Share the bounty, boost the global economy

Why Canada should channel its SDRs to developing countries

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> *Imagine you and your sister are both going through the same economic crisis, but with very different means. You both lost your jobs, but you have a house that is already paid for, and savings. Your sister is a single mom with three kids and an unpaid student debt. The bank is willing to give you a loan, but not to your sister because she is less wealthy and her finances are unstable. Imagine if you could transfer your credit line to your sister, and all it would cost you is a small interest until she gets back on her feet.*

Canada is in a similar situation right now. **In August 2021, because of the Covid crisis, the International Monetary Fund (IMF) transferred CAD$19 billion of a special currency to Canada that has been put in our international reserves.** This is following a historic allocation of US$650 billion in Special Drawing Rights (SDRs), agreed to by IMF member countries to inject money into a global economy badly hurt by the Covid-19 pandemic. With this new emergency issuance, Canada, like other countries around the world, saw its international reserves go up overnight, increasing financial resources to fight the pandemic.

Canada is highly unlikely to use these new resources, because our international reserves were already very well stocked. With widespread vaccination and generous fiscal support, Canada is, like most other wealthy countries, poised to bounce back. Meanwhile, other countries desperately need this resource that is "collecting dust on Canada's shelf".

All IMF member countries received this unprecedented financial support. But because they were distributed according to IMF quotas (that is: the size of the economy), a very small portion went to low- and lower-income countries. **The 54 countries on the African continent got CAD$42 billion—just twice the allocation Canada received.** G7 countries together got CAD$353 billion. [i]

This is while domestic resources, private investment, and other critical financing flows have declined in lower income countries, leaving them with precious little opportunity to earn currency reserves. Hard fought progress has been eroded and longer-term development priorities—from job creation to building effective healthcare systems to stopping a climate disaster—are under threat. The scale of needs is immense: Africa is facing additional financing needs of US$285 billion through 2025 just to respond to the pandemic and needs roughly US$520 billion more through 2025 to get back on track.[ii]

Developing countries are already using this new financial space. In Madagascar the new SDRs will be used to respond to the health crisis and economic recovery[iii], and in Senegal they will be used to strengthen the health system and increase social protection[iv]. The problem is that for too many low-income countries, there are too few SDRs.

This is why we support the call made by over 250 civil society organizations for rich countries to transfer or recycle their SDRs to countries who need them the most.[v] G7 leaders have already backed the voluntary recycling of SDRs, signaling a global ambition of channeling $100 billion from richer countries to lower income economies, which should be seen as a minimum first step. President Macron set the tone by already committing that 20% of France's new SDR allocation would be recycled.[vi] Janet Yellen, the US Treasury Secretary, is encouraging advanced economies to channel their SDRs to developing countries.[vii]

Canada should follow and support this effort by making a strong commitment towards recycling its SDRs, starting with 25% of its new allocation, before the end of 2021. This would mean CAD$4.7 billion, equivalent to roughly two-thirds of Canada's aid budget.

There are two broad ways to channel SDRs to poorer countries: Canada could donate its SDRs or lend them (preferably over a long period of time) as explained in the annex. In both cases, the recycling process is virtually painless because the international reserves are now almost double what is required by law.[viii] The recycling would change nothing to Canada's prospects for recovery, its deficit, or its GDP.

The main direct cost incurred by Canada would be a small interest rate that must be paid to the IMF when SDR holdings fall below Canada's allocation. As table 1 shows, the estimated cost of this interest if Canada recycled 25% of its SDRs ($4.7 billion) would be about $117.5 million if done through grants, and $24 million if done through loans (see Annex for details). This is an incredibly cost-effective way to provide financing to developing countries, with **the return on investment of every single dollar leveraging $50-$175**

	Total	SDR recycling/channeling scenarios			
		20%	25%	50%	75%
Share received by Canada from the US$650 billion allocation					
In CAD$ million	18,895	3,782	4,727	9,441	14,168
Estimated direct cost if recycled towards developing countries*					
As grants (CAD$ million)	472	94	118	236	354
As loans (CAD$ million)	135	27	34	67	101

*Net present value of interest paid to the IMF on the difference between holdings and allocations, based on current rates. See Annex for details.

Not only would recycling SDRs be cost effective, but the benefits would also be enormous. As an example, a rough estimate based on the economic returns of global vaccine distribution shows that for every $1 invested, Canada would get at least $3.40 in economic returns.[ix] At a hypothetical but realistic 15% tax/GDP rate, sharing 25% of SDRs ($4.7 billion) would generate $2.4 billion in federal taxes, much more than the interest paid, even if rates were to increase dramatically.[x] With other advanced economies following suit, Canada's investment would be repaid many times over.

Using SDRs for vaccines or more generally to boost global demand would yield a strong return on investment and improve the outlook for the global trade system- an objective of the management of international reserves. Countries might also use the increased fiscal space to invest in their own health systems, thus improving global health security, or into rebuilding greener economies, all global public goods that Canada would benefit from.

Time is of the essence. What is needed now is a breakthrough in international solidarity and a bold move to restart the global economy and build back better. The SDRs are a once-in-a-generation opportunity to be ambitious and provide a Marshall Plan for the world, with essentially no effect on Canada's deficit or indebtedness.

Canada owns its SDRs and does not need to follow or wait for any multilateral initiative. The Minister of Finance has the full authority to act unilaterally and make a real difference now. While there are a lot of details to settle, the SDRs were created as a reserve of value for a rainy day**. If the global Covid-19 pandemic is not that rainy day, then what is?**

Canada should urgently put its SDR allocation to work where it will have the most impact by:

- Committing to recycling its SDRs to support pandemic response and recovery efforts, and as a first step rapidly channel **an initial 25% of its new allocation to provide its fair share of the US$100 billion** committed to by the G7
- **In addition,** Canada should immediately recycle the excess SDRs it currently holds above its allocation (CAD$455 million)
- Canada should aim to recycle its SDR through grants to low-income countries. Where grants are not possible, recycling SDRs should be in the form of long term, no-interest loans to the IMF or the World Bank.
- Clearing political and technical roadblocks to accelerate the design of the proposed **Resilience and Sustainability Trust** so that it is operational by mid-2022.
- Pushing multilateral development banks, in particular the World Bank and African Development Bank, to work with the IMF to swiftly develop viable options for SDR channeling, and having them operational by mid-2022 at the latest.
- Agreeing to **recycle more of its SDRs once new mechanisms are in place**, based on the scale of need in low and middle-income countries.

Annex: How could recycling SDRs work in practice

It may appear more attractive for Canada to lend its SDRs to other countries, rather than giving them as grants, but considering many low-income countries are at risk of or already experiencing debt distress, creating additional indebtedness would lead to other problems. To the extent possible, Canada should look at options to grant, rather than loan, its SDRs. If loans are chosen, they should be interest-free, carry both a long grace period (the period without any reimbursements) and a long pay-out period (the full maturity period) and have more open eligibility conditions than IMF current lending.

1. Recycling SDRs through grants

The options presented below have no precedents, meaning they will require some creativity and most of all political leadership to be implemented.

Transfers to multilateral institutions. Unless Canada wants to donate its newly acquired SDRs directly to other central banks on a case-by-case basis, it would have to reallocate its surplus to a qualified recipient, such as the World Bank or the African and Asian Development Banks. These could then issue grants to low-income countries outside of their regular allocations. This would be the ideal situation, and could provide, for instance, some of the funding required to bring global vaccination rates to 70%.

Softening of multilateral development bank lending conditions. Canada could also use the funds to buy down the interest (or increase the grace period) for a multilateral development bank loan to a lower-middle income country using the loan, for instance, to protect vulnerable populations. This is less ideal than issuing grants because it contributes to increased indebtedness, although the maturity can be relatively long in multilateral banks.

Improving the concessionality of Poverty Reduction and Growth Trust (PRGT) loans, such as covering the first repayment instalment, increasing the grace period, or donating to the subsidy account which pays the interest on the loan instead of the borrower. Acting through the PRGT would be fast but has the disadvantage of limiting the new funds to countries who are in balance of payment crises and excluding those who played by the book and were frugal with their programs.

Issuing grants in hard currency. Instead of donating the SDRs, Canada could donate the equivalent amount in another currency, which has become excess to requirements after the SDR allocation, and which any development finance institution can receive, removing many constraints around donations.

2. Recycling SDRs through loans

If recycling SDRs into grants is not possible, then recycling them to create more and better borrowing possibilities for lower income countries should be the priority.

Transfer SDRs to the PRGT to increase its lending capacity. This is the most practical and speedy solution because the facility already exists and needs further support, which is why it is the main one being considered for immediate recycling of the SDRs from G7 countries. But without any changes to the terms and conditions, lending would be focused exclusively on low-income countries with balance of payments problems. Demand is forecasted to be high because of the difficult economic circumstances triggered by the pandemic in low-income countries, however it could compound the debt crisis over the medium term. This is why Canada should also support reforms to the PRGT to expand the list of eligible countries and improve the **concessionality** of lending by increasing the grace period and maturity.

Supporting the creation of a Resilience and Sustainability Trust at the IMF. The IMF is working on a new vehicle for vulnerable low- and middle-income countries as part of an effort to expand the number of countries (beyond the 69 PRGT-eligible countries) that can benefit from channeled SDRs. This proposed Resilience and Sustainability Trust (RST) is intended to help countries recover from the pandemic while addressing longer term structural challenges, including combating climate change and improving healthcare systems. Eligibility criteria and conditionalities still need to be determined, but maturities are expected to be longer than 10 years — the current maximum duration of other IMF programs. The RST is expected to be operational in 2022, and there is no clarity yet on the amount of SDRs that could be channeled via the RST. Canada should support these efforts with a view to making it operational by the next G7 Leaders meeting and consider recycling more of its SDRs through this new mechanism once it's operational, on a no-interest basis.

Lend the SDRs to the World Bank. A similar fund could also be set-up at the World Bank, which could lend the SDRs directly to borrowing countries, or use the SDRs to strengthen its balance sheet and raise funds on the international markets in hard currency. The advantage of the World Bank is that its lending usually does not carry the same level of conditionalities associated with IMF loans and that it pursues socio-economic objectives, not just financial ones. In all cases, there are three important elements to keep in mind:

a) The longer the maturity and the grace period, the more flexible the use of the SDRs for loans, and the less conducive it is to unsustainable indebtedness. The feasibility of a 99-year loan could be assessed if there are obstacles to outright donations.

b) If lending the SDRs directly poses problems, other currency reserves, which have become excess to requirements because of the August 2021 SDR allocation could be loaned instead. It is worth noting that Canada provided a loan denominated in US Dollars in July 2021 to the IMF to augment the resources of the PRGT.

c) Canada should avoid lending its SDRs and collect interest on its loan. For Canada, it would be a simple investment of reserve funds as it currently does, would require finding donors to fund a Subsidy Account (several billion dollars to pay the interest to lenders) and would act as a disincentive to increasing maturity and grace periods.

How much would it cost Canada to recycle its SDRs?

Donating "excess" SDRs. When a country's SDR holdings exceed its allocation, it receives a small interest payment on the balance above the allocation. Canada is currently CAD$455 million above its allocation, meaning that it is currently earning interest from SDRs.[xi] By donating these "excess" SDRs, Canada would forego interest payments, which is a relatively simple write off of around CAD$11.4 million.[xii]

Many countries are likely to be seeking to exchange their recently acquired SDRs for other currency. Canada should be proactive in accepting these SDRs and donate the additional surplus SDR holdings thus created. Unlike Canada, other countries may not have as flexible a regulatory and legislative framework.

Donating a portion of Canada's new SDR allocation. Canada's receipt of CAD$19 billion in SDRs in August was a windfall that was unplanned, so transferring the allocation would have little impact on Canada's international exposure or its prospects for recovery.

Donating SDRs to other countries should not entail a cost equivalent to the nominal value of the gift, because SDRs are not money but a reserve instrument. The forecasted deficit in the last Budget does not increase, Canada's indebtedness does not increase either. SDRs are both a liability and an asset, so they do not affect the balance of Canada's Exchange Fund Account. Canada's reserve position at the IMF does not form part of the Exchange Fund Account, according to the Government's Statement of Investment Policy.[xiii]

Donating SDRs would however mean Canada would have to pay an interest in perpetuity. The interest is currently of 0.05%/year, meaning a net present value of the interest cost of around $25 million for every tranche of $1 billion in donated SDRs. This means that if Canada were to donate 25% of its new SDRs, or CAD$4.7 billion, the direct cost in interest rates would be about CAD$117.5 million, an amount that could be absorbed by the Exchange Fund Account.

As a prudent manager, the Government of Canada may need to create a conditional liability in its books to cover the risk that interest rates might go up. By way of illustration, if Canada wanted to cover the risks of SDR interest rates being 1% in perpetuity, twenty times higher than current rate, the Net Present Value of the contingent liability would amount to $500 million, for each billion dollars in donated SDRs. This is not a cost, just an accounting procedure, with an entry of $10 million each year to exercise prudence.

Lending a portion of Canada's new SDR allocation, at no interest. Just like for donations, if SDRs are loaned, each year they are not held by Canada triggers an interest cost. Using the same SDR current rate of 0.05% and assuming that Canada lends the SDRs for 15 years and then receives 20% back in each of the following 5 years, the net present value of the cost would be $7.2 million for each loan tranche of $1 billion, again a small amount that could be absorbed by the Exchange Fund Account.

The associated contingent liability, based on a 1% rate for each of the years would have a net present value of $143 million. Of note, as the final maturity of the SDR loans increases, the cost will become more and more like what they would be in a donation scenario.

The Minister of Finance has the authority in Canada

The Bank of Canada is the agent of the Government of Canada for managing its international reserves. Pursuant to the Bretton Wood and Related Agreements Act and the Currency Act, the Minister of Finance is the decision-maker. The Minister is guided by a Statement of Investment Policy and he/she must act in the same way a person with ordinary prudence would act.

The Bretton Woods Act specifies that the Minister may lend SDRs on any terms and conditions approved by Cabinet, in support of global economic stability. This therefore provides clear authorities to lend over long maturities and to absorb the interest costs.

The issue of authority to donate SDRs is not specifically addressed in legislation, but a prudent person would agree that donating a portion of the windfall SDRs received in August does not threaten Canada's deficit, employment situation or indebtedness beyond what risks already existed in July. As mentioned earlier, Canada's reserve position at the IMF does not form part of the Exchange Fund Account, according to the Government's Statement of Investment Policy.

If the Statement of Investment Policy must be amended to specifically enable donations, the amendment procedure is also under the authority of the Minister of Finance.

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[i] 2021 SDR General Allocation, IMF, August 2021

[ii] Managing Director Kristalina Georgieva's Remarks at Summit on the Financing of African Economies, IMF, May 2021

[iii] https://2424.mg/aides-financieres-lallocation-de-332-millions-de-dollars-du-fonds-monetaire-international-est-deja-versee-a-la-banque-centrale-indique-le-ministere-de-leconomie-et-des-finances/

[iv] https://www.agenceecofin.com/investissements-publics/0409-91184-senegal-le-chef-d-etat-veut-affecter-les-dts-a-la-sante-et-au-social

[v] Civil Society Organizations Call for Principles for Fair Channeling of Special Drawing Rights | by Oxfam International, Washington Office | Sep, 2021 | Medium

[vi] "France to redirect 20% of its allocation from the International Monetary Fund to support African countries",RegionWeek Newsletter Vol V, Issue #190, September 27, 2021

[vii] "Yellen urges wealthy countries to redistribute SDRs to those in need", Devex, 9th September 2021

[viii] As of October 5th, 2021, Canada held US$106 billion in international reserves, or about 6% of GDP, double the 3% commitment from the Government of Canada

[ix] Based on the IMF, WTO, WHO and WB estimate that a US$35 billion grant investment in vaccines would generate US$3,600 billion in economic output for the developed world with about $119 billion going to Canada. If Canada invested US$1 billion in a vaccine fund, and was the only investor, it would generate $119 billion/35 = US$3.4 billion in Canadian economic activity. Under a more realistic scenario with many investors, Canada's investment is repaid many times over

[x] At a $1:$3.40 ROI for investing in vaccines around the world, a $4.7 billion investment from Canada would generate $16 billion economic returns. If these were taxed at 15%, this would in turn generate $2.4 billion in revenues for the Federal Government, compared to a direct interest cost of $34-$118 million.

[xi] Member Financial Data (imf.org)

[xii] Annual interest payments on US$361 million are US$0.18 million, assuming the recent average SDR rate of 0.05%. An annual stream of payments of US$0.18 million has a net present value of US$ 9 million, assuming a discount rate of 2.%, based on the latest Government of Canada long term rate published by the Bank of Canada .

[xiii] Annex 1: Statement of Investment Policy for the Government of Canada (August 2018) - Canada.ca