Using Special Drawing Rights for Climate Finance

A Discussion Paper

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Introduction

Climate change represents a significant obstacle to ending poverty and one of the gravest equity challenges of our time. While the richest countries in the world have been responsible for a disproportionate amount of global carbon emissions which cause global warming, it is the poorest countries in the world that are hit first and worst by climate change.

Climate change has already had disastrous effects on the world's poorest communities. Extreme weather events, sea-level rise, drought, disruption of water and food supplies, and negative impacts on health threaten existing poverty alleviation strategies and mean that more people must further struggle to make ends meet.

In order to help developing countries adapt to the impacts of climate change, developed countries will need to contribute *at least* U.S. $100 billion in public finance per year.[1] Because adaptation finance should be understood as compensation for damages done by rich countries (rather than as aid), climate finance must be provided in the form of grants. It should not be tied to any economic policy conditionality, and must be additional to existing Official Developed Assistance targets.

However, supporting developing countries to adapt to the impacts of climate change is only one part of the climate solution. Developed countries also need to substantially cut their own greenhouse gas emissions and transfer significant sums – similarly estimated at roughly U.S. $100 billion in public resources per year -- to help developing countries to lower their emissions and transition to clean-energy economies.[2]

Developed countries will need to agree to a combination of mechanisms to generate the resources needed for adaptation and mitigation. Such mechanisms could include a financial

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[1] For more information, see "Rich Countries' Climate Debt and How They Can Repay It." An ActionAid Rough Guide. December 2009.

[2] European Commission staff working document accompanying Communication 'Towards a comprehensive climate change agreement in Copenhagen' part 1, 'costs associated with the resulting actions in the energy system and the industrial sectors', http://ec.europa.eu/environment/climat/pdf/future_action/part1.pdf

transaction tax, the redirection of fossil-fuel subsidies in developed countries, and new levies in the aviation and shipping industries.

At the December 2009 climate change conference in Copenhagen, philanthropist George Soros helped draw attention to another means to generate resources for climate change: the use of Special Drawing Rights (SDRs), which are "reserve assets" created by the International Monetary Fund (IMF). Soros suggested that an immediate infusion of SDRs could create a U.S. $100 billion "fast-start green fund" for climate finance that could be part of the answer to developing countries' adaptation and mitigation needs.[3]

At the World Economic Forum in January 2010, IMF Managing Director Dominique Strauss-Kahn echoed Soros's words, marking the first time the IMF has favorably acknowledged the possibility of using SDRs as a finance instrument. Strauss-Kahn was vague in his proposals and said the IMF will issue a paper sometime soon to elaborate. Though Strauss-Kahn seemed to suggest that the IMF could control the "fast-start green fund," it seems unlikely that an institution with no climate credentials would be entrusted with that role.

Strauss-Kahn's speech does open up space for serious, practical consideration of how SDRs could be used for climate finance. In this brief, ActionAid explores how SDRs can be used to contribute to the adaptation and mitigation needs of developing countries. The brief examines what special drawing rights are and how they have recently been used. It then puts forward a proposal for how SDRs could be used for climate finance, and discusses some broader implications of using SDRs for the global economy.

What are Special Drawing Rights?

SDRs are "reserve assets," sometimes thought of as a special currency, issued by the IMF and allocated to IMF member countries. The value of SDRs is derived from a mix of four major currencies, the U.S. dollar, the euro, the Japanese yen, and the U.K. pound sterling. They were devised in 1969, amidst a shortage of both dollars and gold, but they have been used more recently in response to the global financial and economic crisis that struck in 2008.

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[3] George Soros, "Using SDRs to Fight Climate Change," speech at Copenhagen climate conference. December 2009.

A government can use SDRs in two ways. It can use them to build up reserves at its central bank (since increasing reserves provides an instant credit boost and usually means that a country can borrow more and on better terms), or it can convert its SDRs into hard currency.

When a government converts its SDRs into hard currency, it is required to pay a small interest charge, applicable until that government replenishes its SDRs.[4] Currently, with interest rates lowered in response to the financial crisis, the interest rate for SDRs is less than 0.5 percent. It is important to note that there is no fixed price for interest rates on SDRs, which will likely rise along with other interest rates as the global economy recovers.

Once a government converts its SDRs into hard currency, it can use the funds for whatever purpose it chooses. The IMF cannot impose any conditions and it has no voice in how countries use their SDR-derived funds. It is important to note that while the IMF Board can agree to issue any amount of SDRs, an allocation of over U.S. $250 billion would likely require U.S. congressional approval, which would substantially delay the process.

Recent Use of SDRs

In April 2009, in response to the global financial and economic crisis, the G20 called for the first allocation of SDRs in 28 years. In less than five months, the IMF made a general allocation of SDRs worth approximately U.S. $250 billion.

Because the IMF distributes SDRs in proportion to its members' IMF quotas (which are determined by a formula gauging a country's relative weight in the global economy), wealthy countries received approximately two-thirds of the SDRs -- in this case approximately U.S. $165 billion. However, because developed country governments can raise funds on world markets at approximately the same cost as the SDR interest charge, they have seldom, if ever, converted their SDRs into hard currency for their own use.

[4] Replenishing SDRs, also referred to as repurchasing SDRs, occurs when a government restores the principle from its SDRs so that it is left with the SDRs as a reserve instrument. This happens by the IMF facilitating a process in which a government uses hard currency to re-purchase SDRs from an SDR-surplus country.

Using SDRs for Climate Finance

An immediate infusion of resources can happen if developed countries decide to convert their own idle SDRs into cash – up to U.S. $165 billion from the 2009 allocation. This funding can then be transferred to a United Nations Framework Convention on Climate Change (UNFCCC) fund or mechanism. Various options are described below for how the interest on those SDRs could be paid. However, while an immediate infusion of resources for climate adaptation and mitigation is needed, predictable and sustainable climate finance is essential. Therefore, developed country governments must also agree to support ongoing and regular allocations of SDRs for climate finance.

For regular allocations of SDRs, both developed and developing countries could convert their SDR allocation into cash to be transferred to a UNFCCC fund.[5] The fund would then make grants to developing countries for climate adaptation and mitigation, based on the rules established by its governing body. A key issue to be resolved relates to the interest charge which governments incur when they convert SDRs into hard currency. When SDRs are used for climate finance -- particularly for adaptation –developing country governments should not bear any of the costs involved, according to the "polluter pays" principle. Adaptation finance is a form of compensation for the measures developing countries are forced to take in the face of climate change they did not create. Therefore, all adaptation finance must be in the form of grants from developed countries.

There are various alternatives for covering the interest charge for SDRs, including:

1. Selling all or part of the IMF's enormous gold stocks (approximately 100 million ounces), which would likely cover several years of interest payments. (This option would require approval of the US Congress, among others.)
2. Requiring developed countries – those countries historically responsible for creating the climate crisis – to pay the interest charges. This could be seen as a contribution towards the climate debt that developed countries owe to countries in the global south.

[5] For more details on ActionAid's proposal for a new UNFCCC Fund, please see *Equitable Adaptation Finance: The Case for an Enhanced Funding Mechanism Under the UN Framework Convention on Climate Change* by ActionAid.

3. Action by the IMF Board of Governors to "cancel" all SDRs which have been converted to hard currency for adaptation and mitigation purposes. Under this scenario, developing countries would not need to pay interest on or replenish their SDRs. This cancelation could be framed as a specific response to the global threat of climate change, and need not be seen as a precedent for the general use of SDRs.

The IMF Executive Board would eventually have to agree to use regular allocations of SDRs for climate finance and to transfer these resources to a UNFCCC fund. However, the first place of agreement on using SDRs for climate change should be through the UNFCCC, where all negotiations on climate change should take place.[6] The G20 could help advance this process by supporting this non-traditional use of SDRs.

Possible Risks

In the wake of the climate crisis, the potential use of SDRs to generate financing for adaptation and mitigation is very compelling. Still, however, it is important to note the risks that may come along with using SDRs for financing climate change.

One risk is giving the IMF – an institution with an undemocratic governance structure and a history of attaching very harmful conditions to its loans – any role at all in climate finance. However, it is important to note that in the scenarios outlined in this paper, it is not the IMF, but the governing body of a UNFCCC fund, which controls the disbursement of SDRs. Furthermore, the IMF has no hand in how SDRs get used and the IMF cannot attach any conditions to the SDRs. The only role the IMF has is to actually create the SDRs.

Another possible risk is that developed country governments could use SDRs as a way to get out of paying their full climate debt. This is because, depending on how repurchases and interest payments are handled, SDRs could generate significant sums of money without necessarily burdening the Treasuries of developed countries. In the face of this risk, it is incumbent on the climate justice community to insist that SDRs are one of the options to

[6] Reaching political agreement on SDRs for climate finance may be difficult for many reasons, including: 1) many wealthy governments maintain that SDRs should only be used for augmenting reserves; and 2) there may be objections that injections of cash into the global economy will lead to inflation (though this could be true of any solution to the climate finance gap). It is also important to note that the US holds veto power on the IMF board and would therefore need to be in agreement with dedicating SDRs to climate finance.

generate climate finance. However, in order to meet developing countries' staggering adaptation and mitigation needs, and to ensure that developed countries live up to their responsibility for providing public finance to developing countries for climate change, a combination of innovative mechanisms to generate climate finance is needed.

Broader Implications for Use of SDRs for Climate Finance[7]

Beyond providing substantial sums of money to developing countries for adaptation and mitigation needs, the use of SDRs as a vehicle for climate finance could make a significant contribution to the reform of the global economy. The recent global financial crisis has exposed the urgent need for a more equitable financial system for both developing and developed countries.

Reliance on the dollar to perform double duty as both the U.S. currency and as the main global reserve currency was a major factor exacerbating the global financial and economic crisis. The US has incurred a vast trade deficit by importing more goods than it exports. This large and growing trade deficit signals to developing countries that the US will eventually need to correct this imbalance by decreasing its imports and increasing its exports by lowering the value of the dollar so that it can sell its goods more cheaply on international markets.

This inevitable devaluation of the US dollar will cause the value of developing countries' foreign reserves to fall, weakening their domestic currencies and precipitating balance of payments crises. As has been demonstrated in previous episodes, such crises would have devastating impacts on poor countries.

Beyond the excessive trade surpluses (China) and deficits (U.S.) that characterize our global economy, many economists have pointed out that reliance on the US dollar as a global reserve

[7] For more information, see, "Fruits of the Crisis: Leveraging the Financial and Economic Crisis of 2008-2009 to Secure New Resources for Development and Reform the Global Reserve System." Soren Ambrose and Bhumika Muchhala. January 2010. http://www.actionaid.org/docs/sdr_reserve_final.pdf

currency dooms any potential reforms meant to avert future economic crises.[8] They are now concluding that monetary reform, with a *neutral* global reserve currency as its centerpiece, is the best solution. The SDR is by far the most widely-cited candidate to serve as that global reserve currency.

In addition to shielding developing countries from the impacts of the inevitable fall in the value of the U.S. dollar, SDRs have another potential benefit. During financial crisis, developing countries face the threat that foreign investors will flee. To help prevent capital flight, developing countries, particularly China and other countries in Asia, have recently begun to build up substantial dollar stockpiles. These reserve funds help protect the value of a country's national currency when it uses its surplus reserves to buy its own currency on the global market, thereby protecting the value of foreign investment and discouraging capital flight.

There are significant implications for maintaining huge dollar reserves in foreign central banks. First, fewer dollars are in circulation to meet pressing needs like funding climate adaptation. Additionally, because countries generally obtain their surplus by buying bonds from the U.S. Treasury, stockpiled reserves also represent low-interest loans by developing countries to the world's dominant economy, the United States. If SDRs replace the dollar as the global reserve currency, a reformed system could prevent such an inequitable transfer of wealth from developing to developed countries. Moreover, because the amount of SDRs issued could be controlled, and because rules and incentives could be created to keep countries from running large surpluses or deficits (such as making a certain amount of SDRs invalid if kept over a long period of time), it would be more difficult for countries to amass such significant amounts of reserves.[9]

Using SDRs as a vehicle for climate finance would help legitimize their use in the global economy. The very use of SDRs for climate finance would put more SDRs into circulation and broaden awareness of their value among global financial officials. Should the G20 and the IMF

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[8] See, for example, "Policy Response to the Global Financial Crisis: Key Issues for Developing Countries" by Yilmaz Akyüz (May 2009) , "Special Drawing Rights and the Reform of the Global Reserve System," by José Antonio Ocampo (September 2009), and "Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System" (September 2009).
[9] "Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System" (September 2009).

change the rules so that a UNFCCC fund could actually hold and control SDRs (currently only governments can hold SDRs), the case for the SDR as an international unit of exchange and reserve currency would be strengthened. This should contribute significantly to the advance of reforms required to make the global economy work more efficiently and fairly.

Conclusion

Using SDRs for climate finance could be a way to help address the urgent need for the transfer of resources from north to south to address the climate crisis while having co-benefits for the global economy. SDRs should be thought of as part of the puzzle. In order to meet developing countries' adaptation and mitigation needs, a combination of innovative mechanisms is needed. Such mechanisms may include the use of current fossil-fuel subsidies for climate finance, creation of a financial transaction tax, and application of levies in the aviation and shipping industries.

However, using SDRs for climate finance may involve risks. As discussed above, giving any role at all to the IMF in climate finance may not be an acceptable option to some stakeholders. Additionally, developed country governments could try to use SDRs as a way to get out of paying their full climate debt.

Even with these potential risks, the many potential benefits of SDRs make them an option which must not be ignored. Given the current levels of attention from policymakers and the media to the potential for SDRs as a solution to climate finance, developing countries and the climate justice movement must deepen their understanding and debate on this complex topic.

In the next couple of weeks the IMF will be issuing a paper on "out-of-the-box ideas" to generate revenue for climate change, including the use of SDRs. Developing countries and the climate justice movement must be ready to respond to the IMF's proposal and ideally come to agreement on whether and how to firmly place SDRs in the debate at the next round of UNFCCC negotiations. This brief aims to promote a deeper understanding and discussion on this complex topic.

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