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The Case Against the IMF as a Lender of Final Resort

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This paper makes the case against the International Monetary Fund acting as a lender of final resort. We think that on balance the evidence of the past half decade supports those who were cautious about the benefits of large-scale IMF programs. In only a few cases have those IMF packages quickly led to a resumption of private capital flows of a sufficient scale to repay the Fund on time, and even in those cases repayment occurred only after more sustained outflows than originally anticipated. Looking backward, we believe there has been an overreliance on Fund cash to resolve crises. Looking forward, we believe that a richer set of crisis resolution tools should be developed and that the IMF's exceptional access framework (EAF) should be strengthened. The objective should be to establish a credible and time-consistent constrained discretion framework that clearly delimits the circumstances in which large-scale Fund assistance will be provided.

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Compromise or Compromised?

The debate about crisis resolution strategies has focused on two interrelated issues: the role of IMF financial assistance and the appropriate degree of private-sector involvement. It is not surprising, given the nature of the crises during the 1990s, that much of the early debate focused on the resolution of liquidity crises that result, at least in part, from creditor coordination problems. Prominent policymakers in the late 1990s, including Lawrence Summers when he was the US treasury secretary, emphasized the potential role of exceptional financial assistance from the IMF to provide a bridge to and from private-sector lending for countries experiencing systemic capital account crises (Summers 1999). Stanley Fischer famously argued that the IMF should act as an international lender of last resort (LLR) for the international financial system (Fischer 1999). These positions were clearly influenced by the perceived success of the crisis management operations in Mexico in 1995 and in Korea in 1997–98.

But not everyone agreed that very large lending was appropriate. Several commentators, including Kenneth Rogoff (1999), highlighted the moral hazard risks associated with LLR operations. The Meltzer Commission argued that Fund lending should be provided only to countries that met strict prequalification criteria. Within the official sector the Bank of England and the Bank of Canada jointly argued that presumptive access limits on IMF lending should be respected and that standstills should be used to resolve payment difficulties in crises where limited Fund cash would be insufficient to address the problem (Haldane and Kruger 2001). More generally, Andrew Haldane and Mark Kruger argued that the decision-making processes surrounding IMF lending decisions were underspecified and that a "constrained discretion" framework should be devised to provide clarity about the potential scale and availability of IMF financing.

The EAF that emerged in 2003 can be interpreted as a compromise. This moved the Fund toward such a constrained discretion framework by identifying criteria that must normally be satisfied before the Fund can make exceptional loans and by stipulating processes that ensure earlier and more intensive Executive Board involvement before loans are granted. This, though, also institutionalized the idea that the Fund could sometimes breach its access limits, albeit in seemingly restrictive circumstances. To reconcile many different perspectives, the framework is couched in highly qualitative terms so that many operational questions are left unanswered. There is also little bite to the constraint because in exceptional cases the criteria, if not the processes, can be sidestepped entirely by invoking an "exceptional circumstances" clause. Indeed, none of the exceptional access loans granted since the framework has been introduced has fully conformed to the criteria, and in all cases this clause has been invoked.

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Assessing the Case for Large-Scale IMF Lending

Fischer's arguments in favor of making the Fund an international LLR provide a useful framework for assessing the case for large-scale financial assistance from the Fund. Fischer argued that creditor coordination failures often play an important role in capital account crises. In this situation the provision of large-scale liquidity by an international LLR holds open the prospect of averting an avoidable crisis and restoring a good equilibrium in which creditors do not flee (or they return quickly). Drawing on the domestic LLR literature, he noted that an institution needs to satisfy at least three preconditions to have the potential to act as an effective LLR: It must be able to credibly commit to provide sufficient liquidity to resolve a crisis; it should require collateral as a test of solvency and as a protection in the case of a default; and it should lend at a penalty rate, compared with normal times, to guard against the creation of moral hazard and to provide incentives for early repayment. Fischer argued that in practice the Fund had ready access to sufficient liquidity to pass the first test, that the preferred-creditor status (PCS) of the Fund provided a substitute for collateral, and that the surcharge that the Fund demanded for high access under the Supplemental Reserve Facility fulfilled the penalty rate condition.

In a nutshell his argument was that the Fund was equipped to be an effective international LLR in such a way that would not unduly distort ex ante incentives. But if Fischer was able to draw on examples from the late 1990s to motivate his analysis, we think the evidence of the past half decade in particular demonstrates the limitations of the analogy and highlights the risks associated with large-scale IMF lending.

The Track Record

When providing exceptional access, the Fund typically has tried to resolve crises by partially rather than fully filling the financing gap.[1] The logic underpinning this partial approach is that a strategic complementarity can exist among the provision of Fund finance, debtor country adjustment, and private-sector investment decisions. In those cases the provision of Fund cash will support greater debtor country effort and encourage creditors not to flee, with the impact on the debtors and creditors mutually reinforcing each other.

1. The Mexican program of 1994 was the exception to this rule. The Fund, in concert with others, provided enough short-term liquidity to fully fill the incipient financing gap. The adverse reaction of many shareholders, particularly in Europe, to the Mexican bailout prompted the emergence of the partial LLR approach.

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These programs hold out the possibility of securing more private-sector involvement than full "gap filling," something that has been interpreted as a guard against moral hazard. In addition, given that the Fund's resources are limited, the partial approach offers the prospect of husbanding those resources.[2]

Judging the success of IMF programs is very difficult, given that the counterfactual is unobservable. But it is clear that these programs have generally failed to bring about the expected private-sector reactions. As Fund staff (Ghosh et al. 2002) have documented, the net capital flows in the first year of the exceptional access programs during the 1990s were on average approximately 7.5 percent of GDP lower than projected[3]—with the result that the adjustment to the current account necessary to bring about a balance of payments equilibrium was much greater than anticipated. Catherine Hovaguimian (2003) demonstrates that the exceptional access programs of the current decade have been even more disappointing (figure 15.1): The average capital account error in the Argentinean, Uruguayan, Turkish, and Brazilian programs was 11 percent of GDP. In all but the last of these cases the original crisis loans were quickly augmented, indicating an immediate failure of the program to resolve the crisis as anticipated. In each case, also, follow-up programs were agreed on that granted those countries rights to additional Fund money and extended the repayment period for the original loans. The implication is that these countries' fundamentals did not improve enough for them to be able to reaccess private markets in sufficient volume and to repay the Fund as originally planned. Performance has varied across these programs: In particular Brazil has now graduated from Fund assistance and has been making material repayments to the Fund for over a year. Nevertheless the general outcome is clear: These countries' crisis vulnerability has proved much more persistent than the recipients of the most successful of the 1990s programs.

This track record is consistent with theoretical work (Morris and Shin 2003, Penalver 2004), which shows that the range of circumstances in which Fund finance, debtor country adjustment, and private-sector investment decisions are strategic complements can be narrow. IMF programs rely on the direct effects of liquidity provision and the indirect effects of conditionality to change behavior. The mechanics of the liquidity channel are straightforward: The more cash the Fund provides, the more likely it is to resolve coordination problems. Conditionality works by encouraging the debtor country to undertake adjustment to correct the underlying vul-

2. The sum of the IMF's currently usable resources and the General Arrangements to Borrow and the New Arrangements to Borrow amounts to just 11 percent of middle-income countries' external debt.

3. This is the average of the programs for Brazil (1999), Indonesia (1998), Korea (1998), Mexico (1995), and Thailand (1998). Note that Ghosh et al. do not include Russia, which also received exceptional access, in their sample.

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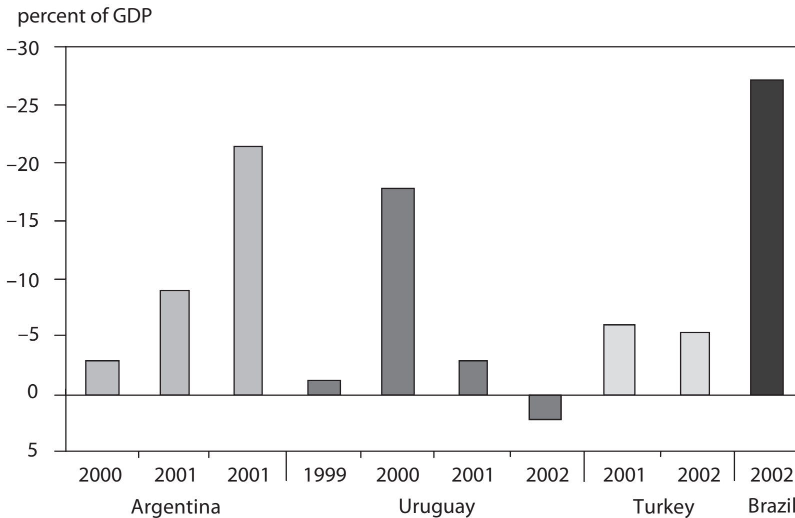
Figure 15.1 Capital account program projection errors for four countries



Note: The second and third bars for Argentina are for January 2001 and September 2001, respectively.

Source: Hovaguimian (2003).

nerabilities that are associated with crises. The more a given crisis is the result of coordination problems and not associated with weakening fundamentals, the less conditionality there need be and the quicker a country could reasonably be expected to implement it. In these cases the conditionality and liquidity channels may well work in tandem. The more that weakening fundamentals contribute to a crisis and need correcting, however, the greater the possibility that the two channels will work against each other. Liquidity effects point toward front-loading assistance, but front-loaded assistance reduces the traction that Fund conditionality has. Without that traction, creditors may well doubt whether the future program conditions will ever be implemented.[4] Conversely, back-loading assistance maximizes the incentives to implement conditionality but is unlikely to resolve the initial creditor coordination failure. Our inference is that programs that rely on catalytic effects are unlikely to succeed in those crises where a material weakening in fundamentals has taken place.

This analysis suggests that one of the key challenges facing the Fund in a crisis situation is to distinguish among types of crises: those that are pre-

4. According to Anna Ivanova et al. (2003), between 1992 and 1998 more than 40 percent of all Stand-By Arrangement programs suffered irreversible interruptions so that the final program review was never completed and roughly one in four conditions was never fulfilled.

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dominantly driven by exogenously determined liquidity shortfalls, those that basically reflect the solvency of a country, and those that lie somewhere in the gray zone in between. The IMF has to decide whether to provide financial assistance, and if so how much, in fundamentally uncertain situations. In this context, the limitations of PCS as an alternative to collateral are apparent. It costs a country next to nothing to grant the marginal lender seniority in the midst of a crisis. Consequently, in contrast with the requirement of posting collateral in the domestic context, demanding seniority does not help the Fund determine the type of crisis it is facing.

Lending without collateral to countries that are prospectively close to insolvency also raises questions about the Fund's risk tolerance. The Fund provides crisis loans on the basis of imperfect information and cannot discount the possibility that the crisis will prove worse than anticipated and that its loan will not be repaid, or at least not repaid on schedule. As with any lender, the Fund has to decide how much risk it is prepared to assume when it makes a loan. Good collateral, which can be liquidated in the event of a failed support program, protects the balance sheet of a domestic LLR. The Fund does not lend with collateral, relying instead on its PCS in the event that a program underperforms. PCS commits a country to prioritize obligations to the Fund but does not provide the Fund with an alternative route to realizing its assets. Although PCS implies that the risk to the Fund that it will suffer a default is (in most circumstances) admittedly small, it places the Fund in a difficult situation when a program is failing.

Demanding prompt repayment in such situations leaves the Fund vulnerable to the charge that the net result of its intervention has been to make the crisis worse. Faced with this dilemma, the Fund has typically extended the maturity of its original loans in the hope that more time (and often more conditionality) will do the trick. The likelihood of rollovers is accentuated by the fact that, even with large-loan surcharges, the Fund's lending rates have often been below the market rates at which countries can normally borrow (figure 15.2),[5] so that debtor countries rarely have a financial incentive to repay the Fund as quickly as possible.

The bottom line is that, although the PCS protects the Fund against credit risk, it does not remove the risks associated with making crisis loans. Instead, it transforms credit risk into liquidity risk. The pattern of repeated large-access programs described above demonstrates that this risk is material.[6] Repeat programs tie up the Fund's resources, reducing its ability to

5. We acknowledge that with Emerging Markets Bond Index Global (EMBIG) spreads at record lows the IMF's surcharges are currently more penaltylike than they have often been for a range of borrowers. Even so, given that the Fund's surcharges are fixed, the incentive to repay early is likely to be stronger for higher-rated countries.

6. For example, following various rollovers, Turkey is not due to repay the Fund fully before 2009, seven years after the initial provision of emergency liquidity.

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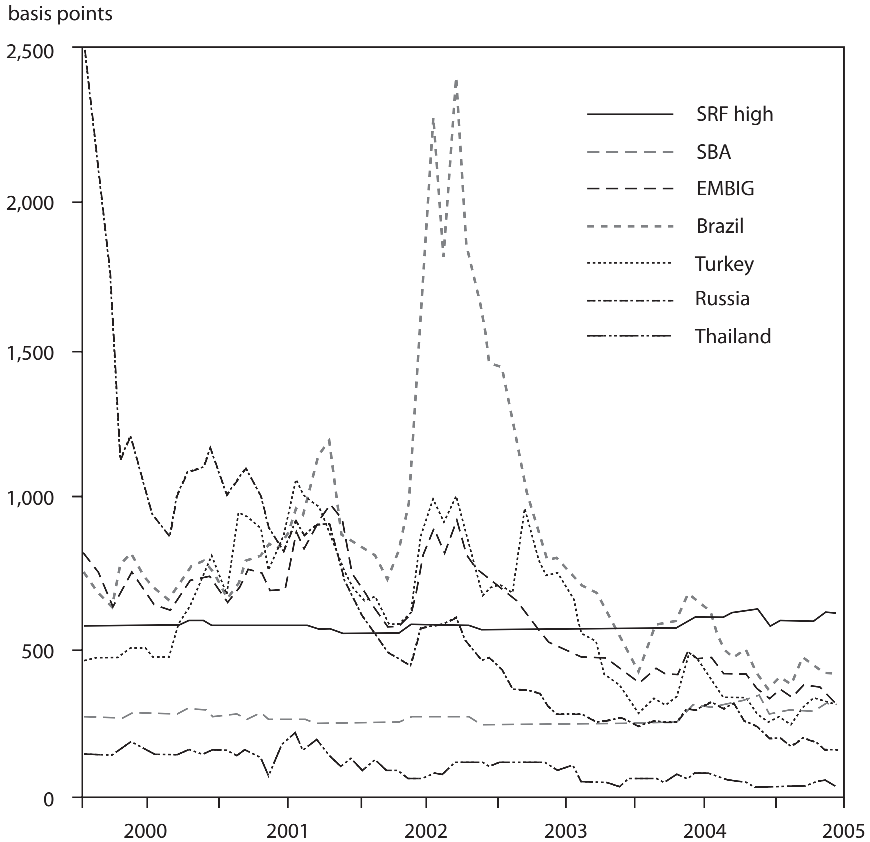
Figure 15.2 Average lending spreads, 2000–2005



EMBIG = Emerging Markets Bond Index Global
SBA = Stand-By Arrangement
SRF = Supplemental Reserve Facility

Notes: Country data are stripped EMBIG spreads. SRF high and SBA series equal the IMF's adjusted rate of charge, less the SDR interest rate, plus 500 and 200 basis points, respectively.

Sources: Data obtained from the Web sites of JP Morgan, www.jpmorgan.com, and the IMF, www. imf. org.

provide help to other members. For example, around the peak of its exposure at end of 2003, 30 percent of the IMF's (potentially lendable) general resources were tied up in loans to Argentina, Brazil, and Turkey.

From the country's perspective, the risk is that large-scale loans simply delay restructurings that are likely to be necessary in any case. This was clearly the case in Argentina. Other recipients of exceptional access in this decade have clearly performed well over recent years but remain highly indebted and vulnerable to internal and external shocks. To an extent the

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rollover of their Fund loans has resulted in the replacement of obligations to the private sector with medium-term obligations to the official sector. As Carmen Reinhart, Kenneth Rogoff, and Miguel Savastano (2003) show, relying on growth to reduce high levels of indebtedness rarely provides a durable solution.

The overall implication is that PCS and lending surcharges are not very effective substitutes for collateral and penalty lending rates. The Fund has to decide whether to make LLR-like loans in fundamentally uncertain circumstances and with fewer safeguards than a domestic crisis lender has.

Adverse Incentives?

Any policy based on the provision of large-scale emergency liquidity also raises questions about moral hazard. Michael Mussa (2002) has argued that, so long as IMF loans are made in accordance with its Articles of Agreement, the potential moral hazard created by such lending is unimportant when set against the benefits that those loans provide in reducing the costs of crises.[7] But even Mussa acknowledges that actual moral hazard risks associated with Fund lending decisions are likely to be accentuated given that geopolitical considerations often play a role. Moreover, the governments that the IMF deals with are agents of their populations and, in the midst of a crisis, politicians often place the utmost priority on avoiding a crisis (on their watch) and may be tempted to opt for risky policies—so-called gambles for resurrection—that are not in the general population's long-term interests. It is not hard to identify examples of both phenomena: The scale of Turkey's programs since 2001 at least conveys the strong impression that geopolitical considerations sometimes matter, and the problems that gambles for resurrection can cause are clearly demonstrated by the Argentine case.

Our point is simply that there is a trade-off: A policy framework that rests upon the provision of large Fund programs will have implications for incentives. The political environment in which the Fund operates is a fact of life; and the larger and more strategically important a country is, the more the market participants and debtor governments are likely to exploit any discretion in a policy framework to seek to game the Fund to provide marginal finance. This is likely to magnify any adverse incentive effects onto a subset of emerging-market economies. Moreover, this intro-

7. The Mussa argument, formalized by Jeanne and Zettelmeyer (2004), is that the moral hazard associated with Fund lending is bounded by the size of subsidy embodied in the relatively low rates at which it lends. Mussa notes that so long as the Fund lends to help adjustment in the face of temporary external imbalances, and does so on senior terms, it takes on minimal risk. In those circumstances it is appropriate to lend close to the risk-free rate, and to do so does not imply a subsidy. Further, he cites the observed absence of defaults to the Fund to support the view that in practice the Fund has not taken on undue risk or lent at a subsidized rate.

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duces an additional political premium that has to be priced in the market, creating an additional source of uncertainty that has the potential to exacerbate crises. Investors' behavior in the months around Russia's default in 1998 demonstrates this point. In our view, the particular challenges that the Fund faces when deciding whether to provide emergency assistance increase the scope for gaming behavior and make doubly important that the framework in which these lending decisions are made is as robust as possible.

An additional behavioral risk is associated with large-scale Fund lending. Given the lack of bankruptcy-equivalent procedures in sovereign cases, the Fund's ability to play a constructive role following a default depends on the quality of its relationship with the defaulting country and its wider credibility with other creditors. In common with all crisis lenders, the Fund assumes reputational risk when it provides emergency financial assistance. Given the lack of a legal framework, however, hits to its reputation may undermine its ability to help resolve crises following defaults more than such judgments affect other crisis lenders. As the Argentine example clearly shows, the Fund's traction over the debtor country can be reduced in the aftermath of default that a Fund program failed to divert and if the Fund cannot promise net new money. Equally, creditors' faith in the Fund's impartiality may be challenged if it has become a large creditor that plausibly (at least in others' eyes) is being influenced by a concern to protect its own assets.[8]

Policy Conclusions

A successful framework for the resolution of external payment crises should minimize deadweight costs without increasing the probability of future crises. This would be the case if the framework avoided a "bad equilibrium" for liquidity crises, facilitated orderly agreements to reschedule or restructure debt where necessary, and avoided excessive risk taking by the IMF. The design of any framework therefore has to balance a number of potentially competing concerns that include the ex post and ex ante consequences of crisis resolution strategies; the effectiveness of the framework in dealing with different types of crises, varying from "pure" liquidity problems at one extreme to clear solvency crises at the other; and the amount of risk that the official sector, through the IMF, is prepared to take on itself in attempting to resolve these crises.

Ex post assessment of a crisis resolution strategy is hampered by the inability to observe counterfactual outcomes. It is therefore unsurprising that different commentators reach different conclusions. William Cline

8. As of February 2005, Argentina's debt to the IMF was equivalent to 17 percent of the debt eligible for tender in Argentina's debt exchange.

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(chapter 14 in this volume) argues that the success rate of exceptional access programs is 75 percent, implying the current strategy that places great reliance on high-access packages is broadly successful. Implicitly Cline equates success with avoidance of default. We are less sanguine as we think it is premature to label a program as successful while the Fund is still owed a substantial amount of cash. Perforce, an exceptional access loan transforms near-term default risk into longer-term event risk, and the exceptional borrowers of this decade remain vulnerable to internal or external shocks. If one occurs while the Fund is owed significant cash, those countries' ability to weather the second shock will be complicated by their existing obligations to the Fund.

It is hoped that will not happen and that the cash will be repaid in all cases according to the current repayment schedules. Even then the question would remain: Is the high-cash option always the most effective crisis resolution strategy? It follows directly from the above that we have doubts. From the Fund's perspective, large loans tie up significant amounts of its liquid assets. As we discussed above, the worse the fundamentals in a given crisis, the greater the likelihood that these resources will be tied up for a significant period of time. Experience has shown that the combination of PCS, IMF surcharges, and conditionality does not mimic the requirement for LLRs to lend at penalty rates and demand collateral, complicating the difficult task of identifying crisis types in real time and heightening the risk that the Fund's assets will be tied up longer than originally anticipated. Moreover, large Fund programs may have ex ante implications of a size impossible to measure. Debate continues about the likely importance of these moral hazard effects, but we do not think they should simply be airbrushed out of the equation. Finally, and most important, alternative strategies are possible. In particular, a number of successful predefault reschedulings or restructurings of debt have helped resolve crises by reducing the overall debt levels and without exposing the Fund to so much liquidity risk. Since 1999, predefault restructurings have occurred in Pakistan, Uruguay, Ukraine, Moldova, and the Dominican Republic. In the case of the Dominican Republic, limited Fund cash provision helped encourage a predefault restructuring.

The conclusion we draw is not that the large-scale provision of Fund cash should be entirely precluded. There may be crisis cases in the future where deteriorating country fundamentals have played only a very minor role and in which Fund cash demonstrably offers the least risky way of resolving a crisis. But we do believe that Fund cash should be used less indiscriminately. Specifically, in those cases where fundamentals have played a more significant role, where material structural reform is warranted, and where the risk of program failure—in the sense of a country's inability to repay on schedule—is higher than otherwise, the alternative approach of a predefault restructuring may sometimes provide a better strategy. This reduces a country's debts to a more sustainable level, ex-

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poses the Fund to less liquidity risk, and has less potential to adversely effect ex ante incentives. To be clear, this is not a call for more defaults; they are costly and should be avoided where possible. Nor is this a call for cavalier sponsorship of predefault restructuring; where debt sustainability is not in question, net present value–reducing restructurings would be inappropriate. But it is our view that the line between cash-only and cash-and-restructuring options should be recalibrated compared with current practice.

The EAF was supposed to deliver greater differentiation in crisis resolution strategies. The specification of additional criteria that constrain the circumstances in which the Fund can provide exceptional loans has the potential to compensate for the particular challenges that the Fund faces, given that it lends without collateral and normally at less than penalty rates. But we are not confident that the framework as is will bring about any change in lending behavior. Instead, we suspect that the bias toward trying to resolve financial crises through large-scale Fund programs will persist. The ease with which the EAF has been sidestepped in the recent rollover programs points in that direction.

Hence the policy conclusion we draw is that further reforms are needed to make the theory of the EAF a reality. A twin-track approach should be adopted. First, the official sector should encourage private-market participants to improve further market-based mechanisms to resolve crises. Second, there should be internal reforms at the Fund to make the EAF a more effective constraint on lending decisions. Reforms along these two lines would be mutually reinforcing: The official sector is more likely to use a range of crisis management strategies if it has more faith in market-based solutions, and market participants are more likely to improve such mechanisms if they anticipate that the official sector will adopt a discriminating approach to future crises.

With regard to the first track, the official sector should encourage market participants to build upon the recently adopted majority amendment clauses. Specifically, greater use of aggregation clauses, which extend the principle of majority voting to cover a specified set of bonds, would make it easier to replicate in more complex cases the predefault reschedulings that several small emerging-market economies have already carried out. Aggregation clauses have been included by a number of countries carrying out bond exchanges, and the International Capital Markets Department has been vocal in arguing that medium-term note issuance programs would provide a mechanism for introducing aggregation clauses outside of bond exchanges.

Another approach could be to develop market-based understandings about the circumstances in which standstills could be used. As Haldane and Kruger (2001) noted, even in the case of pure liquidity crises, standstills can prospectively give debtors and creditors the breathing space needed to reach a cooperative solution and act as a circuit breaker that

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stops self-fulfilling creditor runs. The recently agreed-on Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets (IIF 2005) commits the creditor community to consider "appropriate requests for the voluntary, temporary maintenance of trade and interbank advances, and/or the rollover of short-term maturities on public and private-sector obligations, if necessary." Further work that gave more clarity to what "appropriate requests" might amount to before the next crisis strikes could increase the prospects of principles providing an operational guide during a crisis. As it stands, the commitment may be too vague to be useful in a crisis context. Alternatively, earlier proposals—such as the Buiter and Sibert (1999) suggestion of hardwiring the possibility of payment standstills into contractual clauses[9]—could be revisited.

The objective of making the EAF a more effective constraint could be furthered by enhancing the framework itself and by strengthening the incentives to abide by the framework.

- The exceptional access criteria themselves need to be made much more practical. Currently the criteria state that exceptional programs will be made only if there is (1) a pressing balance of payments need on the capital account, (2) a "high" probability that debts are sustainable, (3) "good" prospects for market reaccess within the time that the Fund is due to be repaid so the program would provide a bridge, and (4) a situation in which the prospects for a successful program are "reasonably strong." The first of these criteria is well defined. The remaining three require the Fund to make subjective judgments. The Fund has gone some way in specifying a debt sustainability framework, but it could go further in recognizing the probabilistic nature of those judgments.[10] Where possible the Fund should develop quantitative measures with which to judge these criteria and make them public. It may not be possible to develop hard and fast rules that can be mechanically applied, but much clearer quantitative norms can and should be established. For example, the Fund could publish guidance indicating how it would assess debt sustainability in future crises and include hypothetical scenarios in which the calculated probability of debt sustainability would be sufficiently high (or too low) to normally justify (or preclude) exceptional assistance. That would reduce market

9. The Buiter and Sibert (1999) universal debt rollover option with a penalty (UDROP) proposal is that all foreign currency lending contracts should include an option to enable the debtor to extend the maturity at a penalty spread and for a fixed number of months. The penalty spread and other features of the contract would be negotiated between the debtor and the creditors. The proposal is intended to give otherwise solvent debtors a vehicle to create breathing space during a liquidity crisis.

10. See Ferrucci and Penalver (2004) for one suggestion on how to do this.

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uncertainty about the application of the framework and increase its ex ante credibility.

- Consideration could be given to disconnecting the metric for determining access levels from quotas. Quotas may never catch up with changes in countries' economic size, and so long as they remain divorced from economic circumstances some countries will justifiably argue that their access rights are unfairly delimited. This undermines the normal access limits. For example, access rights could be linked to the calculated quotas.
- Governance structures at the Fund should be revisited to increase the accountability for large-scale lending decisions. The aim should be to increase the incentives to abide by agreed-on policy frameworks. One step in this direction, which should be uncontroversial, would be to strengthen the risk management practices at the Fund. Specifically, the Fund's provisioning targets could be linked to measures of financial risk on its balance sheet. Uniquely among major financial organizations, the Fund does not measure the risk (be it credit or liquidity risk) associated with its loans. Moreover there is no explicit link between the Fund's provisioning targets and the risk inherent in its loan book. Each of the development banks has reformed its risk management policies during the past decade, and the Fund should follow their lead.

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