balance of payments need. Designations are based on a cooperative mechanism involving countries with sufficiently strong balance of payments positions.

50. **The designation mechanism ensures the functioning of the SDR system in the event that transactions by agreement would not "clear the market."** This mechanism constitutes the legal backing of the SDR system and demonstrates its cooperative basis, by obligating members with a sufficiently strong external position to purchase SDRs using freely usable currencies up to the amounts set under the designation plan.[20] Designation plans are approved on a quarterly basis, but for more than two decades, the designation plans have remained precautionary. However, they can be activated, if needed, to ensure liquidity of the SDR.

[20] Under Article XIX, Section 4, participants may be designated to provide currency and accept SDRs up to the point at which their "excess holdings" of SDRs, i.e., their holdings above allocation, are equal to twice the amount of their allocation (i.e., holdings amount to 300 percent of allocation).

51. **Transactions with designation are subject to a balance of payments need.** The Articles of Agreement provide that a participant will be expected to use its SDRs in transactions with designation only if it has a need because of its balance of payments or its reserve position or developments in its reserves, and not for the sole purpose of changing the composition of its reserves.[21] A participant's use of its SDRs in a transaction with designation cannot be challenged ex ante; however, if a participant persists in failing to fulfill the expectation of a balance of payments need, the Fund may suspend the right of the participant to use SDRs it acquires after the suspension.

52. **The current method of designation is based on a two-step calculation that aims to gradually harmonize excess holding ratios, measured as the participants' SDR holdings in excess of allocation as percent of quota:**

- **First, an "assumed total" amount of designation for a period of two years is notionally distributed among the participants, starting with the member with the lowest excess holding ratio.** This iterative process is continued until the assumed total amount is exhausted and the participants subject to designation achieve a common lowest excess holding ratio among the members considered to be sufficiently strong for designation, which under current rules are those members that are included in the FTP.

- **Second, the notional amounts assigned to individual participants are proportionally reduced by a common factor, so that they sum to the total amount judged adequate for a given quarterly designation plan**. Since the 1970s, the assumed total has been set at five times the quarterly plan total, i.e., the actual designation amounts assigned for each participant have been derived by dividing the notional two-year amounts by five. This approach is used to in order to provide a margin of safety in case that a quarterly designation need turn out to be higher than one-eighth of the projected two-year total.

53. **The current approach ensures that designation would be spread over a broader group of members, if a larger amount needs to be designated**. Figure 5 illustrates how the number of participants subject to designation would increase as the total designation need becomes larger. For instance, if the total designation needs were SDR 5 billion, 22 participants would be designated, whereas if the total designation needs were SDR 18 billion or higher, all sufficiently strong countries (with the exception of three countries that voluntarily have already acquired holdings well in excess of their respective allocation) would be designated.

54. **While the earlier scenarios suggest the potential need for sizable designations, the amounts would be well within the range of the designation mechanism's capacity,**

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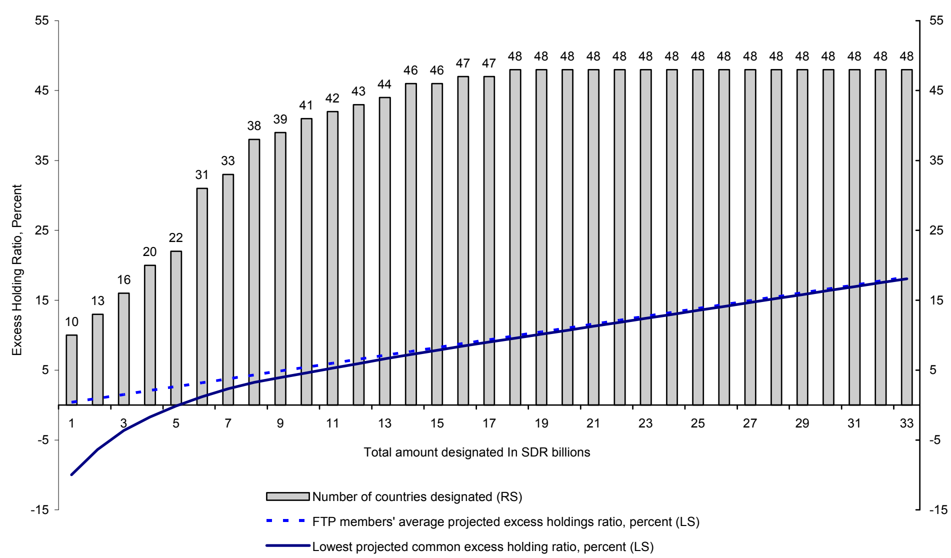
[21] Article XIX, Section 3(a). Certain limited exceptions exist to this requirement, as specified in Article XIX, Section 3(c).

even in extreme scenarios. Current non-FTP members account for less than 20 percent of total Fund quotas and of the proposed cumulative SDR allocations; thus, even in an extreme scenario where all non-FTP members wanted to sell their SDR holdings following the proposed allocation, the transactions would not amount to more than SDR 33 billion—a volume that is well within the potential capacity limits of current FTP members. As discussed above, as transaction needs increase, more participants would be designated and the excess holdings ratio of these participants would rise. As an illustrative example, excess holding ratios would be slightly over 10 percent for all designated participants, if SDR transactions amounted to SDR 20 billion (see Figure 6 for several alternative scenarios). The designation capacity would also remain ample in cases where some of the countries included in the FTP (and thus the designation mechanism) were no longer sufficiently strong for designation.

Figure 5. Designation: Range of Possible Outcomes 1/



1/ Assuming current composition of the FTP. In Figure 5, the lowest projected common excess holding ratio refers to the holding ratio for the designated countries; the FTP members' average holdings ratio refers to the ratio of all FTP members, including those that would not be designated. Three FTP participants with markedly high current excess holding ratios that would not be subject designation in any of the scenarios are not shown (Botswana (56 percent), Libya (47 percent) and Singapore (26 percent)).

55. **Past experience with the designation mechanism and more recent experience with the operationally-similar Financial Transactions Plan (FTP) do not indicate a need for modifying the present mechanism**. Modifications to the mechanism have been considered in the past (see Annex V), but the present system seems to maintain important advantages over possible alternatives, including:

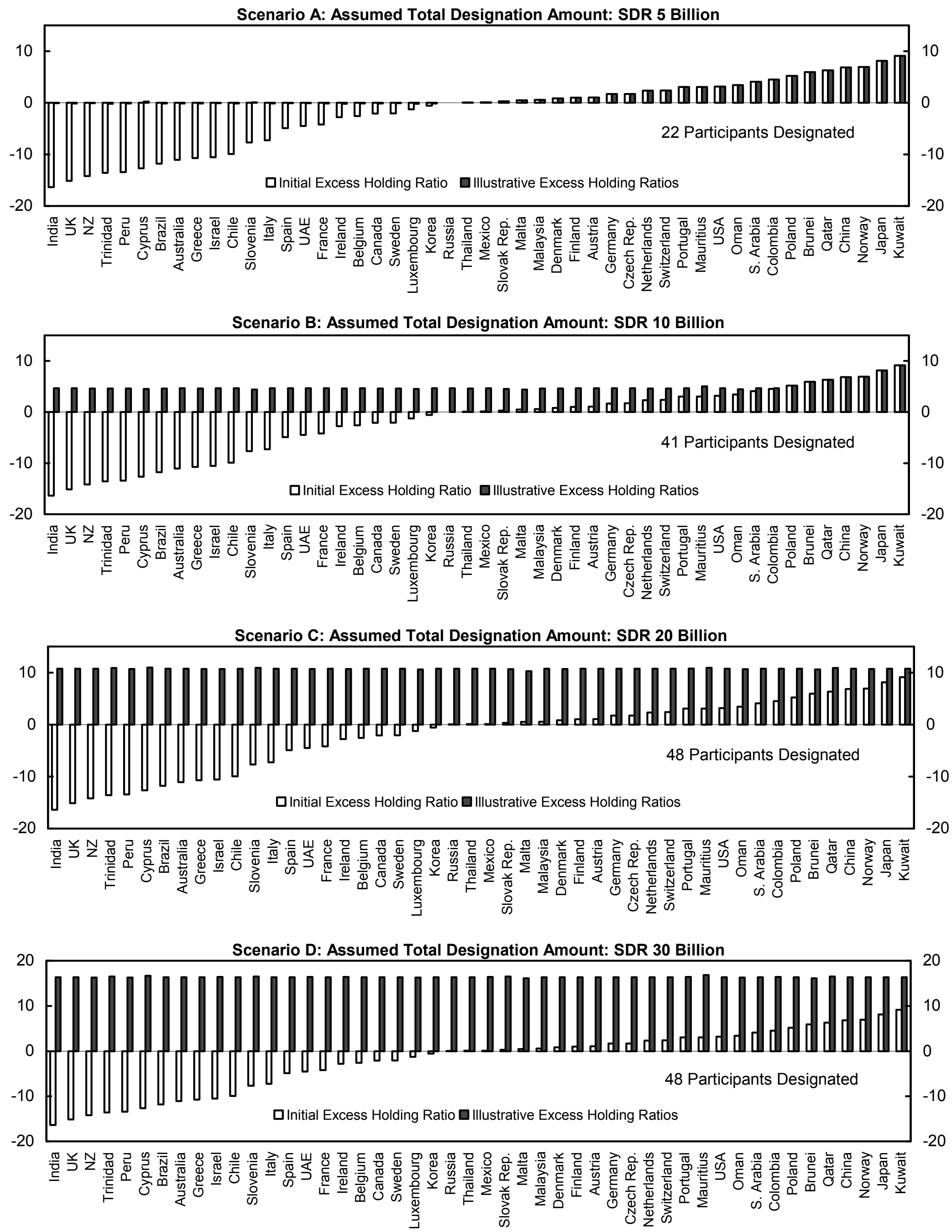
- *Foreign reserves-based approach*. The present mechanism designates members based on their excess SDR holdings, measured *relative to quota*. An alternative would designate members based on their excess holdings *relative to their foreign exchange reserves*. Indeed, this system was in place until 1999, when the Board decided to move to a quota-based system, following a similar modification for the FTP. The key arguments at the time by Board members remain valid, including that quotas (and not reserves) are typically considered the relevant measure of a country's quantifiable rights and obligations to the Fund; that the large dispersion of reserve holdings among members would tend to concentrate designation on a relatively small number of countries, if reserves were used as the metric; and that the designation mechanism should follow similar criteria as those used for the FTP (which is quota based).

- *Holdings-based approach*. Under the "holdings principle," designation would aim to promote equality in the ratios of participants' *total holdings* of SDRs (rather than their *excess holdings*) relative to quotas (or reserves). A key difference with the present approach is that under holdings-based approaches members would tend to move towards their acceptance limits in a less uniform manner.

This said, given that the designation plan was not used for a long time, it will need to be reviewed closely, and future modifications will need to be considered in light of experience. As a first step, staff would propose to come back to the Board with a paper discussing the detailed modalities of an expanded designation plan prior to the implementation of the proposed allocation.

Figure 6. Initial and Illustrative Projected Excess Holding Ratios for FTP Members 1/ 2/

(In percent of current nominal quota)



Source: Finance Department.

1/ These scenarios show FTP participants' initial excess holding ratios and projected ratios for specified designation amount as assumed over a two-year period. Due to rounding, projected common lowest excess holding ratios for participants subject to designation may not be fully identical.

2/ Three FTP participants with markedly high excess holding ratios not subject designation in any of the scenarios are not shown (Botswana (56 percent), Libya (47 percent) and Singapore (26 percent)).

E. Other Post-Allocation Issues

Several post-allocation issues could arise, including the possibility to enter into voluntary redistributions of SDRs; to use SDRs in payment for future quota increases; and to cancel SDR allocations at a future point. While important, these issues are not central to the determination of a long-term global need and the case for an SDR allocation itself, and staff proposes that the issues be taken up, as and if needed, at a future time.

Post-allocation redistribution

56. **Post allocation, participants could enter into voluntary redistributions of SDRs**.[22] There are no provisions in the Articles for redistributing SDRs but participants have considerable flexibility over the use of SDRs. For example, SDRs could be transferred to other holders through loans or grants. A large number of proposals for allocating and redistributing SDRs have been made over the years, and fall mainly into one of two broad categories: (i) proposals to supplement Fund resources by directing SDRs allocated to advanced countries to countries with international liquidity needs; and (ii) proposals to finance development by using SDR allocations for the provision of development finance.[23]

57. **Post-allocation redistributions offer potentially important uses for SDRs, but it has proven difficult to implement such arrangements in the past**. Consequently, no proposal for the voluntary redistribution of SDRs has ever been put into effect. The primary obstacle these proposals face lies in the zero-sum nature of the SDR system: participants are liable to pay SDR charges on all SDRs allocated to them whether or not they hold, use, loan, or donate their SDRs. Redistribution of SDRs therefore has a real cost to the provider (unless such costs were to be assumed by others with their consent, such as the recipients of the redistributed SDRs).[24]

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[22] Any post-allocation redistribution would have as a prerequisite an allocation of SDRs in accordance with the Articles of Agreement. Under the current Articles, a general allocation of SDRs can only be made on the basis of a finding of long-term global need and must be made available to all participants in the SDR Department that have not opted out within the framework specified in the Articles. The proposed Fourth Amendment provides for a special one-time allocation based on equity considerations.

[23] For an overview of proposals for different types of post-allocation redistribution schemes, see Box 1 in *SDR Allocation in the Eight Basic Period—Basic Considerations* (http://www.imf.org/external/np/tre/2001/111601.pdf).

[24] In addition to charges, the participants to which SDRs are allocated would remain liable in respect of their full allocation—and regardless of whether they subsequently transferred their SDRs—for the payment of assessments, for obligations regarding cancellation in the event that there were to be a cancellation of SDRs, and for obligations related to reconstitution if a reconstitution requirement were to be reintroduced.

Use of SDRs in quota payments

58. **SDRs can be used to pay the reserve asset portion of quota increases.** The Articles specify that 25 percent of a quota increase must be paid in SDRs, but also authorize the Board of Governors to allow this "reserve asset" portion of a quota increase to be paid in the currencies of other members specified by the Fund, with their concurrence, or in any combination of SDRs and such currencies. In practice, it is generally expected that a member will, to the extent feasible, pay the reserve asset portion of its quota increase in SDRs. As a result, the GRA's holdings of SDRs tend to increase sharply following general quota increases. The combined reserve asset payments by 54 members eligible for a "second round" ad hoc quota increase under Resolution 63-2 will amount to about SDR 5 billion (see Resolution 63-2 on Reform of Quota and Voice in the International Monetary Fund, adopted on April 28, 2008). Over time, the GRA's SDR holdings are to be brought back to the target range, currently SDR 1–1.5 billion.

Cancellation

59. **While there have been no cancellations to date, the Fund has authority to cancel, in part or in whole, SDRs created under previous allocations**. Cancellation decisions are made for basic periods and involve an opposite finding of that required for allocations: namely an assessment that there is an excess of global reserve assets and hence a long-term need to reduce the existing stock of SDRs created in previous allocations. A cancellation decision could be adopted at a subsequent basic period to that covered by an allocation decision or, in the event of unexpected developments, within the same basic period as that covered by an allocation decision.[25]

60. **The decision-making process for cancellations is the same as that for allocations**. Decisions of the Fund to cancel SDR are adopted by the Board of Governors on the basis of a proposal by the Managing Director, concurred in by the Executive Board. The same majority requirements as those for allocations apply to the Executive Board's concurrence and to the Board of Governor's decision on an SDR cancellation proposal.

V. Issues for Discussion

61. While recognizing the large degree of uncertainty underlying the various staff estimates, do Directors agree on balance that there is a long-term global need for additional reserve assets?

[25] Since allocations and cancellations are based on opposite findings, these two findings cannot be made in good faith at the same time (i.e., the Fund cannot conclude that there is a need both to reduce and increase reserve assets).

62. Do Directors agree that a general SDR allocation at the current juncture would be an appropriate way to supplement existing reserve assets? In particular, do they concur that an allocation equivalent to US$250 billion would help the Fund in fulfilling its objectives, and avoid economic stagnation and deflation as well as excess demand and inflation?

63. Do Directors agree with other features of the proposal, in particular as regards its timing, with the full allocation to be implemented in one step?

64. Do Directors agree to pursue steps that would expand the network of standing two-way arrangements, with a view to improving the liquidity of the SDR market?

65. Do Directors agree that the current method of designation remains appropriate, given its built-in flexibility and its role in ensuring that participants can exchange SDRs?

ANNEX I. HOLDINGS AND ALLOCATIONS OF SDRS, INCLUDING AN ILLUSTRATIVE GENERAL SDR ALLOCATION

Table I.1. Holdings and Allocations of SDRs, Including An Illustrative General SDR Allocation
(In millions of SDRs)

Country	SDR Holdings (April 30, 2009)	Existing Cumulative SDR Allocations	Illustrative General SDR Allocation 1/	Illustrative Cumulative SDR Allocation 2/
Afghanistan, Islamic State of	0.1	26.7	120.2	147.0
Albania	3.6	0.0	36.2	36.2
Algeria	6.3	128.6	931.9	1,060.5
Angola	0.2	0.0	212.6	212.6
Antigua and Barbuda	0.0	0.0	10.0	10.0
Argentina	320.6	318.4	1,572.4	1,890.8
Armenia	2.9	0.0	68.3	68.3
Australia	112.6	470.5	2,403.8	2,874.3
Austria	198.7	179.0	1,390.6	1,569.7
Azerbaijan	0.5	0.0	119.5	119.5
Bahamas, The	0.0	10.2	96.8	107.0
Bahrain	9.2	6.2	100.3	106.5
Bangladesh	1.1	47.1	396.1	443.2
Barbados	0.0	8.0	50.1	58.2
Belarus	0.1	0.0	287.0	287.0
Belgium	366.5	485.2	3,420.4	3,905.7
Belize	2.3	0.0	14.0	14.0
Benin	0.0	9.4	46.0	55.4
Bhutan	0.4	0.0	4.7	4.7
Bolivia	27.5	26.7	127.4	154.1
Bosnia-Herzegovina	0.1	20.5	125.6	146.1
Botswana	39.7	4.4	46.8	51.2
Brazil	0.8	358.7	2,255.0	2,613.7
Brunei Darussalam	12.8	0.0	159.8	159.8
Bulgaria	4.2	0.0	475.5	475.5
Burkina Faso	0.0	9.4	44.7	54.1
Burundi	0.1	13.7	57.2	70.9
Cambodia	0.0	15.4	65.0	80.4
Cameroon	3.0	24.5	137.9	162.4
Canada	644.4	779.3	4,730.6	5,509.9
Cape Verde	0.0	0.6	7.1	7.8
Central African Republic	0.0	9.3	41.4	50.7
Chad	0.1	9.4	41.6	51.0
Chile	36.8	121.9	635.9	757.8
China	789.0	236.8	6,008.8	6,245.6
Colombia	149.1	114.3	574.9	689.1
Comoros	0.0	0.7	6.6	7.3
Congo, Dem. Republic of	0.8	86.3	395.9	482.2
Congo, Republic of	0.1	9.7	62.8	72.6
Costa Rica	0.1	23.7	121.9	145.6
Cote d'Ivoire	0.6	37.8	241.5	279.4
Croatia	0.1	44.2	271.2	315.4
Cyprus	1.8	19.4	103.7	123.1
Czech Republic	13.9	0.0	608.5	608.5
Denmark	192.6	178.9	1,220.2	1,399.0
Djibouti	0.1	1.2	11.8	13.0
Dominica	0.0	0.6	6.1	6.7
Dominican Republic	1.6	31.6	162.6	194.2
Ecuador	17.0	32.9	224.5	257.5
Egypt	72.5	135.9	700.9	836.8
El Salvador	25.0	25.0	127.2	152.2
Equatorial Guinea	0.5	5.8	24.2	30.0
Eritrea	0	0	11.8	11.8
Estonia	0.1	0.0	48.4	48.4
Ethiopia	0.0	11.2	99.3	110.5
Fiji	6.9	7.0	52.2	59.2
Finland	155.4	142.7	938.7	1,081.4
France	627.7	1,079.9	7,975.8	9,055.7
Gabon	0.3	14.1	114.6	128.7
Gambia, The	0.1	5.1	23.1	28.2
Georgia	2.0	0.0	111.6	111.6
Germany	1,429.9	1,210.8	9,661.6	10,872.4

Table I.1. Holdings and Allocations of SDRs, Including An Illustrative General SDR Allocation
(In millions of SDRs)

Country	SDR Holdings (April 30, 2009)	Existing Cumulative SDR Allocations	Illustrative General SDR Allocation 1/	Illustrative Cumulative SDR Allocation 2/
Ghana	0.1	63.0	274.1	337.1
Greece	15.4	103.5	611.3	714.8
Grenada	0.5	0.9	8.7	9.6
Guatemala	1.2	27.7	156.1	183.8
Guinea	0.2	17.6	79.5	97.2
Guinea-Bissau	0.0	1.2	10.5	11.8
Guyana	0.0	14.5	67.5	82.0
Haiti	4.5	13.7	60.8	74.5
Honduras	0.0	19.1	96.2	115.2
Hungary	31.6	0.0	771.3	771.3
Iceland	4.5	16.4	87.3	103.8
India	0.8	681.2	3,088.4	3,769.6
Indonesia	21.5	239.0	1,544.4	1,783.3
Iran	283.4	244.1	1,112.0	1,356.1
Iraq	93.3	68.5	882.7	951.1
Ireland	63.8	87.3	622.7	710.0
Israel	8.5	106.4	689.4	795.8
Italy	189.0	702.4	5,240.3	5,942.7
Jamaica	0.1	40.6	203.1	243.8
Japan	1,974.4	891.7	9,887.8	10,779.5
Jordan	2.0	16.9	126.6	143.5
Kazakhstan	0.9	0.0	271.6	271.6
Kenya	0.5	37.0	201.6	238.6
Kiribati	0.0	0.0	4.2	4.2
Korea	56.4	72.9	2,174.2	2,247.1
Kosovo 3/	0.0	0.0	43.8	43.8
Kuwait	152.7	26.7	1,025.8	1,052.5
Kyrgyz Republic	29.3	0.0	66.0	66.0
Lao, People's Dem. Republic	9.8	9.4	39.3	48.7
Latvia	3.5	0.0	94.2	94.2
Lebanon	21.6	4.4	150.8	155.2
Lesotho	3.9	3.7	25.9	29.7
Liberia	14.2	21.0	96.0	117.0
Libya	587.0	58.8	834.6	893.4
Lithuania	0.1	0.0	107.1	107.1
Luxembourg	13.5	17.0	207.3	224.3
Macedonia, FYR	0.9	8.4	51.2	59.6
Madagascar	0.1	19.3	90.8	110.0
Malawi	0.0	11.0	51.5	62.5
Malaysia	147.3	139.0	1,104.1	1,243.2
Maldives	0.4	0.3	6.1	6.4
Mali	0.0	15.9	69.3	85.2
Malta	11.8	11.3	75.8	87.0
Marshall Islands	0	0	2.6	2.6
Mauritania	0.1	9.7	47.8	57.6
Mauritius	18.8	15.7	75.5	91.2
Mexico	292.7	290.0	2,341.7	2,631.7
Micronesia, Fed. States of	1.4	0.0	3.8	3.8
Moldova	0.0	0.0	91.5	91.5
Mongolia	0.1	0.0	38.0	38.0
Montenegro	0.3	0.0	20.4	20.4
Morocco	12.4	85.7	436.9	522.6
Mozambique	0.1	0.0	84.4	84.4
Myanmar	0.1	43.5	191.9	235.4
Namibia	0.0	0.0	101.4	101.4
Nepal	5.4	8.1	53.0	61.1
Netherlands	650.6	530.3	3,834.3	4,364.6
New Zealand	14.4	141.3	664.4	805.8
Nicaragua	0.0	19.5	96.6	116.0
Niger	1.0	9.4	48.9	58.3
Nigeria	0.4	157.2	1,302.2	1,459.3
Norway	283.5	167.8	1,241.6	1,409.4

Table I.1. Holdings and Allocations of SDRs, Including An Illustrative General SDR Allocation
(In millions of SDRs)

Country	SDR Holdings (April 30, 2009)	Existing Cumulative SDR Allocations	Illustrative General SDR Allocation 1/	Illustrative Cumulative SDR Allocation 2/
Oman	12.9	6.3	144.1	150.4
Pakistan	109.1	170.0	767.8	937.8
Palau, Republic of	0	0	2.3	2.3
Panama	0.4	26.3	153.4	179.8
Papua New Guinea	0.0	9.3	97.7	107.0
Paraguay	28.8	13.7	74.2	87.9
Peru	5.6	91.3	474.2	565.5
Philippines	6.7	116.6	653.5	770.1
Poland	71.0	0.0	1,016.8	1,016.8
Portugal	79.7	53.3	644.2	697.6
Qatar	29.4	12.8	195.9	208.8
Romania	78.9	76.0	765.2	841.1
Russia	1.4	0.0	4,415.8	4,415.8
Rwanda	20.4	13.7	59.5	73.2
Samoa	2.6	1.1	8.6	9.8
San Marino	1.1	0.0	12.6	12.6
Sao Tome and Principe	0.0	0.6	5.5	6.1
Saudi Arabia	480.0	195.5	5,188.4	5,383.9
Senegal	0.1	24.5	120.2	144.6
Serbia	0.4	56.7	347.4	404.0
Seychelles	0.0	0.4	6.5	6.9
Sierra Leone	19.7	17.5	77.0	94.5
Singapore	241.0	16.5	640.6	657.1
Slovak Republic	1.0	0.0	265.5	265.5
Slovenia	7.7	25.4	172.1	197.5
Solomon Islands	0.0	0.7	7.7	8.4
Somalia	0.0	13.7	32.8	46.5
South Africa	223.1	220.4	1,387.8	1,608.2
Spain	148.7	298.8	2,264.5	2,563.3
Sri Lanka	1.2	70.9	307.0	377.9
St. Kitts and Nevis	0.0	0.0	6.6	6.6
St. Lucia	1.6	0.7	11.4	12.1
St. Vincent and the Grenadines	0.0	0.4	6.2	6.5
Sudan	1.1	52.2	126.0	178.2
Suriname	0.3	7.8	68.4	76.2
Swaziland	2.6	6.4	37.7	44.1
Sweden	197.0	246.5	1,779.2	2,025.7
Switzerland	82.6	0.0	2,568.7	2,568.7
Syrian Arab Republic	36.6	36.6	218.1	254.6
Tajikistan	0.4	0.0	64.6	64.6
Tanzania	0.1	31.4	147.7	179.1
Thailand	85.5	84.7	803.6	888.2
Timor-Leste	0	0	6.1	6.1
Togo	0.1	11.0	54.5	65.5
Tonga	0.5	0.0	5.1	5.1
Trinidad and Tobago	0.6	46.2	249.3	295.5
Tunisia	3.3	34.2	212.8	247.0
Turkey	43.2	112.3	884.8	997.1
Turkmenistan	0	0	55.9	55.9
Uganda	0.1	29.4	134.1	163.5
Ukraine	16.3	0.0	1,019.0	1,019.0
United Arab Emirates	11.2	38.7	454.3	493.1
United Kingdom	288.4	1,913.1	7,975.8	9,888.9
United States	6,074.0	4,899.5	27,592.0	32,491.5
Uruguay	2.5	50.0	227.6	277.6
Uzbekistan	0.5	0.0	204.7	204.7
Vanuatu	1.3	0.0	12.6	12.6
Venezuela	13.6	316.9	1,975.0	2,291.9
Vietnam	1.1	47.7	244.4	292.1
Yemen, Republic of	4.2	28.7	180.9	209.6
Zambia	6.7	68.3	363.3	431.6
Zimbabwe	0.0	10.2	262.5	272.7
Total	**18,758.2**	**21,433.3**	**161,493.5**	**182,926.8**

Source: Finance Department.

1/ Illustrative general allocation of 74.27 percent of existing quotas, which is equivalent to 250 billion U.S. dollars based on an SDR/USD exchange rate of 0.645974 on May 29, 2009.
2/ The sum of the existing cumulative SDR allocation and the illustrative general SDR allocation.
3/ The Board of Governors resolution with respect to the membership of the Republic Kosovo was adopted effective May 5, 2009 and Kosovo could join the Fund and become a participant in the SDR Department in the coming weeks. This table also assumes that it would become eligible for the general SDR allocation.

ANNEX II. BACKGROUND ON SPECIAL DRAWING RIGHTS

A. SDRs in a Nutshell

SDR holdings are part of members' reserve assets. SDRs are a means for members to obtain freely usable currencies from other members; they are not a claim on the Fund. The reserve asset character of SDRs derives from the commitment of members to hold and accept SDRs and to honor the obligations underlying operation of the SDR system.

While participation in the SDR department is not required for Fund membership, all current Fund members are also participants in the SDR Department.[26] Other SDR holders include the Fund (which holds SDRs in the General Resource Account (GRA)) and some 15 international organizations prescribed by the Fund.[27] Private sector holdings of SDRs are not allowed.

A cumulative total of SDR 21.4 billion (equivalent to about US$33 billion) has been allocated to members.[28] SDR holdings of the GRA and prescribed holders are acquired through transactions with participants and other prescribed holders:

[26] Members and participants are therefore used interchangeably in this annex. The SDR Department is separate from the General Department under the Articles of Agreement. Assets in one department cannot be used to meet liabilities of the other, except for the reimbursement of the General Department for the expenses incurred in conducting the business of the SDR Department.

[27] Only members that are not participants, non-members, and official entities may be prescribed as holders of SDRs under the Articles of Agreement. The 15 prescribed holders are four central banks (European Central Bank, Bank of Central African States, Central Bank of West African States, and Eastern Caribbean Central Bank); three intergovernmental monetary institutions (Bank for International Settlements, Latin American Reserve Fund, and Arab Monetary Fund); and eight development institutions (African Development Bank, African Development Fund, Asian Development Bank, International Bank for Reconstruction and Development and the International Development Association, Islamic Development Bank, Nordic Investment Bank, and International Fund for Agricultural Development).

[28] Decisions to allocate SDRs are for basic periods, which run consecutively and are normally for five years. The current basic period (the Ninth) began on January 1, 2007 with no decision on allocations. However, in accordance with Article XVIII, Section 4(c), (ii) the Managing Director can make a proposal for an allocation after the start of a basic period in which no decision on an allocation was made whenever he is satisfied that there is a long-term global need to supplement existing reserve assets as described in Article XVIII, Section 1(a) and that broad support exists among participants for the Managing Director's proposal.

Table II.1. SDR Department as at April 30, 2009
(In billions of SDR)

	Allocations	Holdings
Participants	21.4	18.8
General Resources Account	0.0	2.1
Prescribed holders	0.0	0.6
Total	**21.4**	**21.4**

Source: Finance Department.

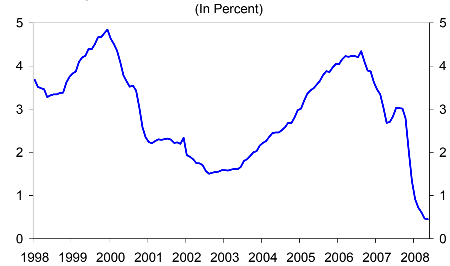
The Fund ensures the liquidity of the SDR in two ways (as further discussed below):

- through a **designation mechanism** in which members with strong external positions are designated to purchase SDRs from members with weak external positions; and

- through **voluntary exchanges** between members and prescribed holders ("transactions by agreement") in a market managed by the Fund.

The value of the SDR is currently determined by a basket of four currencies, and the SDR interest rate is a weighted average of 3-month risk-free rates in these currencies. The basket consists of fixed amounts of the Fund's four freely usable currencies (U.S. dollar, Euro, Japanese yen, and pound sterling). The effective weight of the component currencies fluctuates with market exchange rates. The basket is reviewed every five years. While the SDR interest rate has declined to about ½ percent in recent months, it has exceeded 4 percent at times in the past decade, driven by fluctuations in the underlying market rates (Figure II.1).

Figure II.1. SDR Interest Rate, 1998 - April 2009
(In Percent)



Members receive interest on their holdings of SDRs and pay charges on their cumulative allocations of SDRs at the same rate—the SDR interest rate:

- Members with holdings equal to their cumulative allocations have a neutral net position, and pay no interest on a net basis.

- A new SDR allocation has no impact on net interest payments to members because holdings and cumulative allocations would rise equally.

- Payments of charges by members with SDR holdings below their cumulative allocation equal the net interest receipts of other holders—the SDR Department is a closed system.[29]

There is no obligation under current Board decisions to maintain any particular level of SDR holdings. The SDR system therefore provides members with access on demand to freely usable currencies on an unconditional basis and with no fixed maturity.

B. Brief History of the SDR

The SDR was created by the IMF in 1969 to support the Bretton Woods fixed exchange rate system. In recognition of the inherent constraints on the supply reserve assets (gold and the U.S. dollar) under the Bretton Woods system of fixed exchange rates, the SDR was introduced in order to establish a mechanism for the deliberate creation of reserve assets in order to supplement existing reserve assets, and thereby support the expansion of world trade and financial development.

Two general allocations of SDRs have been made:[30]

- SDR 9.3 billion was allocated at yearly intervals in 1970–72.

- SDR 12.1 billion was allocated at yearly intervals in 1979–81.

There has been no general allocation of SDRs since 1981, but a special allocation was proposed in 1997. The possibility of a general allocation was discussed in the Executive Board a number of times but there was not enough support. Nonetheless, an amendment of the Articles was proposed in 1997 to provide a special one-time allocation to enable all members to participate in the SDR system on an equitable basis (Box II.1).

Until 1981, SDR Department participants were subject to a reconstitution requirement, under which each participant was required to maintain its average daily holdings of SDRs at not less than a specified percentage of its net cumulative allocation over successive five year periods ending each calendar quarter.[31] The elimination of this requirement involved abrogation of both the rules on reconstitution specified in Schedule G of the Articles of Agreement and the implementing regulations and decisions that had been adopted by the Executive Board under that schedule. Any decision to adopt, modify or abrogate rules for

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[29] An assessment is levied on SDR Department participants to reimburse the General Department for the expenses of conducting the business of the SDR Department (recently around one-hundredth of one percent of total levied on the cumulative allocation of each participant).

[30] For further description of previous allocations, see Section III of *SDR Allocation in the Eighth Basic Period—Basic Considerations* (http://www.imf.org/external/np/tre/2001/111601.pdf).

[31] The initial specified percentage was 30, but this was reduced to 15 percent two years before the requirement was abrogated.

reconstitution requires a 70 percent majority of the total voting power (Article XIX, Section 6(b)).[32]

The 1981 decision to abrogate the reconstitution requirement reflected the following considerations: First, the abrogation was seen as an important further step in enhancing the reserve asset characteristics of the SDR, including by improving the general understanding of the SDR. It complemented a number of other changes related to the usage, value, and interest rate of the SDR, all of which were consistent with the objective, as specified in the Second Amendment, of making the SDR the principal reserve asset in the international monetary system. Second, the decision to raise the SDR interest rate closer to the combined market rate (from 60 to 80 percent)— taken shortly before the abrogation of the reconstitution requirement— had considerably lowered the financial incentive to use SDRs in preference to other reserve assets. (This incentive disappeared altogether when the two interest rates were subsequently equalized). Third, experience suggested that the administration of the requirement was very onerous for staff and members, and made it difficult for the latter to assess the implications of possible SDR use, thereby complicating decisions on reserve management.

Box II.1. The Fourth Amendment for a Special SDR Allocation

A consensus emerged in the mid-1990s on the need to resolve the so-called equity problem—many members had joined the Fund since 1981, when the last allocation of SDRs was completed, and had therefore not received an allocation of SDRs (currently 41 members); and some members joining prior to the last allocation had received only part of the allocations made to other members.

The solution to the equity problem agreed by the Executive Board was to amend the Articles of Agreement to allow for a one-time, special allocation of SDRs that would have raised the ratios of cumulative SDR allocations to quota under the Ninth General Review of Quotas to a common benchmark ratio of about 29.32 percent. This would have resulted at the time in a doubling of cumulative SDR allocations to SDR 42.9 billion.

In September 1997, the Board of Governors approved the proposed Fourth Amendment, which was then submitted to the membership for acceptance. The Fourth Amendment will become effective when three fifths of the membership having 85 percent of the total voting power have accepted it. By May 31, 2009, 132 members having 77.70 percent of the total voting power have accepted the Fourth Amendment. Acceptance by the United States, which holds 16.75 percent of the voting power, would therefore put the Fourth Amendment into effect.

[32] Schedule G contains a second rule for reconstitution that was not abrogated in 1981: this rule calls for participants to "pay due regard to the desirability of pursuing over time a balanced relationship between their holdings of SDRs and their other reserves" (Schedule G, paragraph 1(b)). The 1981 paper noted that the Fund has not elaborated any criteria by which observance of this second rule could be tested, and raised the question of whether this rule too should be abrogated. In the event, there was no support in the Executive Board for its abrogation, and it thus remains in effect.

C. Transactions in SDRs and the Role of the GRA

SDRs may be used by participants, the Fund, and prescribed holders in accordance with the Articles of Agreement and decisions adopted by the Fund. The Articles authorize the exchange of SDR for currency among participants both through designation and in transactions by agreement. The Fund is authorized to prescribe other operations among participants and the operations and transactions of prescribed holders. The Fund has adopted a number of decisions that authorize a broad range of operations between participants and prescribed holders, including loans, pledges, donations, swaps and forward transactions.[33]

The Fund's transactions and operations in SDRs are circumscribed by the Articles. The Fund may accept and use SDRs in operations and transactions conducted through the GRA with participants (e.g., quota payments, purchases, repurchases, payment of charges, remuneration) and the Fund may pay principal and interest on its borrowing in SDRs. For example, the Fund normally receives SDRs in members' payments of charges on Fund credit and pays SDRs to members in remuneration on their reserve tranche positions in the Fund.[34] The Fund may sell SDRs to replenish its holdings of the currency of a participant in the SDR Department. However, the Fund may not purchase or borrow SDRs.[35]

The Fund seeks to maintain limited SDR holdings. SDRs are created as a supplement to members' existing reserve assets, and thus the Fund does not maintain large holdings of SDRs for long periods of time. The GRA's holdings of SDRs increase sharply in the event of reserve asset payments of quota increases, and are returned within the desired range over time (currently SDR 1–1½ billion) mainly through transfers of SDRs for purchases.

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[33] Decision No. 5702-(78/39), March 22, 1978 (http://www.imf.org/external/pubs/ft/sd/index.asp?decision=5702-(78/39)); Decision No. 5703-(78/39), March 22, 1978 (http://www.imf.org/external/pubs/ft/sd/index.asp?decision=5703-(78/39)); Decision No. 6000-(79/1), December 28, 1978 (http://www.imf.org/external/pubs/ft/sd/index.asp?decision=6000-(79/1)); Decision No. 6001-(79/1), December 28, 1978 (http://www.imf.org/external/pubs/ft/sd/index.asp?decision=6001-(79/1)).

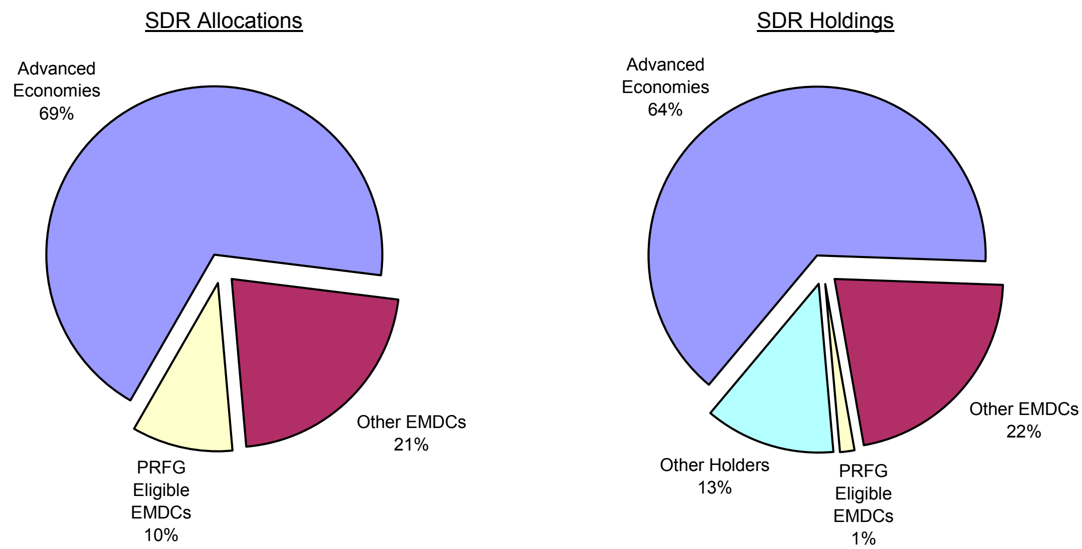
[34] For an illustration of the circulation of SDRs, see Box III.5 on page 113 in *Financial Organization and Operations of the IMF*, Pamphlet No. 45 Sixth Edition, International Monetary Fund, Washington DC, 2001 (http://www.imf.org/external/pubs/ft/pam/pam45/pdf/pam45.pdf).

[35] The Fund is authorized to accept SDRs offered by a participant in exchange for the currencies of other members, with such other members' concurrence (Article V, Section 6(a), (c)). However, the exercise of this authority is conditioned on the Fund's adoption of policies on the selection of the currencies to be provided by the Fund in exchange for SDRs (Article V, Section 6(c)), and no such policy has been adopted to date, such as would authorize the Fund to accept SDRs in these transactions. Separately, the Articles also broadly authorize the Fund to provide SDRs to a participant in exchange for the currencies of other members, with their concurrence, and pursuant to policies on the selection of the currencies to be received by the Fund. Pursuant to this provision, the Fund has adopted policies on the selection of currencies to be received and on authorized sales of SDRs by the Fund.

Box II.2. The Pattern of SDR Holdings

The bulk of SDRs are currently held by advanced economies (Figure). The advanced economies together hold almost two-thirds of total holdings. This holding share is somewhat below the allocation share of advanced economies primarily because holders of SDRs that do not receive allocations, principally the Fund through the GRA, hold about one-eighth of the total. As noted, PRGF eligible members currently hold only a small fraction of their cumulative SDR allocation. On average, the holdings of non-PRGF eligible emerging and developing economies are close to their cumulative allocation.

Figure. SDR Allocations and Holdings, April 2009
(In percent of totals)



Source: Finance Department. The right-hand panel includes countries that never received an allocation of SDRs but have subsequently acquired SDRs through transactions.

ANNEX III. STATISTICAL TREATMENT OF SDRS

This section summarizes the treatments of SDR allocations and SDR holdings in balance of payments statistics (as described in the *Balance of Payments and International Investment Position Manual* (*BPM6*)) and the rationale for these treatments.

SDRs are defined as international reserve assets created by the IMF and allocated to members to supplement existing official reserves (*BPM6* paragraph 5.34). *BPM6* considers SDR holdings to be debt claims on IMF members who participate in the SDR Department of the Fund, and SDR allocations as debt liabilities of members who receive allocations.[36]

A. Treatment in Balance of Payments Statistics

Paragraph 6.84 of *BPM6* states that SDR holdings "*…are reserve assets created by the IMF and are equivalent to liquid balances in convertible currencies in nearly every respect…*"

In both the balance of payments and International Investment Position, **holdings of SDRs** by an IMF member are classified as reserve assets, while the **allocation of SDRs** is recorded as the incurrence of a debt liability of the receiving member, classified in the *other investment* account within the financial account. The holdings and allocations should be shown gross rather than netted. In addition, the SDR allocation is included in long-term reserve-related liabilities.[37]

B. Rationale

Several considerations influenced the treatment in *BPM6*. SDRs (holdings and allocations) are regarded as debt and not shares because, if a country leaves the IMF, there is a requirement to repay the accumulated allocation of SDRs to the SDR Department. Also, countries that have holdings of SDRs below their allocation must pay net interest on that difference, thus, it implies the existence of a debt liability—interest accrues on SDR allocations. Further, if the SDR Department were to be liquidated, the same issue of repaying liabilities would arise. Also, International Accounting Standards require central banks to

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[36] In contrast, the IMF's *Monetary and Financial Statistics Manual* (*MFSM*) considers SDR allocations to be "shares and other equity" on the liabilities side of the accounts, and SDR holdings are included in the item "SDRs" (which is included in official foreign reserves) on the asset side. *BPM6* is the later international standard, and it is also aligned with the *2008 System of National Accounts* (*2008 SNA*), and so the treatments in the *MFSM* will be reviewed when that manual is updated, with a view to harmonizing them with *BPM6* and the *2008 SNA*. The classification in *MFSM* is that used in the report forms used by member countries reporting monetary and financial statistics to the Statistics Department.

[37] *Reserve-related liabilities are defined as foreign currency liabilities of the monetary authorities that can be considered as direct claims by nonresidents on the reserve assets of an economy.* Though not identified as such in the standard components of the balance of payments and IIP, where they are included in other categories (notably portfolio and other investment), reserve-related liabilities are important to monitor. See paragraph 6.115 of *BPM6*. Under paragraph 6.115 of *BPM6*, short-term reserve-related liabilities on a remaining maturity basis are a memorandum item to the IIP; this paragraph also notes that economies may choose to present the full table of foreign currency assets and liabilities separately identifying the short-term reserve-related liabilities.

record both assets (holdings) and liabilities (allocations). *BPM5* did not recognize SDR allocations as a liability (equity or debt).[38]

The *SNA 2008* is entirely consistent with the *BPM6* recommendation on the treatment of SDR holdings and allocations in external sector statistics. For example, consistent with *BPM6*, *SNA 2008* records allocations of SDRs as liabilities. *SNA 2008* paragraph 11.49 states that "…SDRs are assets with matching liabilities but the assets represent claims on the participants collectively and not the IMF…"

[38] The *External Debt Statistics: Guide for Compilers and Users* (2003) is consistent with *BPM5*, but is to be updated to reflect the changes introduced in *BPM6*, including classifying SDR allocations in external debt.

ANNEX IV. VOLUNTARY STANDING ARRANGEMENTS TO BUY AND SELL SDRS

This Annex describes the current uses and operational features of transactions by agreement to buy and sell SDRs. Section A provides a brief background. Section B explains the current uses of transactions by agreement. Section C sets out the basic operational features of voluntary arrangements. Section D discusses the Finance Department's SDR trading plan, which is used to manage transactions by agreement. Attachment 1 provides a sample prototype transaction by agreement under a two-way arrangement.

A. Background

Participants engage in transactions by agreement mainly to acquire SDRs in order to discharge obligations to the Fund. These are voluntary transactions, as opposed to transactions by designation, in which participants in the SDR Department (currently all IMF members) and/or prescribed holders exchange SDRs for currency at the official rate as determined by the Fund. The use of transactions by agreement expanded following the Second Amendment in 1978, when SDR transactions were no longer subject to a balance of payments need. A number of participants with strong balance of payments and creditor positions in the Fund stood ready to buy or sell SDRs in voluntary transactions.

A further development took place in the 1980's when a number of Fund members established more formal transactions by agreement under two-way arrangements to buy and sell SDRs. Previously, members only participated into one-way (buying or selling) arrangements. The Austrian National Bank entered into the first two-way arrangement with the Fund in February 1986. This arrangement allowed the Fund to arrange with the Austrian National Bank purchases or sales of SDRs on behalf of other participants wishing to buy or sell SDRs at any given time. A number of other participants and a prescribed holder entered into similar arrangements in subsequent years.

Currently, the Fund has voluntary arrangements to buy and sell SDRs with 13 participants and one prescribed holder (i.e., SDR market makers). The actual amount of purchases or sales that can be arranged at any particular time depends on the current availability of SDRs within the terms and limits on each voluntary arrangement**.** Aside from the two-way arrangements, a one-way arrangement (to sell SDRs) is also in place with one member (Table IV.1).

Table IV.1 Initial Effective Dates of Voluntary Arrangements

Austria	February-86	Japan	January-90
Belgium	December-86	Netherlands	January-88
Denmark	November-87	Norway	November-87
ECB	April-01	Sweden	November-87
Finland	December-87	Switzerland	December-92
France	August-88	United Kingdom	February-88
Germany	January-76	Venezuela	November-93

Note: All arrangements are two-way (buying and selling) except for Germany (selling only).

B. Use of Voluntary Arrangements for Transactions by Agreement

For more than two decades, transactions by agreement have permitted the voluntary settlement of SDR demand and supply without the need to use the designation mechanism. The quarterly designation plans which were established to ensure that members could exchange their SDRs for freely usable currency have not been activated since September 1987, within a year of the introduction of two-way arrangements.[39]

SDRs may be used by participants, the Fund, and prescribed holders in accordance with the Articles of Agreement and decisions adopted by the Fund. A participant may use SDRs freely, without the requirement of balance of payments need, to obtain an equivalent amount of freely usable currency (Euro, Japanese yen, pound sterling, or US dollar) in a transaction by agreement with another participant at the official rate as determined by the IMF.

The Fund arranges transactions by agreement in a manner that meets, to the greatest extent possible, the requirements and preferences of buyers and sellers. Participants enter into transactions by agreement mainly to acquire SDRs in order to discharge obligations to the Fund which may be paid in SDRs, such as charges and repurchases or repayments. The Fund is willing to assist in arranging these transactions by agreement if requested by either party. The Fund acts as a broker and provides a service to prospective buyers and sellers at no cost.

The availability of two-way arrangements has greatly facilitated the conduct of SDR operations for both members and the Fund. Members who elect to make payments to the Fund in SDRs may wish to acquire sufficient SDRs to meet these obligations as they fall due, or in advance, ensuring timely payments. Once SDRs are acquired by the member, it is a simple procedure for the Fund to debit the member's SDR account as repayments fall due and there is no need to effect payment instructions. Many PRGF-ESF borrowers with small but frequent repayments currently discharge their principal obligations to the Trust in SDRs.

The Fund currently arranges SDR transactions between buyers and sellers through a series of official SWIFT communications. A typical SDR transaction by agreement could be initiated at the request of a member wishing to buy SDRs. Alternatively, the IMF might inform a member of upcoming obligations due to the Fund, and suggest that the member acquire SDRs to fulfill its obligations. Once the basic agreement is reached, the Fund would notify the SDR seller, and would then send payment instructions. The deal would be concluded when the SDR seller confirms receipt of the foreign exchange.

[39] The last transaction with designation took place in August 1987 when Mexico sold SDRs to Austria, Denmark, the Netherlands, and Sweden for a total of SDR 12.5 million.

C. Operational Features of Voluntary Arrangements

The operational features of each individual arrangement are unique, but have certain common characteristics. Arrangements typically include specifications for the *currency or currencies* acceptable in exchange for SDRs, the *range* within which the member's SDR holdings are to be maintained, the *size* or minimum and maximum amounts of SDRs available for purchase and/or sale in any individual transaction, the *exchange rate* to be used, and the *effective period* of the arrangement (Attachment 1).

a. **Currency:** The arrangement should specify the currency or currencies against which SDRs would be bought and/or sold.

b. **Range of arrangement:** The market maker should specify the maximum and minimum level of SDR holdings within which it wishes the arrangement to operate.

c. **Size of Individual Transaction:** If desired, the arrangement could specify a minimum size and/or a maximum size for any single transaction. If this were the case, the market maker could give favorable consideration to ad hoc requests for amounts that fall out of the preferred range.

d. **Exchange Rate**: In accordance with Rule P-6(a) of the Fund's Rules and Regulations, the exchange rate in a transaction by agreement between participants shall be determined under Rule O-2 as of the date of the agreement, or some other exchange rate agreed between participants. The rate normally used is the official SDR exchange rate determined by the Fund two business days before the value date.

e. **Payment Instruction:** The Fund issues instructions on behalf of the transacting parties. To ensure proper and timely processing, the market maker should specify in the terms of the arrangement, the account into which the currency should be paid, and any other requirements (such as cut-off time for the receipt of currency on the value date).

f. **Period of Arrangement:** Arrangements are normally effective until revoked by the market maker.

D. SDR Trading Plan

The SDR trading plan is an internal document prepared by the Finance Department which enables staff to plan and execute purchases and sales of SDRs under voluntary arrangements. The two key components of the trading plan are the demand for SDRs and the supply of SDRs. The two together determine how the trading plan will be executed. The trading plan first forecasts the demand for SDRs in the forthcoming three-month period, and then determines the supply of SDRs available to meet that demand. In this way, staff is able to efficiently manage SDR transactions by agreement for all members, taking into account the various terms of the voluntary arrangements and the needs of SDR buyers and sellers.

Demand for SDRs

The potential demand for SDRs for the forthcoming three-month period is estimated by calculating the total amount of SDRs that members will need to acquire to meet their upcoming obligations to the Fund which will be settled in SDRs. This demand for SDRs can be satisfied from the voluntary arrangements or, subject to certain conditions, from the holdings of SDRs in the IMF's General Resources Account (GRA).[40] Moreover, in order to preserve the liquidity of the voluntary arrangements, large SDR acquisitions (greater than SDR 50 million) would generally be channeled through the GRA if applicable or split between several market makers. Not to overburden market makers with small transactions, SDR acquisitions of less than SDR 10,000 are also channeled, if applicable, through the GRA.

The trading plan projects scheduled demand for SDRs on a quarterly basis. This forecast is based both on members' desire to discharge GRA or PRGF related principal obligations in SDRs and members' need to acquire SDRs to meet upcoming charges. Charges are conservatively projected with a margin to allow for the possibility of an increase in the SDR interest rate. The Fund periodically consults with members on the preference to effect GRA and/or PRGF principal repayments in SDRs or freely usable currencies. Members that repay obligations in SDRs would normally provide the Fund with a standing authorization to debit their SDR account for obligations as they fall due.

Members' SDR holdings are carefully monitored to ensure adequate liquidity to meet obligations that are due and payable in SDRs. Future holdings and needs are projected and assessed by staff using estimates of members' current and future SDR balances, based on scheduled obligations.

The amount of SDRs that a member would need to acquire to meet future obligations (plus a reasonable margin) is then determined. If needed, to ensure that members' SDR holdings accounts maintain an adequate balance, the SDR accounts are typically funded about 10 days in advance of an obligation falling due. Whenever possible, individual member preferences regarding the currency for payment or the amount for the SDR acquisition are also taken into consideration. For example, some members may prefer to pay in Euros or to acquire just the minimum amount to cover an upcoming obligation, while others may prefer to pay in US dollars and acquire enough SDRs to settle multiple obligations over a longer timeframe.

The trading plan may also be called upon to meet unanticipated demand for SDRs at short notice. Members and prescribed holders can come to the Fund to acquire SDRs at any time. For example, a participant may request to buy SDRs to settle financial obligations with another participant, or in order to maintain holdings above their net cumulative allocation and thus avoid incurring quarterly net SDR charges. A member may need to acquire SDRs

[40] Members can acquire SDR from the GRA only to cover interest (not principal) obligations that are due and payable in SDRs within thirty days (e.g., GRA periodic charges, and net SDR charges and assessments).

under very tight deadlines, as it may be the case with the payment for commitment fees on new GRA arrangements approved under the emergency financing mechanism (EFM).[41]

Supply of SDRs

At any point in time, the amount of SDRs available for sale through the market makers can be determined as the difference between the total SDR holdings of all the market makers and the total minimum limits specified under the voluntary arrangements. Similarly, the amount of SDRs that can be bought can be determined as the difference between the total maximum limits defined in the voluntary arrangements and the SDR holdings of all the market makers. As of end-May, 2009, the selling capacity of the market makers was about SDR 1.4 billion and the total absorption (buying) capacity was about SDR 2.8 billion.

It is possible to inject liquidity into the supply of SDRs by disbursing purchases in SDRs within the limits defined by the Financial Transactions Plan (FTP). Members may wish to retain SDRs received in purchases to meet upcoming obligations and thus minimize or eliminate their need for future SDR acquisitions. Conversely, members may wish to sell the SDRs obtained in purchases in exchange for currency, thus increasing the supply of SDRs available under the voluntary arrangements.

Execution of the Trading Plan

The execution of the trading plan involves the careful review of all transactions for the forthcoming period. All requests to buy or sell SDRs are reviewed to ensure that they would be conducted within the established conditions and limits of each individual voluntary arrangement.

The trading plan's heaviest activity tends to occur just prior to the times when charges to the Fund fall due. One peak occurs at the beginning of each of the Fund's financial quarters (May, August, November, and January) when GRA/SDR periodic charges fall due. Another peak period of activity occurs at end-June and end-December, prior to borrowers' payment of semiannual interest to the PRGF-ESF Trust.

The implementation of the trading plan is guided by the specific terms and conditions of the individual voluntary arrangements, including the observance of all details such as advance notification to the market maker. There is no formal quarterly notification of projected usage as in the case of the FTP, and operational difficulties are often handled through a telephone call. Overall, the trading plan is implemented in a way that promotes cooperation between the Fund and the market makers while aiming to use to the extent possible all agreements.

[41] Under EFM procedures the amount of the arrangement or its phasing might not be determined until a very few days before the Board meets to consider and approve the new arrangement, thus leaving a very short window in which to arrange for an SDR acquisition for payment of the commitment fee, due upon Board approval.

ANNEX IV. ATTACHMENT 1: Two-Way Arrangement to Buy and Sell SDRs

1. Until further notice (country) will participate in a two-way arrangement with the IMF ("The Fund") to buy and sell SDRs against (specify currency or currencies) on an equal value exchange basis in transactions by agreement to be arranged by The Fund.

2. The Fund and (country) will seek to maintain (country's) SDR holdings within a range of (specified lower limit) to (specified upper limit).

3. Individual transactions shall normally be in the range of (specified minimum amount) to (specified maximum amount) unless otherwise agreed by ourselves and The Fund.

4. The transaction will be initiated using the official SDR per currency exchange rate determined by The Fund two business days before value date.

5. Currency proceeds are to be credited to our account (Account No.) with (Bank, Location).

6. When selling or buying SDRs with the Fund, we shall promptly inform The Fund (normally via swift) as soon as possible after the transaction has been executed.

7. We reserve the right to inform the Finance Department at any time that we no longer wish to buy or sell SDRs under this arrangement. However, transactions already initiated under this arrangement will be allowed to be completed.

ANNEX V. THE DESIGNATION MECHANISM: OPERATIONAL ISSUES AND A BRIEF OVERVIEW OF ALTERNATIVE APPROACHES

This annex discusses the principles and procedures used in calculating the maximum amounts of designation for participants under the quarterly designation plans. It presents the key features of the current method and revisits some alternative approaches that have either been used or considered in the past.

A. Designation: General Considerations

The designation mechanism provides the guarantee that participants that need to use SDRs can exchange them for freely usable currencies. The use of SDRs in a transaction with designation is subject to a balance of payments need and when a participant advises the Fund that it wishes to use SDRs in this way it must declare that it has a need to do so.[42]

The basic principles for designation are laid out in the Articles of Agreement. Article XIX, Section 5 lays out the general principles for determining which participants should be subject to designation and in what amounts those participants could be called upon to provide freely usable currencies in exchange for SDRs:[43]

- First, a participant shall be subject to designation if its balance of payments and gross reserve position is considered *"sufficiently strong,"*[44] and,

- Second, the participants must be designated *"in such manner as will promote over time a balanced distribution of holdings of special drawing rights among them."*

The Articles also specify an "acceptance limit" for designation. Under Article XIX, Section 4, participants may be designated to provide currency and accept SDRs up to the point at which their "excess holdings" of SDRs, i.e., their holdings above allocation, are equal to twice the amount of their allocation (i.e., holdings amount to 300 percent of

[42] See Article XIX, Section 3.

[43] This Annex does not deal with designation pursuant to Article XIX, Section 5(a)(ii), under which participants shall be subject to designation to promote reconstitution , to reduce negative balances of SDRs, or to offset failures to fulfill the expectation of a balance of payments need when SDRs are used in transactions with designation. There have been no designations under this provision.

[44] However, the Articles specify that this does notpreclude the possibility that a participant with a strong reserve position can be designated even though it has a moderate balance of payments deficit.

allocation).[45] Participants are free to accept SDRs beyond this acceptance limit in any transactions or operations, including in transactions with designation.

These general principles cannot be changed, short of an amendment of the Articles, though they may be "supplemented" by such other principles as the Fund may adopt from time to time. Supplementary principles can be adopted by the Executive Board by a majority of votes cast.

Rule P-5 provides that at quarterly intervals the Executive Board decides on a designation plan in accordance with Article XIX, Section 5, and Decision No. 11976-(99/59)S. The plan lists participants subject to designation and sets the amounts by which designation will be made until the next decision takes effect, i.e. the maximum amounts of SDRs that the participants can be designated to receive during the quarter. The rules for the designation are as follows: [46] [47]

"(a) Participants subject to designation under Article XIX, Section 5(a)(i) shall be designated for such amounts as will promote over time equality in the ratios of the participants' holdings of special drawing rights in excess of the net cumulative allocations to their existing Fund quotas.

(b) The formula to give effect to (a) above shall be such that participants subject to designation shall be designated:

> *(i) in proportion to their existing Fund quotas when the ratios described in (a) above are equal: and*
>
> *(ii) in such manner as gradually to reduce the difference between the ratios described in (a) above that are low and the ratios that are high."*

The concept of excess holdings has remained unchanged since the SDR system was created, but in 1999 participants' quotas replaced their reserves as the denominator in determining the excess holding ratios. Thereafter, no changes have been made to the method of calculating amounts for designation. The rules for designation can be reviewed at any time and changed, if necessary, by a decision of the Executive Board taken by a majority of votes cast. (For more details on the earlier designation method and other alternative approaches, see Section D below.)

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[45] For presentational purposes, "allocations" or "total allocation" are often used in this Annex, rather than the legal term "net cumulative allocation."

[46] The list of participants subject to designation is the same as the list of participants considered sufficiently strong for inclusion in the quarterly Financial Transactions Plan.

[47] See Decision No. 11976-(99/59) S, 6/3/99, (http://www.imf.org/external/pubs/ft/sd/index.asp?decision=11976-(99/59)).

B. The Current Method of Calculating Designation Amounts

The rules for designation require that designation should aim at the equalization of participants' excess holdings ratios "over time." The speed of this harmonization process depends on the particular method used to calculate individual designation amounts for each quarterly plan, as well as the volume of transactions that actually occur.

The current method of calculation is a hybrid of two different approaches. It aims to strike a balance between the objective of promoting over time a balanced distribution of holdings of SDRs and the desire to maintain a fairly broad list of participants for designation.

1) **The "filling-up" method** which directs designation amounts to the participant(s) with the lowest excess holding ratio, and as such promotes more rapid harmonization of excess holding ratios but concentrates designation on relatively few participants; and,

2) **The "proportional" method** which consists of choosing some average or "target" excess holdings ratio, and determining what amounts of designation would be necessary to move the ratio of each participant to that average. The amounts of designation would be then distributed to participants in proportion to these amounts. The method tends to harmonize ratios more slowly, but spreads the designation more widely among the participants.

The current method can be described as follows:

- **First, an "assumed total" of designation for a period of two years is notionally distributed among the participants in the designation plan in accordance with the "filling-up" principle using an iterative approach.**[48] An amount is first assigned to the participant with the lowest excess holding ratio until its ratio has been raised to the level of the participant with the next higher ratio; then both participants are given amounts until the next higher ratio has been reached, and so on, until the assumed total amount of designation has been fully distributed. At that point, a "common" excess holdings ratio has been established for all participants in the plan, except for those participants whose ratios are already above the "common" ratio.

[48] In the earliest designation plans, the "assumed total" was a rough estimate of the likely total of designation over four quarters. However, after the review of designation at the end of the first basic period in 1972, it was agreed that one year was too short period in which to attempt to raise the lower ratios to the vicinity of the higher ratios. A period of two years was agreed, and over time the relationship of the "assumed total" of designation over eight quarters to the amount actually included in quarterly designation plans tended to become standardized, with the "assumed total" being set at five times quarterly plan.

- **Second, the amounts designated to individual participants are derived by reducing the assumed total by a common factor, so that they sum to the total amount judged adequate for a given quarterly plan**. Specifically, the quarterly amounts of designation for individual participants are currently taken as one-fifth of the calculated notional amounts for the next two years, rather than one-eighth in order to provide a margin of safety in the event that quarterly designation needs are higher than the average assumed for the coming two-year period.[49]

The "assumed total" can be viewed as a projection of the likely or potential need for designation over a coming two-year period, but the amounts assigned to individual participants are not projections of their respective designation amounts over the same period. Specifically, it is unlikely that the group of participants included in the designation plan would remain unchanged during the two-year period and that their excess holding ratios would not fluctuate due to any other reason than designation. Therefore, the amounts assigned for individual countries for a two-year period should be regarded as "notional" amounts used simply as a step in the calculation of individual amounts for a particular quarterly plan. The two-step approach makes the current designation approach a hybrid between the filling-up method and the proportional approach. This implies that, even if the participants would be called to provide the full amounts assigned to them in a quarterly designation plan, their ex-post excess holding ratios will not be fully harmonized.

The current method of calculating designation amounts, i.e., the interplay between the assumed total and the reduction by a certain common factor, provides flexibility in adjusting the number of countries subject to designation. The larger the amount of assumed total, the broader the group of participants that will be designated, and the more gradual the harmonization of excess holding ratios will be for a given amount of transactions that will need to be effected through designation mechanism. Even if the assumed totals for a two-year period were different, the actual aggregate amount designated for members can be the same, if the common factor used in scaling down the two-year total is adjusted**.**

In the past, this flexibility has been used from time to time to meet changing circumstances. For example, for a period when the amounts of designation were projected to be minimal, the "assumed total" was set at such a level that only a relatively narrow group of members would be designated. After the oil crisis in 1973, the assumed total was increased to lengthen the list of participants that were assigned amounts of designation, as this was considered prudent in view of the possibility that there could be rapid changes in the balance of payments and reserve position of the participants included in the plan.

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[49] If the same margin of safety for a quarterly designation plan were achieved by factoring in a certain buffer to the assumed total for a two-year period, and then dividing this amount by eight, the number of participants subject to designation would likely be higher and the designation amount per member lower than under the current approach.

C. Execution of the Designation Plan

The implementation of the plan has allowed for some operational flexibility. The general approach has been to designate participants in broad proportion to the amounts for which they are included in a plan, while avoiding undue fragmentation of individual transactions.[50] Some priority in designation has also occasionally been given: (i) to participants that had made net use of SDRs, particularly at times when the volume of designations have been low; (ii) to participants included in successive plans for small amounts but not actually designated in any of them; or (iii) to participants that have lower excess holdings ratios in comparison with other participants included for about the same maximum amount in the plan.

If a participant's balance of payments and reserve position deteriorates during the course of a quarterly period covered by a designation plan, the Executive Board can amend the plan. Proposals for such amendment can be made by a participant, an Executive Director, or the Managing Director. If there were a proposal pending before the Executive Board to exclude a participant from designation, either by amendment of the current plan or adoption of a new plan, the staff would normally refrain from designating the participant concerned.

D. Alternative Approaches to Designation

In the past, some alternative approaches were followed or considered to the currently used approach to designation which aims to harmonize ratios based on participants' "excess holdings" of SDRs to their quotas.

The Reserves-Based Approach Used until 1999

Initially, participants' official holdings of gold and foreign exchange (instead of quotas) were used as the denominator in calculating the excess holding ratios. Participants' gross reserves were considered as the best metric of their ability to provide freely usable currencies against SDRs.

However, over time, a number of developments had made reserves less suitable as an allocation criterion for designation purposes, and in 1999 quotas replaced reserves as

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[50] This operational flexibility is similar to that exercised in the context of quarterly Financial Transactions Plans. Precise proportionality under designation could be assured only if all the participants in the plan, currently 51, were actually designated on the occasion of each transaction, even for very small ones. Such an approach would be operationally inconvenient and burdensome for all the members concerned and for the Fund. Under any other approach, some variation from strict proportionality is unavoidable because it is impossible to predict the amounts and timing of transactions with designation. Experience suggests, however, that broad proportionality can be achieved without undue fragmentation of individual transactions.

the basis for calculating designation amounts.[51] First, changes in the pattern of gross reserve holdings of participants had made reserves a less relevant measure of participants' quantifiable rights and obligations in the Fund (quotas).[52] Second, there were wide differences among participants in the measurement, reporting, and usability of gross reserves. Finally, the introduction of the euro in 1999 entailed substantial changes in the level and definition of international reserves for the individual euro-area members, and compounded the difficulty of relying on reserves as the basis for calculating designation amounts. To varying degrees, these concerns remain valid and suggest that the present, quota-based designation mechanism remain preferable to a reserves-based mechanism.

Holdings Principle

A so-called "holdings principle" would aim at promoting equality in the ratios of participants' total holdings of SDRs (instead of their excess holdings of SDRs) to their holdings of gold and foreign exchange. Such an approach, which was considered in the past, would place the emphasis on designation on those participants whose total SDR holdings represented relatively low proportion of their reserves, irrespective of the amounts of their allocations and any net sales of SDRs they have made. This approach would avoid emphasis on designation of the "net users" of SDRs, which tends to give to the SDR something of the character of credit.

However, for a number of reasons, the "excess holdings" approach was retained and the "holdings" approach was not adopted in the past:

- First, participants with large "excess holdings" would continue to be designated if their reserves were relatively large, and might be brought more rapidly to their acceptance limits.

- Second, other participants, whose reserves are relatively low in relation to their SDR allocations, might not be assigned amounts of designation even if they had used some SDRs because the proportion of SDRs in their reserves would still be relatively high.

- Third, while the SDR was made more attractive as a reserve asset, in part by making the SDR interest rate market-based, it was not clear to what extent participants with relatively large reserve would be willing to increase the weight of the SDR in their reserves.

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[51]The rationale for this modification was the same as that in the revision of the guidelines for allocating currencies under the Financial Transactions Plan (which was at the time called the Operational Budget) adopted a year earlier.

[52] Using reserves as a basis for designation tended to concentrate designation amounts to participants' with relatively large reserves, with the result that such participants' acceptance limits could be reached well before

(continued…)

Approaches based on the "holdings" principle seem to remain inferior relatively to the currently used method of determining designation amounts.

- The move to a quota-based system of calculating designation amounts in 1999 was motivated mainly because participants gross reserves no longer were seen as an objective and uniform allocation criterion for designation purpose, which implied that the "holdings" approach combined with reserves would no longer seem feasible.

- The special allocations under the proposed Fourth Amendment would broadly harmonize members cumulative allocations and their quotas. Such a harmonization would imply that the approaches based on excess holding and holdings would initially yield quite similar results. Over time, however, if members' quotas continue to be adjusted in the absence of further SDR allocations, the results yielded by the two approaches would tend to diverge.

Designation Linked to a Difference Between Holdings and Cumulative Allocations

Once all participants have received an allocation, it would be possible to link designation amounts to some metric related to cumulative allocations. As a result of the proposed general allocation and the pending special allocation under the proposed Fourth Amendment, it is expected that all Fund members will have received an SDR allocation. In principle, this would allow developing a designation key linked to participants' holdings and their allocations:

- **Designation amounts could be distributed on the basis of the participants' unused acceptance obligations, i.e., the difference between their acceptance limit and current SDR holdings**. Since acceptance limits are defined with respect to cumulative allocations (rather than quotas), unused acceptance obligations would be calculated as SDR amounts, i.e. without using quotas in the designation calculation. Under such an approach, all participants would approach their acceptance limits at a uniform pace, measured as a percentage reduction in the unused acceptance obligation. All participants considered sufficiently strong would be designated an amount, unless the participant in question had voluntarily acquired SDRs in excess of its acceptance limit (300 percent of net cumulative allocations). The advantage of this approach would be that it would allow spreading the designated amounts across a large number of participants (i.e., all participants with holdings below their acceptance limit). On the other hand, it would be relatively ineffective in promoting harmonization of participants' excess holdings both relative to their quotas and relative to their allocations/acceptance limits.

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other participants' acceptance limits. Moreover, over time, the reserves based approach tended to shift the burden of designation away from the advanced economies toward emerging market economies.

Summary

The current mechanism of designation would seem to remain appropriate. The "excess holding" principle has been, and can be applied in a manner that avoids concentrating designation on an overly narrow group of participants. Members' quotas continue to provide the most relevant uniform and objective metric of members' quantifiable rights and obligations in the Fund, including in the context of designation. The case for using quotas in calculating designation amounts is further strengthened by the fact that the proposed allocation would closely align members' quotas and their cumulative SDR allocations. More generally, the current mechanism strikes a balance between the objective of promoting over time a balanced distribution of holdings of SDRs and the desire to maintain a fairly broad list of participants for designation. It has proven to work well in the past and it can be flexibly adjusted to meet changing circumstances. Nevertheless, given that the designation plan has not been used for a long time and may be needed to execute a sizable volume of transactions in the future, modifications could be considered as further experience is gained with the execution of the plan.

ANNEX VI. TREATMENT OF SDR ALLOCATION IN FUND-SUPPORTED PROGRAMS

The treatment of the allocation of SDRs in Fund-supported programs should be on a case-by-case basis, taking into account individual country's macroeconomic circumstances and policy framework. In some cases, the need may be to preserve the augmentation of reserves, whereas in others there would be scope for spending the allocation. Due regard would need to be given to debt sustainability concerns given that SDR interest rates are likely to rise, though the allocation is unlikely to have a significant effect on the debt servicing requirements of most countries.

Macroeconomic considerations

The treatment of the allocation in Fund programs should be considered on a case-by-case basis. The principal question is whether the resulting rise in gross reserves should be retained or used, partially or in full. The answer should be in line with macroeconomic considerations, such as the adequacy of reserves or the financing constraints.[53] While the purpose of the SDR allocation is to enhance member countries' access to liquidity, this is not necessarily an argument against "saving" the higher level of reserves if it has a catalytic role in improving confidence. The decision should be based on program objectives, and, in general, could be guided by the following considerations:

- **Where a member has a precarious reserve position, there would be a bias toward locking in much or all of the increase.** Similarly, for a program that aims to bring about an adjustment in the exchange rate or introduce greater exchange rate flexibility, it would not be advisable to use extra reserves to postpone the inevitable adjustment.

- **Where the level of the exchange rate or the scale of central bank intervention is not a concern, or reserves are expected to remain well above a comfortable level, there could be scope for the use of some or all of the additional reserves.**

- **Pre-existing (fiscal and private sector) financing constraints and debt sustainability considerations should be weighed, especially for LICs.** Some emerging market countries and most low-income countries have lost, or never had, access to financial markets and many face binding financing constraints that could be relaxed through the SDR allocation. On the other hand, they also often have inadequate reserves and debt vulnerabilities that call for prudence. Resources available through an additional allocation would be nonconcessional as net users are charged the SDR interest rate, which, while very low at the moment, is likely to rise.

[53] Program accounting considerations are provided in Box 4.

Thus, costs of using allocated SDRs for balance of payments purposes should be weighed against projected debt-service capacity and, in LICs, against more concessional financing that could be available from other sources. For countries that are eligible for assistance under a concessional Fund facility, the SDR allocation should not be seen as a substitute for program-based concessional financing. If the need is urgent, however, the allocation could serve as a bridge until concessional financing is arranged.

- **Countries should neither be penalized nor rewarded for having programs in place already.** The allocation should encourage a fresh look at reserve adequacy in current program cases, as it would for a country coming to the Fund for a program subsequent to the allocation. By the same logic, access under new Fund arrangements should not necessarily be set at a lower level because of the SDR allocation. It should continue to be guided by the existing well-established access criteria.

The allocation could provide additional scope to relax fiscal constraints in some programs. If a program involves greater use of reserves, this opens the possibility of a larger fiscal deficit, especially where fiscal financing constraints are binding. Again, this would be a decision according to individual country circumstances. But any relaxation of fiscal targets should be set in the context of a medium-term framework to ensure that fiscal and debt sustainability and credibility are maintained.

Box V1.1. Program accounting considerations

Program parameters should be adjusted, if necessary, to accommodate the macroeconomic treatment of the allocation. In most cases, this will involve adjustment of NIR targets, though for some it will involve NFA, NDA, or fiscal targets.

Under the latest accounting guidelines, NIR would normally be expected to increase with the new allocation. In the majority of member countries, where the SDR position of the member is shown as assets and liabilities of the central bank (which, as a matter of practice, is often the case where the central bank is the fiscal agency for transactions with the Fund), the additional SDR holdings would directly increase central bank gross reserves. But the effect on NIR will vary according to the treatment of the liability represented by SDR allocation. Recently revised international statistical standards treat the SDR allocation as a long-term foreign exchange liability of the member to the SDR Department—i.e., to the participants of the SDR Department, and not to the IMF itself.[1] Under this treatment, the allocation would have no impact on NFA (because both foreign assets and liabilities increase) but it would normally increase NIR (both because the increased liability is not short term, and because it is not to the Fund).

However, in practice, program accounting treatments are likely to diverge widely. NIR definitions vary in the items that are netted—in particular, they differ on whether only Fund credit, or all liabilities to the Fund, are subtracted, and they also differ on whether only short term liabilities or all maturities are netted. Central banks may treat the SDR allocation as a liability to the Fund, or may treat it as equity as recommended in the Monetary and Financial Statistics Manual. So there may well be cases in which neither NIR nor NFA increase with the allocation. All this suggests that the treatment of allocation should be considered on a program-by-program basis with a careful examination of the accounting framework. Also, the fact that a program target variable is not affected directly by the allocation should not be a reason not to adjust the target, if there is an economic justification to change it.

There may be further complications in countries where the SDR position is shown on the balance sheet of the government rather than the central bank (which, as a matter of practice, is often the case where the ministry of finance is the fiscal agency for transactions with the Fund). To simplify accounting and program monitoring, a typical Fund-supported program consolidates all of the members' positions with the Fund which results in an augmented central bank balance sheet, the monetary authorities' account. In such cases, the SDR allocation would increase gross reserves in the same manner as in the countries where the central bank is the fiscal agent, and the effect on NIR would again depend on the definition of the liabilities that are netted off in its formulation.

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[1] This revised methodology was agreed for the *Balance of Payments Manual* and the *System of National Accounts* in 2008. The *Monetary and Financial Statistics Manual* prescribes that SDR allocations be recorded under the category for *shares and other equity*, but this guidance is to be updated.

[2] Possibly, central banks in some newer members may not even have addressed the accounting treatment of SDR liabilities, because they have not yet participated in an allocation.

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The Chairman's Summing Up
Proposal for a General Allocation of SDRs
Executive Board Meeting 09/64
June 26, 2009

Executive Directors welcomed the opportunity to discuss the staff's initial report on a general allocation of SDRs and its modalities, which they saw as a timely Fund response to the global crisis and calls by the membership to strengthen the global financial safety net. They urged rapid adoption of the Fourth Amendment to the Articles of Agreement to permit those members that had not benefited from previous SDR allocations to have a special "catch-up" SDR allocation.

The Case for a General Allocation

Directors broadly supported a prompt, one-step, general allocation in an amount equivalent to US$250 billion as a collaborative response to the crisis and as addressing the long-term global need to supplement reserve assets. A one-step allocation would meet the immediate need for liquidity, and thereby allow scope for sustainable countercyclical policies where appropriate; citing the magnitude of the allocation, some Directors regretted that a more in-depth analysis of a phased allocation was not provided. Most Directors noted that, over the medium term, the allocation will act as a low-cost liquidity buffer for low-income and emerging market countries and will reduce the need for excessive self-insurance. The proposed allocation would be consistent with the criteria laid down in the Articles of Agreement—namely, "avoiding economic stagnation and deflation as well as excess demand and inflation in the world." Nonetheless, Directors noted that the projected need for additional reserve assets, as well as the SDR component, is subject to considerable uncertainty and judgment. A number of Directors were not convinced that pre-crisis benchmarks for reserve levels provide a useful guide for future demand for reserve assets, particularly given changes in Fund facilities and access, and a few Directors questioned the exclusion of several countries from the sample.

Directors stressed that the SDR allocation should not weaken the pursuit of prudent macroeconomic policies, and should not substitute for a Fund-supported program or postpone needed policy adjustments. Where relevant, the Fund should advise members on the likely macroeconomic implications of their use of allocated SDRs in its surveillance and program discussions and reflect this dialogue in staff reports as warranted. While the SDR allocation would likely have a limited impact on debt sustainability except in a small number of low-income countries, use of SDRs should be fully reflected in debt sustainability analyses. Some Directors stressed that members with arrears to the Fund should use their SDR allocation to retire these overdue obligations. A number of Directors recommended that management establish a set of principles to provide guidance to staff and members on the appropriate implementation and use of the SDR allocation, which do not undermine the reserve asset quality of the SDR.

Noting uncertainties, Directors stressed the importance of the Managing Director's review of the global need for SDRs no later than six months before the end of the current basic period, i.e., by June 2011, which, in accordance with the Articles, will involve consultation with Executive Directors. In this context, some Directors suggested that a future cancellation of some portion of the allocation should not be precluded if conditions so dictate. To mitigate risks associated with such a sizable allocation, some Directors felt that consideration could be given to re-introducing a reconstitution requirement. A few others observed that the present assessment of long-term global need lends support for a sizable increase in the Fund's quota resources.

Post-Allocation Operational Issues

The proposed allocation is likely to raise significantly the volume of transactions in which freely usable currencies are requested in exchange for SDRs, including by countries with balance of payments needs. Directors stressed that it would be preferable to handle such transactions though voluntary arrangements. Most Directors called for ways to expand the transactions capacity of the system of two-way trading arrangements, while ensuring that the potentially higher post-allocation transactions volume can be accommodated in a more balanced way across the membership. This could be achieved both by increasing the amounts that participants with existing arrangements are willing to buy and sell, and by broadening the group of participants with standing arrangements, possibly covering all members with sufficiently strong external positions.

The designation mechanism, under which members with sufficiently strong external positions can be designated to provide freely usable currencies in exchange for SDRs up to specified amounts, ultimately underpins the liquidity of the SDR, providing a backup to voluntary arrangements among members. Most Directors considered that the current method of designation remains broadly appropriate. However, noting that the designation plan has not been activated for a long time, many Directors called for an examination of the scope for improvements.

Directors noted that various options for the post-allocation use of SDRs could be explored, including the role of SDRs in funding financial support for low-income countries with balance of payments needs, although any post-allocation redistribution would be undertaken on a strictly voluntary basis. A few Directors felt that a more transparent way of mobilizing development financing would be preferable.

Next steps

Directors looked forward to a staff paper that will include the Managing Director's report to the Board of Governors with his proposal for a general SDR allocation in an amount equivalent to US$250 billion, which could be effective by end-August 2009. Directors expect to be able to concur with the Managing Director's proposal with key features along the lines described in Section III of the staff report and adopt the relevant decision to this effect. They asked staff to report back to the Board on the scope for expanded voluntary agreements by the time the allocation becomes effective.