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To Protect American Taxpayers, the U.S. Must Block Massive Expansion of International Monetary Fund's Special Drawing Rights

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KEY TAKEAWAYS

Since its founding after World War II, the International Monetary Fund has been a valuable global backstop that has helped the American and world economies.

Expanding the IMF's morally hazardous, unconditional SDRs would be a back door to a huge increase in U.S. foreign aid beyond the control of American taxpayers.

The Trump Administration should continue to exercise the U.S. veto power at the IMF to block implementation of harmful SDR expansion proposals.

There is a proposal circulating in Washington, under the pretext of aiding developing countries affected by the pandemic, to increase the amount of Special Drawing Rights (SDRs) to be available at the International Monetary Fund (IMF) by up to 2 trillion SDRs (about $2.8 trillion). It is being promoted by politicians and think tanks on the left, the foreign aid community, George Soros,[1] and the Chinese Communist Party, among others. The concept of a vast expansion of SDRs was discussed at the IMF's spring 2020 meeting of the International Monetary and Financial Committee.[2]

If approved, it could be as much as a 10-fold increase of SDRs at the IMF over the current level of SDR 204 billion[3] (currently valued at about $288 billion[4])—and would amount to money printing on a global level. The U.S. allocations of SDRs (currently valued at about $55 billion[5]) would also rise exponentially, and the United

States Treasury, as the IMF's principal "designated participant," could be forced to fund additional foreign exchange transactions of $1.5 trillion.[6] The annual cost to American taxpayers to fund just the associated interest-rate and credit-risk subsidies of that massive additional amount could run into the tens of billions of dollars annually.

The IMF itself maintains that its internal SDR transactions are essentially cost-free to American taxpayers and even earn interest for the U.S. government,[7] but that assertion is misleading. SDRs provide a way for developing countries to borrow hard currency through what amount to permanent loans at subsidized interest rates. The funding of those allocations and the related subsidies are paid by the issuers of the hard currency, most often the United States.

The Brookings Institution,[8] the Petersen Institute,[9] and the proposals' other proponents say the SDR expansion will increase the liquidity that developing countries need to rebuild their economies post-COVID. They do not, however, explain the precise mechanics of the SDR process. To do so would reveal the fact that SDRs are not, in fact, cost-free. Neither are they ever paid back by many developing-nation borrowers.

It is true that SDR transactions, which amount in practice to long-term loans made by the United States at short-term rates, do generate some interest income from the IMF. Ignored by the advocates, however, is the interest cost to the U.S. Treasury of obtaining the dollars that are exchanged for the SDRs. That interest-rate spread can add up to billions of dollars, ultimately a cost to U.S. taxpayers.

Since its founding after World War II, the IMF has been a valuable global backstop that has helped the American and world economies. Its regular lending programs, which require recipients to enact structural reforms, have contributed to improved economic governance around the world. SDRs, however, are essentially long-term loans without any conditionality.

At the spring 2020 meeting of the IMF, at which the United States holds the only veto, the Trump Administration blocked adoption of the SDR proposal. That decision by the Administration was correct. This *Backgrounder* explains why, and recommends that the Administration hold fast to its decision.

What Are SDRs?

The fight over the appropriate role of the International Monetary Fund goes all the way back to the creation of the IMF at the Bretton Woods Conference in 1944. The U.S., interested in promoting global trade, focused on creating an organization, the IMF, to stabilize and manage exchange rate fluctuations. The liberal/progressive view from Europe, pushed by John Maynard Keynes and others, envisioned a more expansive global financial organization. Many of their ideas were incorporated into what became the World Bank.

By the late 1960s, both parts of the system were showing strains. Developing countries were beginning to struggle under the burden of excessive debt, and many of the lending projects of the World Bank have failed to produce the hoped-for results. On the monetary front, the adherence by the U.S., U.K., and other developed countries to the Gold Standard reinstituted at Bretton Woods was breaking down. To maintain that system, the U.S. was required to run annual current account deficits in order to guarantee that enough dollars would be available to other countries to settle their international transactions. To address that problem, the IMF created Special Drawing Rights (SDRs) in 1969.

As economist John Williamson explains, SDRs were intended to be a "synthetic reserve asset to supplement the supply of gold."[10] After a run on U.S. physical gold reserves in 1971, however, the Nixon Administration abandoned the gold standard, thereby eliminating the rationale for SDRs. Yet they remained on the books at the IMF, in the new world of floating exchange rates. As Jacques J. Polak and Peter B. Clark have written, "the original reasons for the adoption of the SDR mechanism at the end of the 1960s" were invalidated by the "radical changes in the international monetary system since then."[11]

Currently, SDR 204 billion (roughly equivalent to US$288 billion in 2020) have been allocated to members, including a boost of SDR 182.6 billion in 2009 in the wake of the global financial crisis. At present, the value of the SDR is calculated using a basket of five currencies—the U.S. dollar, the euro, the Chinese renminbi (RMB), the Japanese yen, and the British pound sterling.

Who Is Behind the 2 Trillion SDR Proposal, and Why?

Over the years, most developed countries have used their SDR allocations as intended, holding them as additional reserves to be employed in time of unusual economic stress or crisis. Many developing countries, by contrast, have cashed in their SDRs in exchange for dollars or other hard currencies and have spent those funds for a variety of purposes, including current consumption. Given the relatively low cost of these SDR loans, developing countries and their developed-country foreign aid boosters have been pressing for more SDRs for many years, correctly seeing them as a backdoor to redistribute wealth from rich IMF members to poorer ones. The COVID crisis has given such proponents a new opportunity to exploit.

The foreign aid argument was substantially weakened, however, by the writing and research of former Carnegie Mellon professor of finance Adam Lerrick, who currently serves as a Counselor to Treasury Secretary Steven Mnuchin. Writing in 2004, Lerrick laid out the uncomfortable (and still valid) truth about SDRs functioning as foreign aid:

> Foreign aid is a worthy cause but only if it results in worthy outcomes.... [T]he 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. Aid without determined purpose. Aid without conditions. Aid without oversight. In addition, very likely, aid without results.[12]

China is also pushing hard for the SDR expansion. There are a number of reasons why the ruling Chinese Communist Party wants the increase. The most obvious motive, at the moment, is General-Secretary Xi Jinping's desire to burnish China's image as a world power on par with the United States. In that quest, Xi won a major victory when the IMF added the Chinese renminbi to the SDR basket of world reserve currencies in 2016.[13]

That was done by the IMF in spite of the fact that the Chinese currency is not fully convertible. Convertibility is central to the definition of a global reserve currency. Xi wants the renminbi to be perceived as fully convertible due to its presence in the IMF basket, while retaining his government's power to manipulate the Chinese currency. For evidence of that lack of convertibility, one need look no further than the IMF itself. Its "SDRs per Currency unit and Currency units per SDR" page (updated daily) does not show any value at all for the Chinese yuan (renminbi).[14] That is because the RMB cannot be traded on global currency exchanges.

China's SDR campaign is also likely part of the far-reaching Chinese strategy to weaken America's global hegemony, including, perhaps, by undermining the status of the U.S. dollar as the world's most widely held reserve currency, possibly with the eventual goal of having the dollar replaced by the SDR.

One tangible sign of China's push to replace the dollar with the SDR is evidenced by the IMF's rather spurious creation of different classes of SDRs. In 2016 (when the RMB was added to the IMF basket), the IMF began referring to three types of SDR. The original SDR, known as the O-SDR ("O" for official), is used for transactions between IMF member countries. The U-SDR is the currency in units of SDRs (and vice versa). The last, mostly theoretical, is the M-SDR ("M" for market). Currently, the only significant user of M-SDRs is one of its chief proponents, China.[15] China has created the false illusion of international convertibility using RMB in a series of carefully crafted trade transactions.

As noted by Professor José Antonio Ocampo, the IMF itself has a stated goal (in Article VIII, Section 7, as well as Article XXII) of the Articles of Agreement of the International Monetary Fund to make "the special drawing right the principle reserve asset in the international monetary system.[16]

Some observers have also wondered if the proposed 2 trillion SDR expansion is a step toward sidelining the Federal Reserve and making the IMF the one and only global central bank in a fully financially integrated world. Many on the left would like to see that, not just the Chinese.

How Much Would 2 Trillion SDRs Cost U.S. Taxpayers?

Some proponents of SDR expansion make the claim that the SDR constitutes the only truly "global money."[17] It is not, however. SDRs cannot be exchanged by ordinary citizens and companies to pay for goods, services, or anything. They are primarily a bookkeeping mechanism within the IMF. Only when the SDRs are cashed in for worldwide convertible U.S. dollars by IMF member countries, as they almost always are, do those goods and services transactions (and debt payments) become possible.

Moreover, the "freely usable" dollars that the IMF assumes will always be available are, in reality, not just floating around in the SDR Department at the IMF waiting for an SDR transaction. In fact, they are disbursed by the U.S. Treasury Department for the SDR transaction after being raised through issuance of new U.S. Treasury bonds. In other words, their disbursement incurs greater debt for Americans to pay off via higher taxes.

An expansion of 2 trillion SDRs would be approximately a 10-fold increase of SDRs at the IMF over the current level of SDR 204 billion,[18] and would amount to money printing on a global scale. Transactions involving the new, exponentially higher U.S. contribution to SDRs would likely have to be financed by Treasury via massive issuance of new debt.

In addition, by law, Treasury must fund SDR-associated interest-rate subsidies and credit-risk subsidies annually. In 2004,[19] Professor Adam Lerrick calculated the cost to American taxpayers of an earlier proposed overall increase to SDR 42.9 billion.[20] The projected annual cost of that proposal to taxpayers (to fund the required interest-rate subsidies and credit-risk subsidies) was estimated to be about $750 million per year. Extrapolating those 2004 figures to an SDR 2 trillion level increase in 2020 would imply an annual cost to taxpayers of several tens of billions of dollars.[21]

Would SDRs Incentivize Developing-Country Growth?

The IMF was created to enhance stable, private-sector-led global economic growth through trade and investment—and the biggest group to benefit from that growth has been the world's poor. Too often, however, Keynesian economists at the IMF have bailed out international debts run up by vote-buying politicians in developing-country governments.

When the bill is presented for the inevitable "mornings after" their spending binges, in the form of a new financial crisis to clean up after the failure of the debt-financed, vote-buying programs, the IMF has too often stepped in with a new, morally hazardous bailout—without having first demanded sufficient recipient-country accountability for the prior bailout. The biggest losers from these cycles of financial crises and IMF bailout are the poor.

Expanding the IMF's lending resources by 2 trillion SDR is a backdoor way to do more of that morally hazardous, perpetual, and unconditional lending, and to expand vastly foreign aid to countries, with American taxpayers footing the bill for SDR loans to countries with no strings—loans that in all likelihood will never be repaid. Since IMF member countries have the right to convert their SDRs into dollars without any conditionality, no political reforms can be required, even of countries sometimes ruled by oppressive and/or corrupt regimes.

Indeed, the Report of the International Financial Institution Advisory Commission (known as the Meltzer Commission Report),[22] called for a more limited IMF. The commission, whose members included Heritage Foundation Founder Dr. Ed Feulner, recommended that the IMF stop all long-term lending and focus only on maintaining short-term liquidity for emerging economies. The IMF should not be in the business of protracted bailouts, which is exactly what the SDR expansion would resemble.

Writing a few years ago on a related issue, Harvard economics professor Greg Mankiw called the IMF's faith that some forms of "expansionary" government spending (such as on infrastructure) will spur growth of the "free-lunch view." It might be "theoretically possible," says Mankiw, but he was skeptical "about how often it will occur in practice."[23]

Instead of an unwise and ill-considered decision to substitute SDRs in the place of regular IMF lending with the usual conditions requiring structural reforms, the IMF should heed the advice of Treasury Secretary

Mnuchin. At the spring 2020 IMF meeting,[24] when Mnuchin announced the U.S. rejection of a proposed SDR expansion, he noted in a press release that SDR allocations are not the right policy tool to respond to crises. "Almost 70 percent of an allocation would be provided to [the member countries of the Group of 20 (G20)], most of which do not need, and would not use additional SDRs to respond to the crisis…[while] all low-income countries, including those facing urgent balance of payments needs, would receive just three percent of any allocation."[25]

The Many Downside Risks of Massively Expanded SDRs

The SDR Department at the IMF remains a little-understood financing system that was designed to plug short-term gaps under the gold standard. Although it is no longer fit for that purpose, it has been converted into a wealth redistribution system that forces 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."[26]

As Dr. Lerrick said in 2004,[27] encashed SDRs force the United States to borrow the money and then to finance what are, in practice, long-term loans (equal to an increase in the U.S. permanent contribution to the IMF) while charging only short term-rates. "The difference between the rates is the interest cost [and subsidy cost] to the U.S. government of providing resources to the SDR Department."

SDR expansion could also benefit IMF member countries that are hostile to the United States (e.g., Iran, Turkmenistan, Zimbabwe, the People's Republic of China, and Venezuela). Overall, Secretary Mnuchin fears that the policy, if adopted, could turn a short-term (pandemic) health crisis into a long-term financial crisis.

From a practical standpoint, the absorptive capacity of developing countries of a sudden windfall of new SDRs would likely be very limited. As some have observed, this SDR plan appears to be just a version of so-called "Modern Monetary Theory" in which the Left argues the proposition that the government can print money with abandon without any negative consequences: a free lunch.

Recommendations for the Administration and Congress

The Trump Administration should continue to exercise the veto power of the United States at the IMF to block implementation of harmful SDR expansion proposals.

- **The Administration's Office of Management and Budget should work with the Treasury Department to move the annual subsidy costs to American taxpayers of the existing level of SDRs from off-budget to on-budget.**

- **Congress should pass legislation to facilitate the move of SDRs onto the annual budget and pass a joint resolution expressing opposition to the expansion of SDRs by up to 2 trillion.** The resolution should include the same recommendations included in Secretary Mnuchin's announcement of the U.S. rejection at the spring 2020 IMF meeting—that there are better and more targeted funding vehicles to help developing countries' economic recovery from the pandemic.

- **IMF member states could enhance IMF support to low-income countries by providing grants to the Catastrophe Containment and Relief Trust (CCRT) and through other grants and loans.** Secretary Mnuchin correctly stated as much. This is a better, more targeted approach than expanding SDRs. Advanced economies could also explore using their existing SDRs to support low-income countries.

Conclusion

Just as courageous American conservatives would have demanded in 1944 when the IMF was established, the heirs of their philosophical tradition in the Administration and Congress today should tell the IMF to drop the request for a massive expansion of SDRs. The IMF should use its ample existing lending resources to plug short-term liquidity gaps, stop all long-term lending, and focus on giving better policy advice to get its member countries back on the path to greater economic freedom.

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Endnotes

1. "Soros's suggested method provides aid that will "enable, encourage, and reinforce" voluntary compliance with international standards relating to environment, education, and labor. His proposal? The richer countries in the IMF issue Special Drawing Rights (SDRs) for international assistance—i.e., international reserve assets—a process that shares the burden equitably, with the United States paying its fair share. A board of "eminent persons" chooses who's eligible for assistance, and a separate audit commission evaluates those chosen." George Soros, "On Globalization," *Publishers Weekly*, March 18, 2002, https://www.publishersweekly.com/978-1-58648-125-4 (accessed October 1, 2020).
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19. Lerrick, "Opening A Back Door to Foreign Aid: The SDR Department at the IMF," p. 6.
20. Graham Hacche et al., eds., *Annual Report: 2005*, International Monetary Fund, p. 66, https://www.elibrary.imf.org/doc/IMF011/00323-9781589064263/00323-9781589064263/Other_formats/So sheeturce_PDF/00323-9781451923759.pdf (accessed October 1, 2020).
21. To make a precise calculation, the total annual cost to the Treasury Department of the combined interest-rate subsidy and the credit-risk subsidy at the current total IMF level of SDR 204.2 billion would have to be extrapolated up to the amount of the proposed expansion. At SDR 2 trillion, it is certain that the figure would be *tens* of billions of dollars—annually.
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