INTERNATIONAL MONETARY FUND

Guidance Note for Fund Staff on the Treatment and Use of SDR Allocations

Prepared by the Strategy, Policy, and Review Department
(In collaboration with the Finance, Legal,
Monetary and Capital Markets, and Statistics Departments)[1]

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I. Introduction

1. **Against the backdrop of the global financial crisis, the IMF has decided to implement a US$250 billion general allocation of special drawing rights (SDRs).**[2] In addition, the Fourth Amendment of the Fund's Articles of Agreement has recently become effective, and will make available to SDR Department participants a special allocation of up to an additional SDR 21.5 billion (US$33 billion).[3] Nearly US$115 billion of these combined allocations will go to emerging market and developing countries, including about US$20 billion to low-income countries (LICs), thereby providing an important boost to the reserves of countries with the greatest needs (the allocation by country is available here). The provision of such significant *unconditional* financial resources will help liquidity-constrained countries address the fallout from the global crisis by limiting the need for adjustment through contractionary policies and by allowing greater scope for countercyclical policies in the face of deflation risks. Further, over the longer run, additional reserve asset needs are projected to be large; the forthcoming allocations, while covering only a part of those needs, would help meet them in ways conducive to systemic stability and with significant advantages over borrowed reserves, which would need to be rolled over and may be less cost effective.

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[2] See http://www.imf.org/external/np/sec/pr/2009/pr09264.htm and the related background documents.

[3] The special allocation would amount to a total of SDR 21.5 billion if no current SDR Department participant were to opt out. The SDR amount allocated to each participant is determined by the application of a common benchmark as described in new Schedule M of the Articles of Agreement (which was added to the Articles of Agreement by the Fourth Amendment).

2. **The general allocation will be made in one step on August 28, 2009. The special allocation pursuant to the Fourth Amendment will be made on September 9, 2009.** The global need for SDRs will be kept under review. As is required under the Articles, the Managing Director will determine no later than six months before the end of the current basic period, i.e., by June 2011, after consultation with Executive Directors, whether the requirements set forth in the Articles are in place for a Managing Director proposal for a further general SDR allocation or cancellation that would have broad support among SDR Department participants.

3. **This note provides guidance that is applicable for the use of both the general and special SDR allocations**. It is primarily motivated by the request of Directors during discussions on the general allocation for "a set of principles to provide guidance to staff and members on the appropriate implementation and use of the allocation, which do not undermine the reserve asset quality of the SDR." Further, the guidelines present some basics about the SDR to facilitate its implementation and use, and set a consistent framework for assessing the macroeconomic implications of the allocation at the country level.

4. **The note is organized as follows**: The next section sets out accounting considerations. Section III provides guidance on macroeconomic implications of the allocation and related policy advice for both program and non-program countries. Section IV discusses the implications for Fund-supported programs, including conditionality, access, and low-income country issues. The treatment of SDR allocations in debt sustainability analysis is explained in Section V. Box 1 presents key legal considerations related to the treatment of SDR allocations. For a primer on the SDR and on transactions between member countries and the SDR Department, see Annex I. Annex II presents details on reconstitution requirements for SDR holdings, which were abrogated in 1981 but if re-established would have implications for use, especially for members with balance of payments needs. Annex III discusses the statistical treatment of SDRs. Annex IV provides implications for reserve management.

II. Accounting Considerations

5. **Under the latest accounting guidelines, net international reserves (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,[4] *the additional SDR holdings would directly increase central bank gross*

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[4] SDRs are allocated to Fund members that are participants in the SDR Department (currently all members). The Articles of Agreement do not prescribe the accounting treatment of SDRs by members. As a matter of practice, in most cases, the SDR position is recorded in the books of the fiscal agency (the fiscal agency is designated by the member to deal in operations and transactions with the IMF on behalf of the member country in accordance with the Articles and the Fund's rules—see Box 1), which for most members is the central bank . However, as a legal matter, the fiscal agency designation does not determine where the SDR position is to be

(continued)

reserves. But the effect on NIR will vary according to the treatment of the liability represented by SDR allocations. Recently revised international statistical standards treat *the SDR allocation as a long-term foreign exchange liability of the member to the participants of the SDR Department* (see Annex III).[5] Under this treatment, the allocation will have no impact on net foreign assets (NFA) (because both foreign assets and liabilities increase) but it would increase NIR.

6. **In practice, accounting treatments are likely to diverge widely; teams should encourage countries to reflect immediately their new SDR allocation in reserve assets and in long-term liabilities in line with *BPM6*,** even if the country has not yet moved to *BPM6*.[6] Central banks may be currently treating the SDR allocation as a debt liability to the Fund, or as equity as recommended in the *Monetary and Financial Statistics Manual*. Countries' NIR definitions may vary in the items that are netted—in particular, there are cases in which all reserve-related liabilities, regardless of maturity, are subtracted from NIR.[7] So there may well be cases in which NIR does not increase with the allocation, or in which NFA does increase. Country teams will need to examine the individual cases carefully to understand which situation applies, and should advise that the treatment be in line with *BPM6*. But different accounting methods should not lead to different macroeconomic treatment (see paragraph 19).

7. **For program purposes, NIR is defined in the Technical Memorandum of Understanding (TMU)**. SDR holdings are included in the reserve assets within NIR, but there is much variation across TMUs concerning the liabilities that are to be deducted in order to derive program NIR. If the TMU deducts short-term liabilities or liabilities to the IMF, this deduction would not cover the SDR allocation (see paragraph 5), and hence program NIR would increase as a result of the allocation.

8. **There may be cases where the SDR position is shown on the balance sheet of a government agency rather than the central bank.** In these cases, positions with the Fund,

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recorded; the accounting treatment is determined by the domestic legal and institutional framework in the member country.

[5] This revised methodology was agreed for the sixth edition of the *Balance of Payments Manual (BPM6)* 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.

[6] The rationale for the BPM6 treatment of the allocation as a long-term foreign exchange debt liability is that: (1) countries are required to pay interest to the SDR Department on the allocation they have received, and arrears arise if payments are not made, and (2) a country would be required to repay its allocation of SDRs in certain circumstances such as upon termination of its participation in the SDR Department or upon liquidation of the SDR Department.

[7] Central banks in some newer members may not even have addressed the accounting treatment of SDR liabilities because they have not yet received an SDR allocation.

including SDR holdings and allocations, would be recorded as financial assets and liabilities of the government agency. To simplify accounting and program monitoring, a typical Fund-supported program consolidates all of the member's 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.

9. **For countries with regional central banking arrangements, the treatment of the allocation and its use by members will depend on the specific legal arrangements.** This note does not cover these specific arrangements, which should be clarified by the area department concerned in consultation with relevant functional departments as warranted.

III. General Macroeconomic Implications and Policy Advice

10. **The most significant economic effect of the allocation is an increase in gross reserves corresponding to the higher SDR holdings.** The allocation involves two elements: an increase in the member's *allocation* of SDRs (liabilities) and a matching increase in its *holdings* of SDRs (assets). The distinction between the allocation (which is fixed) and the holding (which can vary) is particularly important for program design. Countries may wish to reconsider both reserve adequacy and reserve asset composition after the allocation.

11. **A central question is whether this rise in gross reserves should be retained or used, either partially or in full.** As discussed in Box 2, use of the allocation in the narrow sense of converting the SDR into other currencies is primarily a question of reserve asset composition and management, which is discussed in detail in Annex IV. This section focuses on the possible use of the allocation in the broader sense that it can free up liquidity for reducing debt or increasing absorption. The appropriate approach will vary from country to country (and program to program), according to the adequacy of reserves, the financing constraints on the program, and other factors.

Box 1. Key Legal Considerations Related to the Treatment and Use of SDR Allocations

Pursuant to the Articles, SDRs are allocated to Fund members that are participants in the SDR Department (Article XV). Regardless of the specific accounting treatment followed by members, or of the entity that acts as a member's fiscal agency, obligations and rights arising under the Articles of Agreement from members' participation in the SDR Department—including those related to the use of SDR allocations—are obligations and rights of the relevant member/SDR Department participant and not of the fiscal agency or other entity of the member.

Under Article V, Section 1, each member is to deal with the Fund only through its fiscal agent, and the Fund is to deal with the member only with or through the same agent. Accordingly, instructions from a member for the transfer of SDRs must be given by its fiscal agency (see also Rule G-2 of the Fund's Rules and Regulations).

The Articles of Agreement do not prescribe a specific accounting treatment for SDR allocations. Accordingly, members are not obliged under the Articles to follow a specific accounting framework or methodology in respect of their allocations. Members who voluntarily subscribe to specific statistical best practices would be expected to present and disseminate their data in line with the best practices to which they subscribe.

SDR allocations are a form of unconditional liquidity. SDR Department participants do not have to meet any specific requirements for the receipt of their proportional share in a general allocation. And following such allocation, they have a right to use their SDRs where they have a balance of payments need to obtain currency from members on the Fund's designation plan, and may also use their SDRs to obtain currency from other participants in transactions by agreement.

Despite the unconditional nature of an SDR allocation, there is nothing in the Articles that requires the Fund to design UFR program targets in a manner that automatically ensures the full use of all SDRs allocated to a member. Rather, a case-specific analysis may be undertaken of the extent to which the design of program targets that assume full use of a member's SDR allocation would or would not be consistent with the optimal implementation of its Fund-supported program (e.g., with optimal reserve levels and/or fiscal targets), given the member's circumstances. The relevant legal provisions in this context are not only those governing the use of SDRs, but also those governing the use of the Fund's GRA resources (which apply by extension to the use of resources in the PRGF-ESF Trust). These provisions require the Fund, in the context of a member's use of its resources, to establish conditions that will help the member to resolve its BOP problems while also ensuring adequate safeguards for the temporary use of the Fund's resources (Article V, Section 3(a)). In any case, the design of program targets so as not to automatically assume the full use of allocated SDRs does not constitute conditionality on the SDRs, but rather on the use of the Fund's resources: the member could use its SDRs and still meet these targets through other means.

While potential indirect limitations on SDR use resulting from program targets are thus not impermissible, as discussed above, it should be noted that direct limitations on SDR use (e.g., establishment of a PC on SDR use) would be more problematic. First, members have a right under the Articles to use their SDRs in specified circumstances as summarized above, and a Board UFR decision directly restricting such use would be at odds with these provisions. In addition, a condition on use of SDRs per se is unlikely to be reasonably related to the purposes for which UFR conditions are to be established under Article V, Section 3(a): ultimately, what matters in helping a member solve its problems and ensuring safeguards for the Fund is not SDR use as such, but rather the strength of the member's Fund-supported program in broad macroeconomic terms.

Box 2. Use of the SDR Allocation

What constitutes "use" of the allocation in the context of macroeconomic policies? "Use" defined narrowly is the drawdown of initial SDR holdings either for spending or to change the composition of reserves. However, since SDR holdings are part of the pool of reserve assets, it is difficult to identify their specific usage. For example, the SDR holding may be maintained, but provide a cushion that allows for selling other reserve assets to finance a larger balance of payments deficit. At a conceptual level, therefore, use in the context of macroeconomic policies can be considered in a broader sense to be the difference between actual gross reserves, and the sum of the SDR allocation and the level of reserves that would have existed without the allocation.

What is the opportunity cost of using the allocation? The opportunity cost is the missed interest income associated with the net decline in gross reserves. Given the different scenarios for usage (see above), this cost need not be linked exactly to the SDR interest rate. Nonetheless, given the nature of the SDR as a composite currency, the SDR interest rate may be seen as a useful approximation.

12. **Where a member country has a precarious reserve position, there would be a presumption of saving much or all of the increase in reserves resulting from the SDR allocation**. A justification for the one step nature of the general SDR allocation was that in the global financial crisis, many countries needed to bolster promptly their reserves, in some cases to rebuild them after recent drawdowns caused by spillovers from the crisis, and in other cases to build up a more comfortable reserve cushion to guard against a higher level of risk or vulnerabilities. Similarly, countries that aim to bring about an adjustment in the exchange rate or introduce greater exchange rate flexibility, may require an increased level of reserves. For dollarized economies where the central bank is the fiscal agent, locking in much of the increase would help bolster the limited scope to exercise lender of last resort functions.

13. **Where the level of reserves is not a concern, there is generally scope to use some or all of the additional reserves**.[8] This can be done by running down either SDR holdings or other reserve assets (from a reserve management point of view, the choice of which to do would be an asset allocation decision; see Annex IV). From a macroeconomic perspective, it is important to consider to what extent the allocation should be saved or used (in the broad sense) to reduce debt, loosen fiscal constraints, and/or provide additional liquidity to the private sector for higher absorption (e.g., through allowing higher imports). The "spend and

[8] Where reserves are already far in excess of target levels and expected to remain so, the SDR allocation may not be considered a significant enough development to warrant any adjustments to macroeconomic policies.

absorb" framework is useful to clarify the modalities for partial or full use of the allocation to stimulate the economy.[9]

14. **An important question is whether to relax fiscal constraints and pursue countercyclical policies.** The SDR allocation may allow for the possibility of a larger fiscal deficit and/or greater use of reserves for budgetary financing, especially where fiscal financing constraints are binding. This can be achieved by increasing net central bank credit (directly or indirectly) if the central bank holds the SDRs, or by direct conversion of SDRs into other currencies by the Treasury if the fiscal authority is the holder of the SDRs. The decision to relax would depend on individual country circumstances. For example, in cases where revenues are adversely affected by the global crisis, the SDR allocation can help provide the liquidity needed to let automatic stabilizers work and preserve spending levels (although program financing from official sources may be more appropriate in some cases, as discussed below). Any relaxation of fiscal policies should be set in the context of a medium-term framework to ensure that fiscal sustainability and credibility are maintained. Consideration should also be given to whether the adverse shock is *temporary or permanent*—with the latter calling for adjustment rather than financing—and to the need to promote quality spending. The SDR allocation can also support countercyclical monetary policies and help limit excessive exchange rate adjustment.

15. **The allocation can also help reduce expensive public debt or arrears**. In cases where the allocation is used to help reduce external debt, the country's net foreign asset position would remain unchanged. The authorities could also consider using the SDR allocation to reduce expensive domestic public debt or domestic arrears. In both cases, the decision should ideally be taken within the framework of an overall debt management strategy.

16. **Use of the SDR allocation, particularly in low-income countries, warrants specific considerations related to debt vulnerabilities, capacity constraints, limited access to markets, and access to more concessional financing**. Due regard should be given to debt sustainability concerns particularly in LICs given that use of the allocation is effectively charged at the variable nonconcessional SDR interest rate, which though currently

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[9] A "spend" approach to the increased fiscal space provided by the full/partial drawdown of the allocation would be reflected in higher overall budget deficits. In the case of "absorption," the central bank makes foreign exchange available for higher balance of payments financing. This allows for higher net imports by the private and/or public sector, facilitated by fiscal deficit financing or higher credit to the private sector, where the monetary impact is sterilized through the foreign exchange sale. For a review of the spending and absorption framework, see *Aid Inflows—The Role of the Fund and Operational Issues for Program Design*, with companion papers available at http://www.imf.org/external/np/sec/pn/2007/pn0783.htm. See also Berg, Andy et al, 2007, *The Macroeconomics of Scaling Up Aid: Lessons from Recent Experience*, IMF Occasional Paper No. 253.

at historical lows has averaged about 5.5 percent over the long term.[10] [11] Thus, the cost of using SDRs for balance of payments purposes should be weighed against projected debt-service capacity, and against more concessional financing that could be available from other sources.

17. **When considering the possible use of the allocation, it is important to consider its nature as liquidity support—not a transfer of wealth**. In some cases, the authorities' prior understanding may have been that the allocation is comparable to concessional donor support, or even a grant. In fact, no wealth transfer occurs, because the use of SDRs incurs an interest charge at a nonconcessional rate. However, the allocation can help overcome binding liquidity constraints that may otherwise limit the scope for stabilization policies, for example, short-term expenditure smoothing. Staff should stress to country authorities that the allocation should not be viewed as substituting for donor support or providing liquidity for specific spending projects.

18. **Staff reports should describe clearly the implications of the SDR allocation for the country concerned.** They should indicate that, in the first instance, the allocation provides additional reserve assets. In cases where reserves were already at a comfortable level, reports could mention in broad terms to what extent the allocation may have helped loosen liquidity constraints, thus facilitating a reduction in more expensive debt, countercyclical macroeconomic policies, and/or higher absorption by the private sector. If the allocation is planned to be used, missions should discuss the possible need to reconstitute SDRs over time if reconstitution requirements were to be reintroduced by the Board (see Annex II).

IV. Implications for Fund-Supported Programs

19. **The SDR allocation will generally require an update of Fund-supported programs, with a fresh look at reserve adequacy and macroeconomic policies.** The appropriate use of the SDR allocation (balancing the need for higher reserves and for smoothing of external adjustment) will be decided on a case-by-case basis, taking into account the considerations discussed in Section III. Several principles apply:

- **Different accounting methods should not lead to different macroeconomic treatment**. For example, if in one country NIR increases with the allocation but in another it does not, this should not be a reason to allow the use of the additional gross reserves in the one case but not in the other. In the same vein, the entity designated as

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[10] In this context, the allocation may be compared with an open-ended line of credit at the SDR interest rate.

[11] SDR allocations do not fall within the definition of "debt" under the Fund's *Guidelines of Performance Criteria with Respect to External Debt in Fund Arrangements*, and are therefore not subject to the external debt limits established pursuant to those Guidelines (¶ 27).

fiscal agent may differ across countries, and this should not result in different macroeconomic treatment of the allocation.

- **Similarly, countries should neither be penalized nor rewarded for having programs in place already**. The allocation should encourage a fresh look at reserve adequacy and the mix of policies in current program cases, as it would for a country coming to the Fund for a program subsequent to the allocation.

- While program targets could indirectly result in limits on the effective use of an SDR allocation (in the broad sense) if they are not set or adjusted to ensure use of the entire allocation, direct limits on SDR use would be problematic, in particular, as members have the right to convert their SDR holdings into other currencies under specified circumstances (Box 1).

20. **Access to financing under Fund arrangements will continue to be guided by established criteria, while taking into account the impact of the SDR allocation.** Access is generally determined by: (i) the member's actual or potential need for resources from the Fund; (ii) ability of the member to service its indebtedness to the Fund, including the strength of the adjustment program; and (iii) the member's outstanding use of Fund credit and its record in using Fund resources in the past. By increasing the level of gross reserves, the SDR allocation will generally tend to reduce a member's balance of payments need and may therefore have an impact on the determination of access. However, there is no presumption that the SDR allocation would in itself justify a lower level of access or early repayments under individual Fund arrangements.[12] A higher level of reserves (or increased absorption) may well be justified in the context of increased economic risks or spillovers from the global crisis or otherwise changing country circumstances.

21. **In the case of LICs, use of the SDR allocation should not be seen as a substitute for program-based concessional Fund financial support**. Given the low interest cost of Fund concessional financing[13] and the risk of a rising and volatile SDR rate, financing through one of the Fund's concessional facilities is generally less risky and costly than use of the SDR allocation. To meet new or increased balance of payments needs, larger access

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[12] In any case, the Fund cannot unilaterally reduce access under existing arrangements, nor can it call for early repurchases of GRA credit other than in very narrowly specified circumstances. There are also additional requirements for decreases in access under PRGF arrangements (and ECF arrangements, when the pending LIC reforms become effective), including that the improvement in the member's balance of payments justifying the decrease must derive in particular from improvements in the external environment.

[13] Under the new LIC facilities architecture approved by the Executive Board on July 23, 2009 (but not yet effective, pending the receipt of consents by PRGF-ESF Trust lenders and subsidy contributors), interest rates for the new Extended and Rapid Credit Facilities (ECF and RCF) have a zero interest rate, and loans under the Standby Credit Facility (SCF) a rate of 0.25 percent. In addition, the Board approved exceptional interest relief on credit under the Fund's concessional facilities for all low-income countries through end-2011.

under a concessional Fund arrangement would thus generally be more appropriate than use of the allocation by drawing down reserves. If the need is urgent, the allocation could however usefully serve as a bridge until more concessional financing is arranged.[14]

22. **Once the appropriate macroeconomic treatment of the SDR allocation has been decided (see Section III), program parameters should be adjusted accordingly, normally, at the time of the next review**.[15] In most cases, this will involve adjustment of NIR targets, though NFA and net domestic assets (NDA) are also likely to be affected where applicable.[16] Net credit to government and other fiscal performance criteria should be re-examined as well, both on the basis of the SDR allocation (which may loosen financing constraints in some cases) and other changes in economic circumstances. The necessary adjustments will need to be considered on a case-by-case basis as fiscal criteria differ widely across countries and programs.

23. **SDR allocations do not fall within the definition of "debt"** under the Fund's *Guidelines on Performance Criteria with Respect to External Debt in Fund Arrangements*. Therefore, they are not subject to program external debt limits established pursuant to those Guidelines.

V. Implications for Debt Sustainability

24. **The Board has directed the use of SDRs to be included in debt sustainability analyses (DSAs)**. While recognizing that the SDR allocation would likely have a limited impact on debt sustainability except in a small number of LICs, they nevertheless held the view that use of SDRs should be fully reflected in DSAs.

25. **External DSAs at the Fund are conducted based on a concept of gross external debt**. Thus, the empirical model underlying the LIC debt sustainability framework (DSF) establishes indicative policy-dependent thresholds for the present value (PV) of gross public and publicly-guaranteed (PPG) external debt as a ratio to exports, GDP and revenue, and gross debt service as a ratio to exports and government revenue. In middle-income countries

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[14] If part of the allocation is used as a bridge to a Fund-supported program, country teams should discuss with the authorities the use of the allocation and to what extent it is aligned with the prospective objective of the Fund's concessional financing: building reserves or relaxing external financing constraints.

[15] Existing performance criteria established at a previous program review (or approval of the arrangement) that are the basis for the next review are not automatically "adjusted" unless the existing TMU includes an explicit adjuster for the SDR allocation.

[16] See paragraph 7 for a discussion of program accounting issues. The adjustment in targets will depend both on the individual account treatment and the appropriate use (in the broad sense) of the allocation in the individual country.

(MICs) too, the literature emphasizes the importance of using gross external debt and the external debt sustainability template is based on such a concept.

26. **A country's liabilities in the SDR Department should not, however, be included in the *nominal* stock of gross external debt in DSAs**. This is because, as noted above, members are under no obligation to reconstitute their SDR holdings. In addition, country conventions regarding the recording of SDR allocations should be explicitly noted in DSA write-ups, especially where such conventions differ from their treatment in the DSA.

27. **Instead, the aim should be to capture in DSAs the net debt interest obligations that arise when SDR holdings are less than cumulative allocations.**[17] In such a circumstance, the debt service on the net difference should be included in the DSA. Although this may appear inconsistent with its accounting treatment, whereby members pay interest on their entire allocation and receive interest on their holdings of SDRs, such treatment is justified on the following grounds:

- The drawdown of members' holdings of SDRs may be viewed as being similar to a purchase from the Fund (albeit with the important difference that there is currently no obligation to reconstitute SDR holdings), which is always included in DSAs.

- Such a treatment is also similar to the drawdown of outstanding credit lines, where DSAs would be based on the utilization, rather than the size of the credit line.

28. **Specifically, the *net interest cost* associated with the drawdown of members' SDR holdings should be included in the LIC DSA.**[18] This will impact the magnitude of debt service and the PV of PPG debt, and hence, all of the debt indicators that are formally assessed under the LIC DSF.[19] However, since members are currently under no obligation to reconstitute their holdings, staff should not, at this time, incorporate any schedule of reconstitution of SDR holdings (Annex II). In MICs too, the net interest cost associated with the drawdown of SDR holdings should be included in the calculations of debt service ratios.

29. **The LIC DSA template has been updated, and the new template should be used for all forthcoming DSAs**.

- All the debt sustainability calculations associated with drawdown of SDR holdings will be built into the new template, but staff will need to input the size of the

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[17] Net interest cost here refers to interest paid on the SDR allocation net of interest received on the member's holding of SDRs.

[18] Net interest cost here refers to interest paid on the SDR allocation net of interest received on the member's holding of SDRs.

[19] The PV of the debt in question is calculated as the discounted stream of the debt service due on the debt.

drawdown, including any projected future drawdowns, and the WEO projections of the SDR interest rate.

- In the event that data provided thus far by some authorities included the drawdown of their existing SDR allocations in the nominal debt stock, this would need to be purged from historical data.

- Furthermore, as members convert to reporting their balance of payments data on the basis of *BPM6*, the interest cost associated with the entire allocation will be reflected in interest payments. To be consistent with the definition of external debt used in the DSA (see paragraph 26), interest payments should be recorded only in the case and to the extent that interest is actually paid. (Interest is not paid by the member where its holdings exceed its allocations of SDRs.)

30. **All debt service on the SDR allocation is ineligible for HIPC debt relief from the Fund**. As noted above, the SDR allocation is a liability to the SDR Department and so not debt to the Fund.

ANNEX I. OVERVIEW OF SDR-RELATED TRANSACTIONS AND OPERATIONS[20]

31. **SDRs may be used by Fund members, prescribed holders, and the Fund in accordance with the Articles of Agreement and decisions adopted by the Fund**. SDRs cannot be held by private entities or individuals. The Fund has adopted a number of decisions that authorize a broad range of operations among participants and prescribed holders, including loans, pledges, donations, swaps, and forward operations.[21] In particular, the Articles authorize the exchange of SDRs for currency among participants. The SDR is a potential claim on the freely usable currencies of Fund members; it is not a claim on the Fund. It also serves as the unit of account for the Fund and a number of international organizations.[22]

32. **The SDR Department is separate from the General Department under the Articles of Agreement**. The resources in one department cannot be used to meet the obligations of the other, except that the General Department is reimbursed for the expenses incurred in conducting the business of the SDR Department. While participation in the SDR Department is not required for Fund membership, currently all Fund members are also participants in the SDR Department. Other holders of SDRs include the General Resources Account (GRA) within the General Department and international organizations and monetary institutions prescribed by the Fund.[23]

33. **The SDR Department is self financed; its basic structure is relatively simple**: it charges interest on participants' SDR allocations at the same rate as the interest paid on their SDR holdings. The interest payments and receipts in the SDR Department cancel out overall, i.e., it is a "closed system." Interest is charged (or paid) quarterly on a net basis to participants. The Fund determines the SDR interest rate weekly based on a weighted average of representative interest rates on three-month debt in the money markets of the SDR basket currencies.

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[20] This annex and the next were prepared by the Finance Department. Questions related to transactions and operations in the SDR Department can be addressed to: sdroperations@imf.org

[21] In practice, the bulk of SDR transactions consist of spot sales/purchases of SDRs against freely usable currencies.

[22] A more detailed discussion on SDRs is in http://www.imf.org/external/np/exr/facts/sdr.HTM

[23] 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, International Development Association, Islamic Development Bank, Nordic Investment Bank, and International Fund for Agricultural Development).

34. **The SDR is used extensively in transactions and operations between Fund members and the GRA**. This plays a significant role in the circulation of SDRs:[24]

- **Inflows of SDRs into the GRA include:** (i) payments of charges owed to the GRA,* (ii) interest earned on the GRA's own SDR holdings,* (iii) reimbursement for the cost of conducting business with the SDR Department,* (iv) repurchases, and (v) the reserve asset portion (25 percent) of payments of quota increases.

- **Outflows of SDRs from the GRA include:** (i) purchases under GRA arrangements, (ii) remuneration payments on members' reserve tranche positions, (iii) repayments of loans (e.g., bilateral and under the New Arrangements to Borrow (NAB)), (iv) interest payment on outstanding loans, and (v) SDRs acquired by members to pay charges and assessments.*

35. **Certain PRGF-ESF Trust operations are conducted in SDRs**. The PRGF-ESF Trust receives part of its loan resources and contributions in SDRs. At the request of the borrowing members, the PRGF-ESF Trust may also disburse loans in SDRs. In addition, most borrowing members choose to make interest and principal payments on outstanding loans in SDRs.

36. **The Fund ensures the liquidity of SDRs in terms of freely usable currencies to underpin the status of SDRs as a reserve asset**. Participants engage in transactions to acquire SDRs in order to discharge obligations to the Fund or in order to adjust the composition of their reserve assets. The Fund also ensures liquidity between SDRs and freely usable currencies when a member or prescribed holder wishes to buy or sell SDRs. Normally, the SDR market clears on a voluntary basis through transactions by agreement. However, in the event that there are not enough voluntary buyers of SDRs, the Articles provide for a designation mechanism to guarantee the liquidity of the SDR.

- **Voluntary market** (transactions by agreement): A participant or prescribed holder may use SDRs freely, without representing a balance of payments need, to obtain an equivalent amount of currency in a transaction by agreement. Participants can conduct such transactions bilaterally with any participant or prescribed holder. However, in practice, such transactions are made through a market in SDRs coordinated by the Fund via voluntary standing arrangements to buy and sell SDRs with a group of participants and one prescribed holder. The Fund's role is to facilitate transactions by matching the interested seller/buyer with one of the counterparts to

[24] An asterisk indicates that these charges/interest must be paid in SDRs. In all other cases, the Fund generally offers SDRs as an alternative to currencies in payments it makes to, or receives from, its members; in practice, the majority of purchases, repurchases, and loan repayments tend to be made in currencies, while remuneration, interest on loans and reserve asset portion of quota payments tend to be paid in SDRs.

the two-way arrangements. Since September 1987, voluntary transactions by agreement have assured the liquidity of SDRs. Currently, the system of voluntary standing arrangements is being expanded to ensure that, to the extent possible, voluntary transactions by agreement continue to ensure the liquidity of the SDRs. (A timeline and steps involved in a typical transaction by agreement is provided in Box I.1 below.)

- **Designation mechanism** (transactions with designation): To underpin the usability and reserve asset character of the SDR, the Articles provide for a designation mechanism that ensures that a member with a balance of payments need can obtain the requisite freely usable currency without delay. Members with sufficiently strong external positions for inclusion in the Financial Transactions Plan (FTP) can be designated by the Fund to buy SDRs with freely usable currencies up to the amounts specified in the "designation plan."[25] A member is expected to use its SDRs to obtain freely usable currency under the designation mechanism only if it has a need to use its SDRs because of its balance of payments or reserves position, or developments in its reserves, and not for the sole purpose of changing the composition of its reserves. Designation plans have been adopted on a precautionary basis during the period that the voluntary market has supported SDR liquidity, but they can be activated if needed to ensure members with a BoP need can exchange SDRs for freely usable currency.

Box I.1. Timeline to Buy or Sell SDRs in a Transaction by Agreement[1]

- T – (about) 10 business days: Member notifies Fund, requesting to buy (or sell) SDRs.
- T – (about) 5–10 business days: Fund arranges trade under a voluntary agreement.
- T – 5 business days: Fund sends advance notice to SDR seller, including amount and value date.
- T – 2 business days: Fund instructs SDR buyer to pay freely usable currency to seller.
- T – 2 business days: Fund advises SDR seller of expected payment of freely usable currency from buyer.
- T: Value Date.
- T or T+1 business day: SDR seller confirms receipt of currency to Fund.
- T or T+1 business day: Fund confirms debit to SDR seller.
- T or T+1 business day: Fund confirms credit to SDR buyer.

Dates are approximate except in the case of instructions, which are always sent on day T – 2.

[1] These settlement modalities apply to the majority of the voluntary standing arrangements.

[25] Designation plans are approved by the Executive Board quarterly, currently on a *de facto* precautionary basis. Amounts are assigned to members with the aim of harmonizing "excess holdings ratios" over time, which are a member's SDR holdings net of its cumulative allocation in percent of quota. Under the Articles, each member's obligation to provide freely usable currencies under the designation plan cannot cause its SDR holdings to exceed 300 percent of its cumulative allocation.

ANNEX II. RECONSTITUTION REQUIREMENTS FOR SDR HOLDINGS

37. Reconstitution requirements for holdings of SDRs were established with the introduction of the SDR, but were abrogated in 1981. The Executive Board could, with a 70 percent majority of the total voting power, re-establish the same rules or adopt different reconstitution rules.

Main rationale

38. The original reconstitution requirement reflected the desire to ensure that the new liquidity resulting from the creation of SDRs would not be used to finance prolonged balance of payments deficits, generating a permanent transfer of real resources from countries that accumulate SDRs to countries that use them on a net basis. The concern about the size of such transfers was greater in the past because the SDR interest rate was previously set below market interest rates.

Rules of reconstitution

From 1969 to 1981

39. The first of the rules (which is no longer in effect) is that a participant in the SDR Department must maintain its average daily holdings of SDRs at not less than a specified percentage of its average net cumulative allocation over successive five-year periods ending each calendar quarter. That percentage was 30 until January 1, 1979 when it was reduced to 15, at the same time that the SDR interest rate was raised from 60 percent of the combined market interest rate (a weighted average yield of short-term money market rates) to 80 percent.

40. This rule allows a participant to use all its SDRs, but if it does so it will need eventually to reconstitute its holdings by acquiring an amount of SDRs sufficient to increase its average daily holdings to the required minimum. Countries experiencing severe shortages of foreign exchange sometimes had difficulties in complying with the reconstitution requirements, which were generally considered complex by participants. To help participants meet the reconstitution requirement, the Executive Board decided, in December 1971, that participants with a need to acquire SDRs could do so from the GRA, or from another participant, enabling them to acquire SDRs at a time of their choosing rather than by being designated to receive them, possibly at a difficult juncture.

41. The second rule for reconstitution requires participants to "pay due regard to the desirability of pursuing over time a balanced relationship between their holdings of special drawing rights and their other reserves." While this rule remains in place, the Fund has not elaborated any criteria by which observance of this rule could be tested.

After 1981

42. Reflecting the increase of the SDR interest rate to the level of the combined market rate (effective May 1, 1981), the enhanced liquidity of the SDR, including via voluntary SDR trading agreements, and the perceived complexity of the reconstitution mechanism, the reconstitution requirement under the first rule was abrogated, effective April 30, 1981.

ANNEX III. STATISTICAL CONSIDERATIONS[26]

43. The recording of the SDR allocation raises some important statistical issues that the Statistics Department (STA) intends to address as described below.

44. There are several differences between the treatment of SDRs in *BPM5* and *BPM6*. In particular, *BPM6* requires a liability to be recorded in the international investment position (IIP) for allocations of SDRs (no liability is shown under *BPM5*). Also, when new SDRs are allocated, *BPM6* requires transactions to be recorded in holdings (assets) and in allocations (liabilities); under *BPM5*, no liability (neither a transaction nor a position) was recorded, and new holdings of SDRs were generated through valuation adjustments and not transactions. Finally, under *BPM6*, interest is recorded on a gross basis for holdings and for allocations; *BPM5* is less clear, but interest probably was recorded on a net basis (that is, only the net settlement payment may have been entered as an interest receipt or as an interest payment).

45. For the SDR allocation of US$250 billion in August 2009, STA intends to record SDR holdings and allocations in the IIP, and to record transactions in the BOP, consistent with *BPM6*. That is, US$250 billion will be recorded in financial transactions for holdings and for allocations. (The special allocation occurring in September under the Fourth Amendment to the Articles of Agreement would be treated similarly.) Further, the global net IIP will decrease in the data for August 2009 by US$33 billion because STA will be entering a liability for the cumulative US$33 billion of SDRs that were allocated in prior years.

46. STA intends to revise historical transactions and positions data in 2012, when it converts its statistical publications (*International Financial Statistics* and the *Balance of Payments Statistical Yearbook*) to a *BPM6* presentational basis. At that time, it will also remove the valuation adjustment for the US$33 billion of existing allocations, and record the amount instead in transactions in the proper years. Also, interest receipts and payments will be reviewed to ensure that transactions are recorded consistent with *BPM6* guidance.

47. The *BPM6* is entirely consistent with *2008 SNA*. However, the IMF's 2000 *Monetary and Financial Statistics Manual* (*MFSM*) records allocations of SDRs in "shares and other equity." This treatment in the *MFSM* is now being reviewed. Although the *MFSM* will not be updated in the near future, monetary statistics published in *IFS* will reflect the classification of SDR allocations as liabilities to nonresidents (foreign liabilities) rather than as "shares and other equity," as is currently the case. The modalities for informing member countries of this change in classification are currently being considered. (STA will work with the member countries, to assure that data on SDR allocations are disseminated on their national websites.) In addition, the IMF's 2003 *External Debt Statistics: Guide for Compilers and Users* (*Debt Guide*) does not recommend recording liabilities (neither equity nor debt) for allocations of

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[26] Prepared by the Statistics Department.

SDRs. Although the *Debt Guide* will be updated in several years, STA is working with the World Bank and others to advance the timetable for aligning the data in the IMF/World Bank Quarterly External Debt Statistics (QEDS) database with *BPM6*. A summary of the treatment in the manuals is shown in Table II.1 below.

Table II.1. Accounting Treatment in Statistical Manuals

	BPM5 (1993)	**BPM6 (2008)**	**MFSM (2000)**	**External Debt Guide (2003)**
1. Are SDR holdings shown in positions?	Yes, as holdings of SDRs in official reserve assets.	Yes, as holdings of SDRs in official reserve assets.	Yes, as holdings of SDRs (part of “monetary gold and SDRs”) in assets.	Excludes SDRs from debt instrument assets.
2. Are SDR allocations shown in positions?	No.	Yes, as debt liabilities.	Yes, in “shares and other equity.”	Excludes SDRs from debt instrument liabilities.
3. Are transactions or “other flows” (valuation adjustments) recorded?	Valuation adjustments (not transactions) in assets (holdings) after each new allocation; no entry in liabilities.	Financial account transactions (not valuation adjustments) in assets and liabilities after each new allocation.	Flows are not applicable to the balance sheet. However, new allocations are recorded in positions in “shares and other equity” in on the liability side, and in “SDRs” on the asset side.	No.
4. On what basis is interest recorded?	Unclear, but probably recorded net.	Gross, for holdings and allocations separately.	Unclear, but probably recorded net (as a memorandum item).	Not applicable.

BPM5 refers to the fifth edition of the *Balance of Payments Manual.*
BPM6 refers to the sixth edition of the *Balance of Payments and International Investment Position Manual.*
MFSM refers to the *Monetary and Financial Statistics Manual.*
External Debt Guide refers to the *External Debt Statistics: Guide for Compilers and Users.*

ANNEX IV. IMPLICATIONS FOR RESERVES MANAGEMENT[27,28]

48. **Current practices in managing SDR holdings and allocations vary widely across member countries**. While some countries manage SDR holdings as part of their reserves (e.g., managing SDR currency exposure through the underlying currencies), several others do not take SDR holdings into account in day-to-day reserves management. When it comes to managing risk exposures arising from SDRs, some manage the SDR holdings on a "gross basis;" i.e., not taking the SDR allocation into account, whereas others manage the holdings on a "net basis;" i.e., taking a whole balance sheet view and recognizing that the allocation is an SDR-denominated liability which offsets risk exposures of the SDR holding.

49. **The US$250 billion SDR allocation, given its size, is likely to stimulate discussions among central banks on the management of SDRs as a part of reserves**. The main reason for some central banks not including SDRs in their reserve management framework is the nature and small size of their SDR holdings relative to total reserves. Member countries that joined the Fund after 1981 do not have an SDR allocation, as allocations have not been made since then.

50. **Like other reserve assets, SDR holdings expose central banks to various financial risks, which need be understood, measured, and appropriately managed**. Most of the risks only arise on a "net basis," so the management of them should also be done on that basis; i.e., taking into account both the holdings and the allocation. For the most part, the risks are very similar to those of other reserve assets, but SDR holdings also have some unique features. The most important risks—liquidity, currency, interest rate, and credit risks—are briefly discussed below.[29]

Liquidity risk

51. **As having liquidity in the case of an extreme need is considered a key feature of reserve assets, the liquidity risk in SDR holdings is minimal**. SDRs are equivalent to liquid balances in convertible currencies in nearly every respect.[30] In case a member declares

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[27] Prepared by the Monetary and Capital Markets Department.

[28] As noted above, the SDR allocation and holdings are accounted for in the central bank's balance sheet in most member countries, but in some countries these are on Ministry of Finance's balance sheet. The discussion in this section focuses on the SDR holdings that are managed in central bank's balance sheet.

[29] MCM will prepare an 'external guidance note' for members (and the public at large) on SDRs and reserves management, where these issues are discussed and analyzed in more detail with examples of how member countries are dealing with this issue.

[30] *BPM6*: 6.84.

a balance of payments (BoP) need, the *designation mechanism* provides a guarantee that members that need to use SDRs can exchange them for freely usable currencies.

52. **However, in normal circumstances (where there is no BoP need), SDRs are not as liquid as cash balances and thus are slightly more exposed to liquidity risk**. SDRs can be traded between members, in almost all cases through voluntary standing arrangements (see Annex I). This is done through the Fund's SDR Department and 14 members/prescribed holders that have volunteered to buy/sell SDR within pre-set limits on overall amounts and individual transactions. In advance of the allocation, it is expected that the number and size of the voluntary arrangements will be expanded substantially, thereby increasing the liquidity of SDRs, but there may still be some practical limitations on dealing large volumes in a short period.

Foreign currency risk

53. **The new SDR allocation *per se* does not change the foreign currency risk of foreign reserves as it comes with an equivalent holding**. This follows from the basic Asset and Liability Management (ALM) principle that when assets' exposures (holding) are exactly matched with liabilities' (allocation) exposures, the net exposure is zero.

54. **Foreign currency exposure of a net SDR holding is typically smaller than for an individual currency owing to the diversification benefits of a basket of currencies**. Nevertheless, a net SDR position is subject to currency risk given that the value of the SDR is based on the market exchange rates of the four currencies included in the SDR basket.

55. **If, however, SDR holdings are treated on a "gross basis," the new allocation is likely to lead reserve managers to adjust their positions**. Reserve managers typically manage currency risk by maintaining the currency composition of reserves close to their currency benchmark, or by hedging most or all currency risk vis-à-vis their currency numéraire. A new SDR holding on a "gross basis" will alter the currency composition of reserves and create a currency "exposure" against the benchmark or the hedged position. If this "exposure" were more than a pre-determined threshold, a reserve manager would transact in the underlying currencies to return to the benchmark or to the hedged position. But these transactions would open a foreign exchange exposure because, from the whole balance sheet perspective, the "exposure" did not initially exist. Therefore, hedging activities should be limited to the net open position.

Interest rate risk

56. **The new SDR allocation *per se* will not affect the interest rate risk of the foreign reserves portfolio**. SDR interest is effectively earned or paid only on the net SDR position (allocations minus holdings), so interest rate risk exposure only arises on a "net basis."

57. **For a net SDR position, duration risk is negligible**. The SDR interest rate is determined weekly using a weighted average of representative interest rates on three-month debt in the money markets of the four SDR basket currencies. This means that a net SDR position effectively is a floating rate deposit with weekly resets, making the most commonly used interest rate risk measure—duration—to be one week. As for currency risk, the diversification of the SDR basket makes the risk even smaller compared with just a single currency's interest rate risk.

58. **However, as with other short duration assets or liabilities, the "re-investment" or "re-financing" risk can be significant**. Hence, an increase in interest rates could adversely impact those with negative net SDR positions (see paragraph 19), particularly LICs, and reserve managers need to consider overall asset and liability management practices to offset these risks. In addition, the overall duration of the portfolio would need to be set consistently with the overall objectives for reserve management.

Credit risk

59. **A positive net holding of SDRs might be viewed as a credit risk exposure to the other participants of the SDR Department**. However, these exposures are usually excluded from the credit risk management framework. The SDR Department is not an entity with actual obligations to a participant; rather, participants ultimately have claims on other participants in the Department. In any event, these potential exposures are typically larger than would be allowed for any other single entity, and a risk manager cannot actively manage them as they result directly from participation in the SDR Department.