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Opening a Back Door to Foreign Aid: The SDR Department at the IMF

by

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A First Deputy Managing Director of the International Monetary Fund (IMF) once jested that one of his goals was to complete his tenure without understanding what the SDR[1] Department did. Congress cannot afford this luxury while US taxpayers are paying the bill.

The SDR Department is an arcane system of financing that was designed to address a potential global shortage of international reserves. Now, it has been transformed into a redistribution mechanism that compels rich countries to lend on demand to poor nations at a highly subsidized floating interest rate--the weighted average of the lowest short-term interest rates in the world. The United States is the chief source of these perpetual and unconditional loans. US lending now reaches $5 billion and costs taxpayers $300 million per year. A cost that appears nowhere in the Federal budget.

The IMF now proposes to double the size of this pool of funding. Approval has been secured from more than 75% of IMF membership and awaits only the seal of the US government. The new distribution will be skewed toward developing countries: almost 50% will be sent to these debtor governments in contrast to their present 30% share. If ratified by Congress, US exposure could easily surpass $12 billion in hidden foreign aid without control over where the funds go or the ends to which they are devoted. The cost to US taxpayers would then reach $750 million per year.

Unfettered Foreign Aid in Disguise

Foreign aid is a worthy cause but only if it results in worthy outcomes. For more than a decade, the SDR Department at the IMF has been a back door to what could become open-end US aid--but aid unlike any other. Aid to all nations from the oppressive and corrupt to the democratic and upright. Aid on demand. Aid disguised as perpetual loans.

[1]The Special Drawing Right (SDR) is the unit of account of the IMF and is used to denominate all Fund finances. The SDR's value was originally set in terms of gold but now is a weighted average of the US dollar, Euro, Japanese yen and Pound Sterling.

Aid without determined purpose. Aid without conditions. Aid without oversight. And, very likely, aid without results.[2]

SDR indiscriminate giving, which looks only at position in the world economy but is blind to human rights abuses and the rule of law, now proposes to offer total financing of $465 million to Iran, $90 million to Syria, $100 million to Sudan and $80 million to Myanmar while the regime of Mugabe in Zimbabwe will obtain $115 million and the government of Chavez in Venezuela will be able to borrow $840 million.

The Origins of the SDR Department

The SDR Department was established in 1969 when the international financial system was still based upon the gold standard and fixed exchange rates to address short-term imbalances. It was feared that the slow rate of gold production would limit the growth of international reserves and lead to either a devaluation of the US dollar or constraints on international trade. As a solution, the IMF would print SDRs or "paper gold" and allocate them among its members. Governments would agree to accept SDRs at a fixed rate of SDR 35 per ounce of gold. The IMF would create SDRs whenever there was deemed to exist a "long-term global need to supplement existing reserve assets."[3] The SDR was to become the primary reserve medium in the international monetary system.

When the Bretton Woods system collapsed in 1971-73 and the world moved to a system of floating exchange rates, the rationale for SDR creation disappeared. The SDR Department found a new function: it morphed into a foreign aid mechanism to transfer money from rich to poor countries.

Quotas provide the vast majority of IMF resources and are familiar to Congress which authorizes periodic additional funding, most recently in 1998. These finance the General Department where IMF lending takes place. The SDR Department is completely separate and has been provisioned by General Allocations of SDRs distributed in proportion to IMF quotas. To date, there have been two General Allocations totaling SDR 21.4 billion (US$ 31 billion at current exchange rates): SDR 9.3 billion in 1970-72 and SDR 12.1 billion in 1978-81.

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[2] In contrast, IMF standard loans must be individually approved by the Board, carry conditions of reform and are reviewed quarterly for compliance in advance of disbursements.

[3] International Monetary Fund Public Information Notice No. 02/3, January 10, 2002, page 2.

Magic Money?

The IMF can print SDRs without backing, creating the illusion that SDRs are costless. For this reason, the interest rate on SDR loans was originally zero. It was gradually raised to the floating SDR interest rate that is a composite of the lowest short-term interest rates in the world.

The problem is that no one in the real world wants SDRs. General Electric will not accept SDRs as payment for generators. Merck will not deliver vaccines. JP Morgan Chase will not cancel loans. Money only has a value if it is accepted as payment for goods and services. SDRs do not qualify.[4] In order to use the SDRs received, the poor countries return them to the IMF and exchange them for US dollars, EUROs, Yen and other real money. Where does the Fund obtain the necessary real money? From the rich countries. Where do the rich countries find the cash? By issuing debt and taxing their citizens.[5]

SDR Allocations are Slated to Double

In 1993, the IMF proposed to augment SDR holdings through a new General Allocation of SDR 36 billion. However, the leading industrialized nations were not convinced that a shortage of international reserves existed and did not support the proposal.

But there was a perceived inequity in allocations. Many IMF members had joined the Fund after the last SDR allocation and had not received SDRs. Also, the relative economic importance of other members had increased beyond their share of past SDR allocations. In response to a US and UK proposal, the IMF Board passed a 1997 resolution for a Special Allocation of SDR 21.4 billion that would double the total outstanding and achieve a corrected distribution: cumulative SDR allocations would measure 29.3% of IMF 1997 quotas for all members.

Rather than increase the supply of SDRs to address the issue of equitable distribution, the existing stock of SDR 21.4 billion could have simply been reallocated among the members to achieve a uniform distribution at 14.7% of 1997 IMF quotas. But, for many members whose shares would diminish, the balances had already been drawn down and the money was long gone. Here was a golden opportunity to advance a redistribution

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[4] SDRs are accepted as settlement of inter-government transactions and of payments due to the IMF.

[5] If, instead of sterilizing the creation of SDRs by the IMF, rich countries print additional amounts of their own currencies to exchange for the SDRs, allocations of SDRs would be inflationary on a global basis.

agenda that would more than double, in the Fund's own words, this "net transfer of real resources to countries that lack ready access to capital markets".[6]

Nations with more than 75% of the IMF voting power have approved the increase and implementation awaits only US accord, with its 17% voting share, to reach the necessary 85% majority.

How the SDR Department Works

SDR allocations initially create credit balances in each member's account in the SDR Department. Each country pays interest on its allocation and receives interest on its credit balance at the same SDR floating interest rate. The SDR interest rate is a weighted average of the yields on specified risk-free short-term instruments in the US, UK, European and Japanese money markets whose currencies compose the SDR. The US dollar component is the three-month US Treasury bill.

When a country exchanges its allocated SDRs for freely usable currencies, the government's credit balance falls below its allocation. The country has borrowed the difference between its allocation and its credit balance at the SDR interest rate. When a country accepts additional SDRs in exchange for freely usable currencies, its credit balance rises above its allocation. The country has lent the excess of its credit balance over its allocation at the SDR interest rate. If a country does not use its SDRs and does not accept SDRs in exchange for freely usable currencies, its credit balance equals its allocation and it has no cost or benefit because the interest payments received and paid exactly offset each other.

Rich countries agree to exchange their freely usable currencies for SDRs on demand. This is what gives SDRs their value. Poor countries therefore receive their SDR allocations and exchange their SDR credit balances for US dollars, EUROs or Japanese yen. This creates an effective perpetual loan from the rich countries to the poor at the SDR interest rate. Contrary to standard IMF loans, there is no obligation or even expectation of repayment of the loan and there are no conditions of economic reform or policy adjustment.

Drawing from Deep US Pockets

The SDR department is, in essence, funded almost entirely by the United States. Over the last ten years, US lending has averaged $4.1 billion, virtually matching developing country borrowing of $3.8 billion. Over the last three years, American loans have risen

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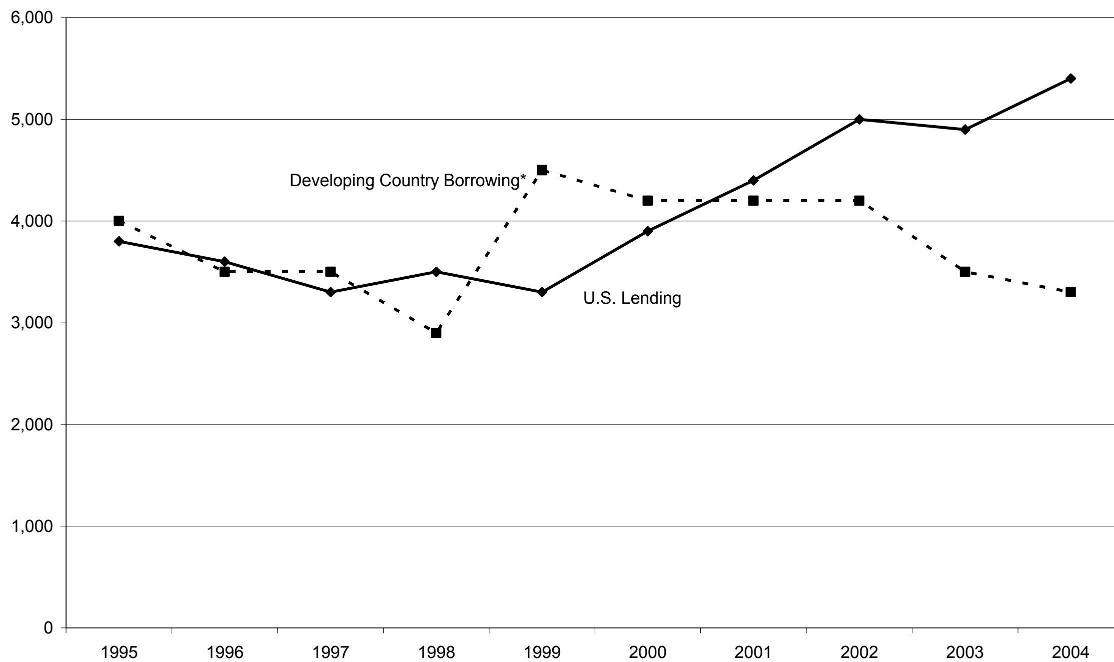
[6] Silent Revolution: The International Monetary Fund, 1979-1989; J. Boughton; page 926. International Monetary Fund. 2001.

to more than $5 billion, exceeding developing country borrowing by $1.4 billion. (See Graph I.) The other industrialized countries as a group are actually net borrowers from the SDR Department in the amount of approximately $4 billion. The only other significant supplier of funds is Japan that contributes financing of approximately $1.3 billion.

Graph I

U.S. Lending-Developing Country Borrowing*
($ Amounts in Millions)



*Excluding China

Source: IMF International Financial Statistics

A $300 Million Annual Price Tag; On the Way to $750 Million

When the United States sends resources to the SDR Department, they are exchanged for a credit balance in its SDR account at the Fund. Fiscal treatment for any "exchange of assets" was made clear in the 1967 President's Commission on Budget Concepts. This defines the subsidy element of an "exchange" as the difference between the Treasury's cost of funds for the term of the provision of resources and its rate of remuneration.

With the goal of matching the maturity of the government's assets and liabilities, long-term assets must be financed through long-term debt, short-term assets with short-term liabilities. If the assets have a higher risk than US Treasury securities, allowances for loss must be created. Both subsidy elements must be reflected as US budget

expenditures. Together, these SDR Department charges add up to an annual cost to US taxpayers of $330 million. (See Table I.) The current SDR allocation proposal would more than double the present US contribution of $5 billion to an estimated $12 billion with a projected cost to taxpayers of $750 million each year.

Table I

Cost to U.S. of IMF SDR Department
($ Amounts in Millions)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004*	Average 1995-2004
U.S. Net SDR Position	$3,800	$3,600	$3,200	$3,500	$3,300	$3,900	$4,400	$5,000	$4,900	$5,400	$4,100
Interest Subsidy	40	50	40	20	30	0	80	160	150	200	77
Credit Risk Subsidy	230	130	70	150	180	150	190	200	140	130	157
Total Cost to U.S.	$270	$180	$110	$170	$210	$150	$270	$360	$290	$330	$234

* First 6 months annualized

Sources: IMF International Financial Statistics
Treasury Bulletin
J.P. Morgan Chase

A 3% Interest Subsidy: Lending for the Long Term; Short Term Returns

To maintain the illusion that the interest rates on US government assets and liabilities match, past Treasury Departments have insisted that US SDR positions at the Fund are short-term assets because, in theory, they can be redeemed at will. If this right were ever exercised, a bankrupt SDR Department would result. The US SDR position is a permanent contribution and should be assigned a long-term cost.

To create a *bona fide* maturity structure of US/IMF assets and liabilities, as instructed by the President's Commission, the effective cost is determined by assigning:

a 20-30 year interest rate for the component of the US SDR position which is, in essence, a permanent paid-in equity contribution;

a 7 year interest rate for the component which is committed for the foreseeable future;

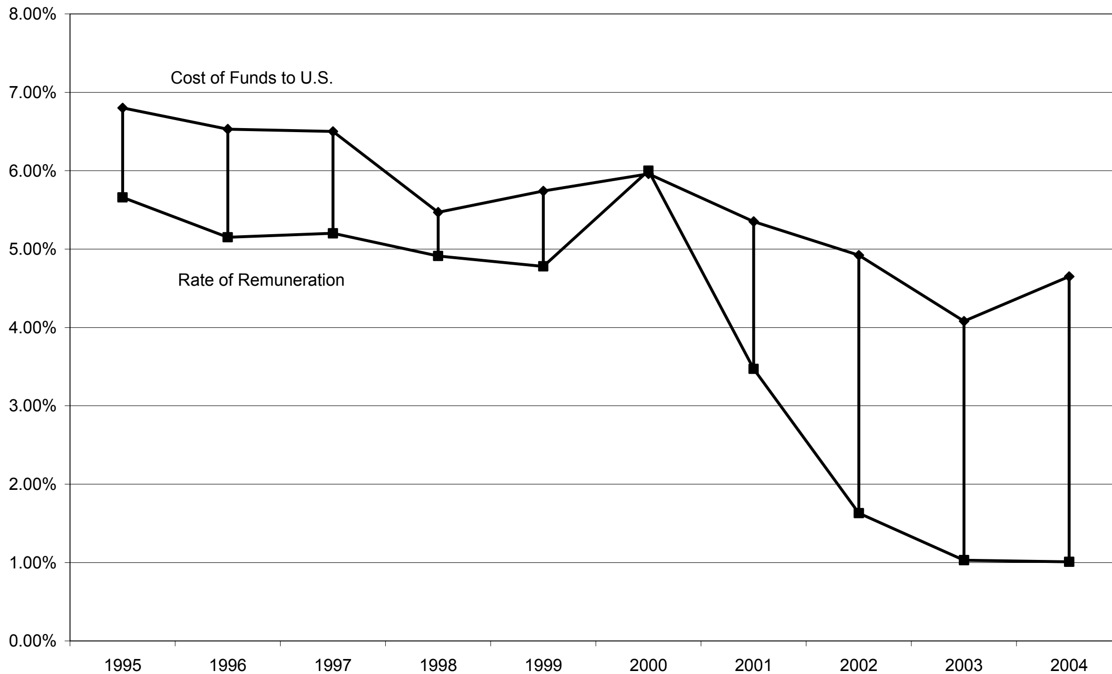
a 3 year interest rate for the component which is expected to vary in the medium term; and

a 3 month-1 year interest rate on the portion of the US SDR position subject to short term fluctuation.

The United States is financing a predominantly long-term asset at a cost of 4.7% in 2004 and receiving a short-term three-month US Treasury bill rate of remuneration of 1.0%. The difference between the rates is the interest cost to the US government of providing resources to the SDR Department and has averaged more than 3% or $170 million per annum over the last three years. (See Graph II and Table I.) This translates into a gift of an interest subsidy to SDR borrowers. The cost is not separately identified but hidden in the government budget under the general interest cost of the Federal debt.

Graph II

Interest Subsidy: Difference between U.S. Cost of Funds and Rate of Remuneration



Sources: Treasury Bulletin
IMF International Financial Statistics

A Real Risk of Loss as Developing World Debt Grows

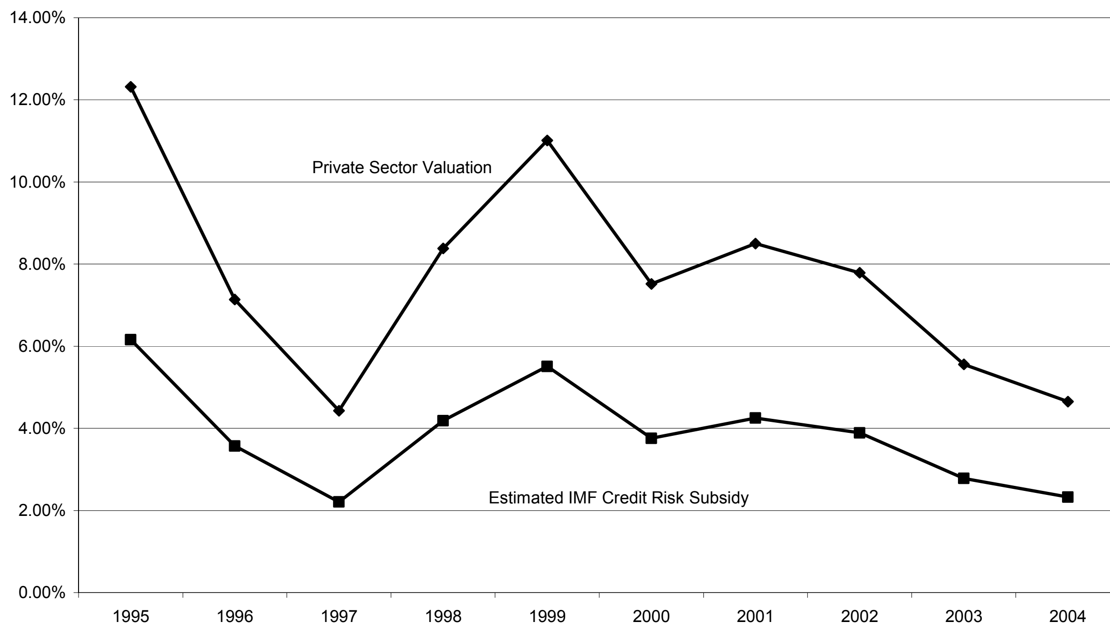
In the capital markets, the valuation of risk is one of the foundations of emerging market investment. The risk premium over the interest rate on US Treasury securities is the proxy for the market's prediction of the potential for loss on sovereign loans.

The JP Morgan Emerging Markets Bond Index, a composite of 19 major sovereign borrowers,[7] reveals that over the 1995-2004 period, the average risk premium over US Treasury securities was 7.7% per annum. Even a conservative approach to risk for the US SDR position--one-half of the private sector premium--adds up to a risk allowance that should have averaged $160 million per annum over the last three years. (See Graph III and Table I.)

If losses in the SDR Department were distributed in proportion to relative allocations of SDRs, as opposed to SDR holdings at the time the loss is incurred, the credit risk subsidy cost of the SDR Department to the United States would be reduced by an average of $ 39 million per annum over the last 10 years.

Graph III

Developing Country Credit Risk



Source: J.P. Morgan Chase

Redistribution without Conditions: A Costly Precedent

At the IMF, the struggle for redistribution from rich to poor has been long and heated, fueled by growing global guilt and pressure from developing countries to create a "link" between SDR allocations and economic need. In short, aid by entitlement.

[7] Argentina, Brazil, Bulgaria, Colombia, Ecuador, Egypt, Malaysia, Mexico, Morocco, Nigeria, Panama, Peru, the Philippines, Poland, Russia, South Africa, Turkey, Ukraine, Venezuela.

The SDR Department originated as a mechanism for two-way short-term exchanges between equals. Now, what is portrayed as an "equitable distribution" masks a one-way permanent transfer from rich to poor. Developing countries receive SDRs, exchange them for US dollars and spend the proceeds. The US, that has no use for SDRs, simply accumulates an ever-growing stockpile of costly pieces of paper.

Every lesson the world has learned from 50 years and $500 billion of failure to stamp out poverty in developing nations is violated by a move to more SDR allocations. Unconditional giving stands in the way of constructive reform. It destroys the incentives to create the solid ethical and economic environment that is the prerequisite to growth. There will be no means to measure results and no desire to do so.

Ratification by Congress of the SDR expansion would mark the beginning of a new series of demands on US generosity. Already 63 governments or more than half of IMF developing country members with SDR allocations have consumed their existing shares. (See Table II.) This appetite for "free money" without restraints can only grow.

Table II

SDR Balances Drawn Down: 64 Countries*
(as of 6/30/04)

Europe (4)
Bosnia & Herzegovina
Croatia
Iceland
Romania

Middle East (4)
Afghanistan
Iraq
Syria
Turkey

Asia (10)
Bangladesh
Cambodia
India
Indonesia
Myanmar
Philippines
Solomon Islands
Sri Lanka
Thailand
Vietnam

Africa (31)
Benin
Burkina Faso
Burundi
Cameroon
Cape Verde
Central African Rep.
Chad
Comoros
Congo Rep.
Congo Dem. Rep.
Cote d'Ivoire
Djibouti
Equ. Guinea
Ethiopia
Gabon
Guinea
Kenya
Liberia
Madagascar
Malawi
Mali
Mauritania
Nigeria
Sao Tome & Prin.
Seychelles
Somalia
Sudan
Tanzania
Togo
Uganda
Zimbabwe

Latin America (15)
Bahamas
Barbados
Brazil
Costa Rica
Dominican Rep.
Grenada
Haiti
Honduras
Jamaica
Nicaragua
Panama
Peru
St. Vincent & Gren.
Trinidad & Tobago
Venezuela

*SDR holdings equal to less than 5% of allocations.

Sources: IMF International Financial Statistics
IMF 2003 Annual Report