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# Reflections on the Function and Facilities for IMF Lending

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When the International Monetary Fund provides financial support to member countries from its general resources, the IMF is what it is supposed to be—the primary official international lender of final resort to countries facing actual or potential difficulties in meeting their international payments obligations. To a strictly limited extent, the IMF also functions as a provider of loans on highly concessional terms (often in cooperation with the World Bank) to the poorest developing countries to help meet a variety of their needs. Through its power to create and cancel special drawing rights (SDR) in strict proportion to members' quotas, the Fund has a means of augmenting or reducing the general supply of international reserves.

In this chapter, I reflect primarily on the first of these IMF financing activities—those that use the general resources of the Fund. These resources come from the Fund's drawing on (that is, borrowing from) its (creditor) members, potentially up to the limit of their respective quotas in the Fund. Resources are provided to the Fund with the assurance that they will be used for the purposes prescribed in the IMF's Articles of Agreement. Specifically, members supplying general resources to the Fund have been assured that other members' borrowings from the Fund will be temporary and that safeguards will be maintained to guarantee that IMF loans using these resources will be used appropriately for the fundamental purpose of helping to resolve balance of payments difficulties in a

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manner consistent with the interests of the international community, including the obligation of repayment. These long-standing commitments necessarily and desirably limit lending of the Fund's general resources to the basic purpose for which they were originally intended.

I also discuss why, if the IMF continues to provide concessional support to poor countries, this should be kept as a strictly separate activity from loans using the Fund's general resources. Specifically, I emphasize that the resources for this concessional lending must remain separate from (and come from sources other than) the Fund's general resources. Further, under the recently established presumption that it is morally unconscionable to insist that very poor countries should repay outstanding loans, I conclude that the IMF should probably get out of the business of concessional lending at least for the poorest developing countries that have been granted complete debt write-offs. I do not consider issues concerning the SDR, other than to note that the SDR continues to play a useful role as the unit of account for the IMF's other financing activities.<sup>1</sup>

Its Articles of Agreement require that the Fund "adopt policies on the use of its general resources," and they impose a variety of restrictions to ensure reasonable uniformity of treatment of members concerning their potential access to Fund credit and the rates of charge and maturities of Fund loans. Accordingly, the Fund does not engage in free-form lending, with a wide variation of maturities and charges depending on the specific member and the particular circumstances that give rise to its need for Fund credit.<sup>2</sup> Instead, the Fund has established (and has often modified or eliminated) a variety of facilities under which loans with uniform maturities and schedules of repayment may be provided to meet broad categories of balance of payments need.

An important subject of this chapter concerns whether the Fund now has an appropriate set of facilities or whether important new facilities would help the Fund better to fulfill its desirable functions. Principally, I shall argue that flexible use of the present combination of outright purchases, the Stand-By Arrangement, the Extended Fund Facility, and the Supplemental Reserve Facility provides pretty much what the Fund needs for general resources lending, together with a separately financed facility (currently the Poverty Reduction and Growth Facility) to handle concessional lending to

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1. The SDR is defined in terms of a basket of major currencies, currently consisting of 0.4620 euros, 221.0000 Japanese yen, 0.0984 pounds sterling, and 0.5770 US dollars. The value of the SDR fluctuates in terms of national currencies. The SDR was worth approximately 1.45 US dollars in September 2005.

2. The Fund sometimes authorizes "outright purchases" that are not associated with all of the usual paraphernalia of a standard Fund program. The Fund also maintains a liberal attitude to requests for borrowing within the first credit tranche. Reserve tranche purchases should not be counted as borrowing from the Fund because a member is merely taking out resources that it has deposited with the Fund, and there is no obligation of repayment of reserve tranche purchases.

poor countries. One might also consider what I like to call the “deadbeats refinancing facility” to deal with the special problems of rolling over Fund loans to countries that have been forced to default on their privately held sovereign debt—as in the current case of Argentina. Other new challenges (such as initial IMF assistance for the transformation of the former Soviet Union in the early 1990s provided through the Systemic Transformation Facility) may call for creative new facilities. However, the search for the Holy Grail in the form of some new, grander version of the failed and cancelled Contingent Credit Line—with prequalification for very large scale IMF loans to countries with outstanding policies, to be disbursed in the event of asserted need without further consideration of IMF conditionality—is fundamentally futile.

To develop these main points, I will first consider the basic conceptual rationale for IMF lending using its general resources. This harks back to the purposes formally stated at the beginning of the IMF’s Articles of Agreement. As I shall explain, the statement of the purpose for IMF general resources lending effectively constitutes the mandate for the IMF to function as the primary official international lender of final resort.<sup>3</sup> This is followed by reflections on the nature and role of lenders of final resort within national economies and on why the IMF is needed to play this role for countries at the international level. The particular features of IMF general resources lending—high security of repayment, reasonable interest rates, and appropriate conditionality on the policies of borrowing countries—are intimately related to the special function of this lending and to its capacity to supply important public-goods benefits, without generating the significant problems of moral hazard often associated with public-sector interventions. With the conceptual function for IMF general resources lending established, it is then possible to consider what form of IMF facilities would be appropriate and desirable for carrying out this function and, equally important, which would not.

## The Purpose of IMF General Resources Lending

The term “lender of final resort” does not appear in the IMF Articles and is not part of the standard IMF lexicon. This term is one that I have used for

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3. Stanley Fischer (1999) provides an interesting and worthwhile exposition of his views on the need for an international lender of last resort and of the role of the IMF in this regard. I see the concept of the “lender of final resort” as quite different from the “lender of last resort,” with many important examples of how the function of lender of final resort is performed within national economies, including by private-sector entities. Unlike the classic lender of last resort that supplies virtually unlimited liquidity in a crisis but at a penalty rate, lenders of final resort provide resources to specific entities in distress at reasonable interest rates but with important conditions and constraints on the borrower. The IMF behaves as a lender of final resort, not as a lender of last resort.

many years to describe the basic function of IMF general resources lending. It is meant to be distinguished sharply from the concept of the lender of last resort, which, according to Bagehot, prescribes that in a crisis a central bank should lend freely but at a penalty rate. For example, the US Federal Reserve acted as the lender of last resort (but without the penalty rate) for the United States after September 11, 2001, to avoid disruption of the US and the world's financial systems. In contrast, the IMF does not, and was never intended to, pump large amounts of general liquidity into global financial markets to help avert a worldwide financial crisis.

Instead, the IMF provides loans to specific countries to help them deal with difficulties in meeting their individual international financial obligations. Article I(v) of the IMF Articles of Agreement describes the purpose of the Fund:

To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with the opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.

“Temporarily” means that IMF resources are provided as loans that must be promptly repaid, not as gifts or grants. “Under adequate safeguards” means that the IMF can and does impose conditions along with its loans. These conditions are supposed to provide reasonable assurance that IMF loans will be promptly repaid, which in turn requires that the member undertake measures to “correct maladjustments” in its balance of payments—but measures that will not do avoidable economic damage to the member or other countries. IMF loans are not supposed to go as a first resort to countries that merely want relatively inexpensive IMF credit, but only to countries that have a credible balance of payments need for which IMF lending is plausibly necessary.<sup>4</sup>

## Lenders of Final Resort Within Nations

It is important to recognize that this lender-of-final-resort function of the IMF does have analogues within national economies, in both official-

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4. Members may make use of their reserve tranches by asserting a balance of payments need that may not be questioned by the Fund. The Fund also maintains a liberal policy toward borrowings in the first credit tranche (up to 25 percent of quota). Borrowing beyond the first credit tranche requires an assertion of balance of payments need that may be challenged by the Fund. The Fund may refuse or scale back requests for borrowing and impose relevant conditionality. In the IMF programs from 1995 through 1997 to support Russia, one might reasonably question whether there was a credible case of balance of payments need or whether the true purpose was to provide budgetary support, despite the fact that Russia maintained significant current account surpluses. Similar questions might be asked about the recent large IMF support programs for Turkey. More generally, however, there usually has been a credible case of balance of payments need for countries receiving IMF support.

sector and private-sector activities. One comparatively rare case in the official sector is when a central bank provides financial assistance to an individual bank that is illiquid and possibly even insolvent (rather than a general injection of liquidity into the financial system). The Federal Reserve's discount-window lending to Continental Illinois National Bank and the arrangement for its takeover by Bank of America in 1985 is an example of this. More commonly, governments (not central banks) provide credits or credit guarantees as methods of last-resort financing (for example, New York state and federal guarantees to help New York City avoid potential default in the mid-1970s; loan guarantees provided by the US government to Chrysler Corporation in the early 1980s; guarantees to some US airlines in the aftermath of September 11, 2001; and innumerable such activities in Western Europe and elsewhere).

Even more commonly, businesses experiencing financial difficulties and unable to obtain additional credit on virtually any terms will approach their major creditors and seek a restructuring of existing debts on reasonable terms but almost always subject to tough conditions and close monitoring that these creditors impose on the businesses' activities. Alternatively, a business in difficulty may seek a white knight—a lender or investor who will inject new equity or credit and help renegotiate terms with existing creditors in exchange for meaningful power to influence the business's operations and a chance to gain if the business recovers. In another alternative, the firm may seek formal bankruptcy protection to enable it to defer payments to existing creditors and subordinate their loans to new debtor-in-possession financing.<sup>5</sup> Along with this comes general supervision of the business by the court and significant conditions on what the business can do in many areas such as major new investments, payments to shareholders, and salaries of management. Through each of these mechanisms, final-resort assistance on reasonable terms is provided to businesses that cannot access normal credit sources—but subject to significant conditionality on the business's operations.

When a business facing financial difficulties is solvent but illiquid, and sometimes even when a business is insolvent, these mechanisms for final-resort assistance serve important private and public purposes. When a business closes and its assets are liquidated for the benefit of creditors, there are usually significant losses not only for the business's owners but also for its creditors, employees, suppliers, and the general public (including lost tax revenue). If the business is fundamentally sound and capable

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5. The way bankruptcies are handled in the legal system influences how things are done when a firm does not resort to formal bankruptcy. In the United States, recognition by creditors that a firm might seek protection under Chapter 11 of the bankruptcy code may be an incentive to agree to a debt restructuring outside of formal bankruptcy. Alternatively, some creditors or white knights may favor formal bankruptcy as a means of involving a wider set of claimants (workers with contracts, pensioners, suppliers) in a write-down.

of meeting its obligations in the longer term but fails because of a short-run inability to meet cash requirements, a good deal of the losses sustained in its failure are unnecessary from both a private and a public viewpoint. Even if the business is insolvent and not capable of meeting all of its obligations in the long run, it still may be worth significantly more as a going concern than the liquidation value of its assets. It then makes sense, both privately and publicly, to keep the business operating while restructuring and writing down the claims of its owners, existing creditors, and others.

When final-resort assistance is privately supplied by lenders and investors, whether or not in the context of formal bankruptcy protection, the strong presumption and expectation is that desirable private and public purposes are being served. Of course, private lenders and investors of final resort may make mistakes in diagnosing that the nature of a firm's difficulty is illiquidity or recoverable insolvency when the firm truly is "worth more dead than alive." But private lenders and investors of final resort often take substantial losses when they make such mistakes—which are offset against gains they make when they get the diagnosis right. Private lenders and investors of final resort thus have an important incentive to get it right in individual cases, and there is strong discipline for them to be right on average.

This incentive and discipline do not imply that the operations of private lenders and investors of final resort achieve perfect economic efficiency. More generally, the mechanisms available within countries to deal with illiquid or insolvent enterprises, including the legal system of bankruptcy, also cannot be presumed to achieve perfect efficiency.<sup>6</sup> But economic inefficiency usually implies that there are unexploited opportunities to make profit or avoid loss. Pursuit of profit and avoidance of loss are powerful motivators for private-sector actors. As Ronald Coase (1960) explained, these motivations tend to lead the private sector toward reasonably efficient outcomes.

The incentives and discipline of the private sector do not operate in the same way when the public sector provides final-resort assistance. The public sector usually does not take an equity position when it supplies

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6. Bankruptcy laws vary considerably across different jurisdictions and have changed markedly over the years (for example, we no longer have debtor prisons). Surely not all of these widely varying approaches to bankruptcy can be perfectly economically efficient. Moreover, one can see significant inefficiencies in bankruptcy statutes in many cases. The 1978 amendments to US bankruptcy law (which I refer to as "Deadbeats Relief Act") made it very much easier for individuals to declare personal bankruptcy and (especially in some states) still protect a significant part of their assets. The massive increase in personal bankruptcies in the United States (to more than 1.5 million in the economic boom year of 1999, when many declared bankruptcy for at least the second time) suggests that personal bankruptcy had been made too easy. The result presumably was higher interest rates for all households in order to make up for the cost of deadbeats who escaped their obligations, sometimes as a strategy planned in advance. Recent amendments to US law have made personal bankruptcy somewhat more difficult.

last-resort assistance.<sup>7</sup> Accordingly, unlike the private sector, there is usually no direct financial gain to the public sector when its last-resort assistance is successful to offset losses when such assistance is a mistake. When mistakes are made in the public sector, they tend not to be acknowledged in a timely and transparent manner. Instead, the taxpayer is stuck with the bill many years later, often without a clear understanding of how that happened or who really was responsible for it.

Despite these concerns, public final-resort lending can be justified when important public purposes are to be served—purposes that are not adequately reflected in the profit and loss calculus of relevant private-sector actors. In particular, in some circumstances there can be important negative externalities from a business failure that private mechanisms of resolution do not take adequately into account or are incapable of managing. For example, failure of a very large bank leading to formal insolvency and resolution through the normal (and usually very time-consuming) legal processes of bankruptcy would be very disruptive to the entire financial system and could threaten a financial crisis. The government, usually operating through the central bank, serves a legitimate public purpose by providing lender-of-final-resort support to the failing bank. Even if the bank is fundamentally insolvent and the final-resort support involves some (usually very well disguised) cost to the taxpayer, government support that allows a speedy resolution and avoids financial-market turmoil and possible financial crisis is often the better of two evils.

Of course, it is desirable to keep the need for such public-sector interventions and their potential cost to the taxpayer limited by proper regulation of the financial system. More generally, it is important to recognize that, beyond their direct cost to the taxpayer, such lender-of-final-resort activities of the public sector often generate significant economic inefficiencies through the mechanism of moral hazard. Keeping these costs within reasonable bounds is a continuing struggle.

## The Primary Official International Lender of Final Resort

At the international level most countries (that are not the issuers of the world's major international currencies) face the possibility of a potential need for external final-resort financing. This is so because, although domestic central banks may be able to function as lenders of last resort and lenders of final resort in domestic currency, they cannot perform these functions in terms of the major foreign currencies in which the country

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7. There are exceptions. Federal loan guarantees for Chrysler were provided with low charges (no penalty rate), but Chrysler was required to give warrants to the federal government for the purchase of its equity at its very depressed price. When Chrysler recovered, the warrants became quite valuable. Chrysler suggested the warrants should not be exercised, but the US Treasury rightly refused this request.

necessarily conducts a good deal of its international commerce and financial activities. When such a country faces large external payments obligations relative to its level of reserves of international currencies and its ability to access in foreign currency credit on reasonable (if any) terms, it naturally seeks an international lender of final resort as the alternative to an extremely costly and disruptive default on its international obligations, or a crushing constraint on the domestic economy to fit international currency needs within available resources, or both.

For a number of reasons, however, private-sector lenders and investors are not capable of performing the lender-of-final-resort function for countries in the international arena. They cannot participate meaningfully in the management decisions of a country and, more generally, lack the means and legitimacy to structure and enforce appropriate conditionality on sovereign borrowers that is essential for final-resort lending. They are not in a position to secure and enforce agreements for the subordination of claims of existing creditors, either domestic and international. Moreover, private lenders are in a relatively poor position to enforce collection of their claims as final-resort lenders—as the recent experience of private lenders to the Argentine sovereign has again dramatically demonstrated. Private lenders generally lack the resources necessary for the very large scale of lending that is sometimes appropriate for sovereigns needing final-resort assistance.

National governments are much better positioned than the private sector to take on lender-of-final-resort support for other governments, and they do sometimes play this role, for example, in the case of US bilateral lending to Mexico during the “tequila crisis.” However, there are significant problems with the bilateral approach, particularly when no single country is ready, willing, and able to take on the responsibility vis-à-vis a particular client (as was the United States in the Mexico case). Experience (such as that with the so-called second lines of defense for Indonesia and Korea during the Asian crisis) shows that it is difficult to organize ad hoc multicountry packages of support when no single country is prepared to undertake alone the international lender-of-final-resort function.

The IMF solves this difficult problem of collective action because the resources for final-resort lending by the IMF are pre-positioned through IMF quotas, and the touchy burden-sharing issue among final-resort creditors is resolved by the agreed-on principles through which the IMF taps these general resources. The IMF is also experienced in negotiating relevant, appropriate, and acceptable conditionality with final-resort borrowers, and it has well-developed procedures for adjusting this conditionality to meet a wide array of contingencies. This does not mean that there are no difficulties or controversies about IMF conditionality, but the problems in this area are surely far fewer than would be encountered with efforts to design and implement appropriate and acceptable conditionality in an unstructured array of ad hoc bilateral arrangements for final-resort

lending.<sup>8</sup> In this regard, it is noteworthy that when bilateral support is provided to a country facing external payments difficulties, this is often done as supplemental support in the context of an IMF program—where the policy conditionality for the supplemental support is primarily that of the IMF program.<sup>9</sup>

## The High Security of and Low Interest Rate on IMF Loans

Another feature of the IMF contributes importantly to its effective functioning as an official international lender of final resort—IMF loans are almost always repaid, and repaid with interest. In fact, the vast bulk of IMF loans are repaid within 3 to 5 years (or, for loans under the Extended Fund Facility, within 15 years). Sometimes the maturities of IMF loans need to be extended before repayment is finally made, and in a few cases countries have gone into prolonged arrears on their IMF loans. These cases, however, are the basket-case countries (at present, Liberia, Somalia, Sudan, and Zimbabwe with total overdue obligations of approximately SDR 1.8 billion) where civil war, economic disintegration, or both have unraveled the basic fabric of a functioning society.<sup>10</sup> Under intense international pressure and the tacit or explicit threat of expulsion from the IMF, even these countries do make some payments on their IMF loans, as Sudan (which has by far the largest prolonged arrears to the Fund) has done for

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8. In the aftermath of the crisis of 1997–98, the political leaders and general popular opinion in several Asian countries remain somewhat hostile toward the IMF, with widespread sentiment that the IMF did not treat Asia very well during the crisis. Indeed, some honestly believe that the IMF was largely responsible for the crisis, and some exploit this notion for their own purposes. For example, in Korea the crisis of 1997–98 is commonly referred to as “the IMF crisis.” Although there is reason to criticize some of what the IMF did during the Asian crisis and to be concerned that the IMF did not do all that it might have to ameliorate the crisis (as indicated in the report of the IMF’s Independent Evaluation Office [IMF 2003]), it is absurd to suggest that the crisis was primarily the fault of the IMF. Abetted by developments in the world economy and the global financial system, Indonesia, Korea, Malaysia, and Thailand were themselves primarily responsible for the crises that damaged their economies through the activities (or lack of action) of their governments, financial institutions, and private businesses. (The multiple underlying causes of the Asian crisis were detailed and analyzed at a very early stage by the IMF [1997]. Subsequent analyses have refined but have not fundamentally altered the conclusions of that early assessment.) Indeed, at least in the case of Thailand, nearly a year before the crisis started, the IMF warned the authorities quite forcefully that serious trouble was brewing.

9. The US Department of the Treasury’s bilateral support package for Mexico in 1995 was negotiated after the IMF program was put in place in mid-January. The Treasury Department insisted on additional collateral and higher interest rates for its support, but it primarily relied on the policy conditionality of the IMF program.

10. In 1995, seven countries had protracted arrears to the Fund amounting to SDR 2.8 billion. Bosnia, Serbia, and Zambia have cleared their arrears.

many years and as Zimbabwe has just agreed to do.<sup>11</sup> Sometimes even these hard-nut prolonged arrears cases are successfully resolved with repayment of Fund loans, as happened with Peru in the 1990s and more recently with Zambia and Zaire (now once again the Congo). If the resolution involves new Fund loans under its concessional facilities, it is probably fair to say that the Fund (or its members) suffered some implicit financial loss; and some cases are still outstanding in which the cost of ultimate resolution is uncertain. Nevertheless, compared with the total cumulative volume of IMF lending (cumulatively more than SDR 300 billion committed under IMF arrangements since 1953), losses to the Fund from nonpayment of loans and nonpayment of interest are very small.

This repayment record contrasts sharply with repayments to private lenders by countries that have received IMF loans. Significant write-downs were ultimately required of private lenders to several countries involved in the debt crisis of the 1980s, but IMF loans to these countries (mainly made to help resolve the crisis) were fully repaid. More recent restructurings of private loans to Ecuador, Russia, Ukraine, and Uruguay have involved significant losses to private creditors; again, IMF loans have been fully serviced.

Bilateral official creditors have also effectively subordinated their claims to those of the IMF. For many years, Paris Club reschedulings of official bilateral credits for developing countries in financial difficulty have involved effective write-downs of the present value of these claims, and the degree of concessionality in Paris Club reschedulings has been rising over time. Countries benefiting from these reschedulings of official bilateral credits were required to obtain at least equally favorable terms from their private creditors (with an exemption for most trade credit). In contrast, the IMF (and other multilateral international financial institutions) were accorded preferred-creditor status and permitted to assert their claims in full.

Indeed, the acid test of the very high security of IMF loans is whether these loans (and their associated charges) are repaid in full. Complaints by critics of IMF lending, such as Gregor Irwin and Chris Salmon (chapter 15 of this volume), that “debtor countries rarely have a financial incentive to repay the Fund as quickly as possible” and that the Fund “should require collateral as a test of solvency . . . in the case of a default” are beside the point. Reasonably rapid repayment of IMF loans is desirable in order to contain the overall use of IMF resources and limit their use to final-resort financing. William R. Cline (chapter 14) is clearly right that usual repayment periods for IMF loans are consistent with these objectives. The mean-

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11. The IMF's Executive Board devotes a great deal of attention to cases of prolonged arrears to the Fund and is seriously intent on pressing countries with prolonged arrears to repay the Fund. This is evident in, for example, the amount of space accorded to this issue in the regular publication of the IMF's Legal Department, *Selected Decisions and Selected Documents of the International Monetary Fund*.

ingful test of the very high quality of the IMF's "collateral" is its demonstrated ability to collect on its loans even when others cannot.

Recently, under the heavily indebted poor countries (HIPC) initiative, the preferred-creditor status of the IMF and the other international financial institutions (IFIs) has been modified with respect to (approximately 35) very poor developing countries. For these countries, the IFIs have been asked to participate in debt write-downs (in present value terms), and for the poorest of the poor they have recently been asked, under appropriate circumstances, to write off their loans entirely. For the IMF, this new policy concerns primarily loans under the Fund's concessional facilities together with some general resources loans still outstanding from many years ago. I will return to this topic later. For the IMF's general resources lending, its preferred-creditor status remains intact—at least so far.

Because of its preferred-creditor status and, more generally, because IMF loans are almost always repaid in full even when other creditors' loans are not, it is appropriate that the IMF charge quite low interest rates on its loans. The IMF standard rate of charge does include a modest premium over the SDR interest rate (which is the rate of remuneration paid to countries supplying resources to the IMF). This modest premium covers the administrative costs of the IMF and has allowed over the years for the buildup of a general and special reserve now totaling SDR 5.7 billion.<sup>12</sup> This reserve provides ample protection that any losses sustained by the IMF from its general resources lending will not result in costs to members supplying general resources to the IMF.

Private creditors typically charge much higher interest rates to developing countries than the IMF rate of charge—if these countries can access private credit at all. But private creditors do not enjoy the strong security that the IMF has for its loans. Private creditors do sometimes sustain very substantial losses on their loans to countries that are actual or potential recipients of IMF assistance, and they need to charge interest rates that reflect the risk of such losses. Indeed, during the 1990s interest rates for emerging-market sovereigns in international credit markets averaged about 600 basis points above the London Interbank Offered Rate (LIBOR), in contrast with an IMF rate of charge that was typically somewhat below LIBOR.

Contrary to a commonly held but erroneous view, however, it is not appropriate to use interest rates charged by private creditors as the standard

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12. The IMF also has a Special Contingent Account-1 (SCA-1) with a balance of SDR 1.6 billion to deal with potential losses from outstanding cases of protracted arrears. This reserve has been built up by applying a small surcharge to the standard rate of charge and a modest reduction to the rate of remuneration below the SDR interest rate. When arrears cases are cleared (without loss to the Fund), members receive rebates of their contributions to SCA-1. The Fund also has reserve accounts (including the Special Disbursement Account [SDA]) to cover potential losses from its concessional lending facilities. In addition, the Fund owns 103 million ounces of gold with a book value of SDR 5.9 billion and a current market value of more than SDR 30 billion. This provides a huge hidden reserve to cover possible IMF loan losses.

for what the IMF should charge on its loans.<sup>13</sup> For good reason, the IMF has much better security for its loans than do private creditors. Just as a mortgage lender whose claim is secured by valuable real property typically charges a much lower interest rate than an unsecured lender of someone's credit card balance, so too the IMF's highly secured loans appropriately bear a much lower interest rate than loans of private creditors who face the prospect of substantial losses in the event of default. Moreover, the IMF has no need to charge a penalty rate (as suggested by Irwin and Salmon in chapter 15) in order to constrain the volume of its lending. It controls directly the amounts lent to individual members; and, provided that it operates properly within its mandate, it limits lending to final-resort balance of payments needs.

Indeed, the relatively low interest rate that the IMF is able to charge and the strong security for its loans that makes this feasible are intimately linked to the IMF's responsibility as the (primary) official international lender of final resort. For a country facing actual or threatened difficulties in meeting its external obligations, it is not particularly helpful to receive IMF assistance that comes with a very high interest rate. The need for the country to make large interest payments to the IMF increases the likelihood that it will be unable to overcome its external payments difficulties without substantial damage to its economy or, possibly, default on its other external credits. If the country is forced to restructure its non-IMF credits, these creditors will effectively and inappropriately absorb at least part of the cost of overly high interest rates charged by the IMF because necessary payment of this interest will diminish the resources available to service the country's other obligations. Meanwhile, the IMF will prosper by collecting high interest rates on its highly secure loans—but to what end?

## Outrageous Moral Hazard

Perhaps the most frequent complaint from critics of IMF final-resort lending is that it generates substantial moral hazard. The basic idea is simple and appealing. As they are usually caricatured, "IMF bailouts" supposedly relieve countries and their private creditors of at least a meaningful part of the losses that they ought to sustain when imprudent overborrowing and the necessarily associated overlending lead a country into external payments difficulties. Because the IMF has an established policy of providing such bailouts, both countries and their creditors anticipate that in the event of difficulty an IMF bailout is likely to come. This expectation en-

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13. For example, the Meltzer Commission (IFIAC 2000) expounds on this fallacy as does Adam Lerrick (2003). The usually reasonable Congressional Budget Office (CBO 2004) recognizes that IMF loans have much lower losses than private loans but nevertheless uses the difference between private credit costs and the Fund rate of charge as the primary measure of the subsidy involved in Fund lending.

courages excessively risky behavior. Indeed, some have even suggested that expectations of IMF bailouts were a principal cause (perhaps even the principal cause) of the destructive emerging-market financial crises of the past decade.<sup>14</sup>

No doubt, many government interventions that might be characterized as lender-of-final-resort operations do generate a good deal of moral hazard. For example, when governments regularly provide relief to victims of natural disasters such as floods, the expectation of such relief may induce people to expose themselves to greater risk of loss from floods than a reasonable risk-return assessment would support in the absence of expectations of such relief. This moral hazard is most clearly a problem when government relief is in the form of grants. It also arises, but to a lesser extent, if the government provides loans to help finance recovery after a disaster but charges a rate of interest that does not fully cover the government's own borrowing costs and the losses that may reasonably be expected because some recipients of relief loans will not repay, or if the government supplies disaster insurance at premiums that do not fully cover the risks of losses.

If the government charges a fully appropriate interest rate or insurance premium, there should then be little or no problem of moral hazard. Such loans or insurance might not be perceived as supplying much relief, however, by either the victims of disaster or the general public that wants real relief to be extended. Thus, in activities like disaster relief it is wise to recognize that, although government interventions should be structured to limit problems of moral hazard, such interventions are nevertheless likely to generate significant moral hazard as a necessary part of the game.

Major natural disasters also can give rise to substantial international relief efforts, as was the case after the Indian Ocean tsunami of December 26, 2004. Expectations of such relief presumably do generate some moral hazard problems, but the public that broadly supports international disaster relief, both through their governments and through private charity, does not feel—and rightly so—that such moral hazard problems are usually a major concern.

For countries facing economic dislocations caused by problems of meeting their international payments obligations, there is clearly not the same degree of sympathy and support for humanitarian assistance from the citizens of other countries as there is for victims of natural disasters. Accordingly, it is not appropriate for other governments (which represent their

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14. This position is held by many, especially European, central bankers and was forcefully expressed in the *Wall Street Journal* on February 3, 1998, in "Who Needs the IMF?" by three prominent Americans: George Shultz, William Simon, and Walter Wriston. The Meltzer Commission report (IFIAC 2000) is also sympathetic to the view that moral hazard arising from IMF lending is a major problem. Others are skeptical that moral hazard associated with IMF lending played any major role in most emerging-market financial crises of the past decade; see, for example, Roubini and Setser (2004), a number of my papers (Mussa 1999a, 1999b, 2004), and Mussa et al. (2000).

citizens) to provide substantial grants of assistance—at the expense of their citizens—to countries facing such international payments difficulties.

This conclusion changes, however, when loans are provided that do not involve significant cost or risk of loss to the countries making credit available. In this case, there should also be little legitimate concern about moral hazard. Loans that have high security for repayment and are at interest rates that cover creditors' borrowing costs, administration costs, and modest premiums for the residual risk of nonrepayment do not shift the burden from a country experiencing external payments difficulties or its existing creditors to the citizens of the countries supplying emergency assistance. Without such burden shifting, official assistance loans cannot generate significant moral hazard. This is the essential and indisputable argument that IMF loans consistent with the IMF's function as lender-of-final-resort, with high assurance of repayment, and with appropriate interest charges do not generate significant moral hazard.<sup>15</sup>

## Real Hazard and Public Purpose

If IMF loans do not shift any significant part of the burden from a country facing external payments difficulties to the IMF (and to the countries supplying credit to the IMF), one might reasonably ask: What purpose do IMF loans serve?

First, it is essential to recognize that the international community has a public interest in establishing and sustaining a reasonably open system of international commerce. Individual countries and their peoples generally benefit from open policies toward international commerce, both their own and those of other countries. The IMF Articles of Agreement explicitly recognize the international public good of an open system of international commerce in the statement of the IMF's purposes in Article I (for current account transactions) and in Article IV (for capital market transactions).

Second, the founders of the IMF believed, with good reason, that economies with relatively open policies toward international commerce expose themselves to greater risks of disturbances from external sources and especially to risks associated with potential interruptions in their ability to meet their international payments obligations. For many countries, this increased risk from openness is probably greater now in a world of relatively free international capital movements than in the world of extensive capital controls observed and anticipated by the founders of the IMF.

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15. Moral hazard is a very broad concept that has many applications in economics. I have argued elsewhere (Mussa 1999a, 1999b, 2004) that aspects of IMF operations do raise important concerns about moral hazard, but these concerns are not the simple notion that IMF bailouts automatically create significant moral hazard because they transfer to the taxpayers of IMF creditor countries an important part of the losses from financial crises that should rightly be borne by others.

The risk from openness raises two important public-goods problems (as we would now describe them) at the international level. Countries are discouraged from adopting open policies toward international commerce in order to limit the risk from openness, thereby reducing the gains from a more open international system for themselves and for others. Also, experience suggests that when confronted with external payments problems, countries may resort to policies unnecessarily destructive to their prosperity (such as harshly contractionary monetary and fiscal policies) or destructive to the prosperity of other countries (such as trade restrictions and excessive currency depreciation).

Loans from the IMF to countries with external payments difficulties address these public-goods problems. The prospective availability of such loans in the event of difficulties is intended to “give confidence to members” to adopt and maintain relatively open policies because the availability of such loans ameliorates the risks from increased openness. In the event of external payments difficulties, IMF loans help to diminish the need for unduly tight domestic policies; and the conditionality associated with IMF loans constrains countries from resorting to trade restrictions or encouraging rather than resisting excessive currency depreciation.

IMF loans provide important benefits to countries facing external payments difficulties even though repayment and appropriate interest charges are strictly enforced because such loans help to overcome an important market failure in the international financial system. As emphasized previously, national economic systems typically provide diverse mechanisms for supplying lender-of-final-resort support for domestic entities facing difficulties in meeting their payment obligations. When the entity is worth more alive than dead (even if it is insolvent), these mechanisms help to contain the damage to the entity in difficulty, its creditors, employees, suppliers, and the economy in general from the damage that would ensue if closure and liquidation were the only alternative. In the international system, for sovereign countries closure and liquidation are not alternatives. There is, however, substantial real hazard to a country from the economic and financial disruptions typically caused by an interruption in its ability to meet its international payments obligations or even a serious threat of such an interruption; and this real hazard affects others in the international economic and financial system.

For example, the countries principally involved in the emerging-market financial crises of the past decade suffered cumulative real output losses ranging from approximately 10 percent of annual GDP to more than 100 percent.<sup>16</sup> Losses were large even in many cases where official international assistance from the IMF and other sources helped to ameliorate them. Moreover, the losses were not limited to residents of countries ini-

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16. Estimates of these losses, based on calculations by the IMF, are presented in Williamson (2005).

tially thought to be in potential balance of payments difficulty. Spillover and contagion spread crises to other countries, adversely affecting their residents. Foreign creditors of and foreign investors in the crisis-afflicted countries suffered substantial losses, as did exporters to these countries and many of those who had to compete with these countries' exports. Any doubt that the international community perceived an important public-goods problem is refuted by the approval of a large IMF quota increase (including by the always skeptical US Congress) at the height of the crisis. Indeed, behind-the-scenes consideration of a possible SDR allocation—anathema to most IMF creditor countries—confirms the high degree of concern.

The world economy and the international monetary and financial systems have changed enormously since the IMF was founded six decades ago. They have evolved in ways and to an extent that were not envisioned by the founders of the IMF. Nevertheless, the experience of the past decade confirms that, in broad conceptual terms, the intended function for IMF general resources lending prescribed in Article I(v) of the Articles of Agreement remains highly relevant in today's world. The IMF is the primary international official lender of final resort for countries facing difficulties in meeting their international payments obligations. In performing this function, the IMF continues to provide important international public goods. The special features of IMF general resources lending—very high security of repayment, reasonable interest charges, and appropriate conditionality on the policies of borrower countries—are consistent with and essential to this basic function.

With the end of the par value system of pegged-but-adjustable exchange rates in the early 1970s and with the advance of global capital markets and security of access to these markets now enjoyed by the industrial countries, the countries that are likely candidates for IMF loans have changed considerably. The candidates will evolve further as more countries gain better assurance of sustained access to global financial markets and have less potential need for an official international lender of final resort. It is hoped that a time will come when the availability of IMF general resources lending is much less needed than it has been recently. That time is not yet.

## **The Flexible Stand-By Arrangement and Other Fund Facilities**

The Articles of Agreement allow a member very wide discretion in using the Fund's general resources within its reserve tranche and up to the limit of the first credit tranche, subject to an assertion of balance of payments need by the member. This makes perfect sense for a member's reserve tranche as the resources therein have been deposited in the Fund, in hard currencies, by the member. A member is allowed virtually absolute discre-

tion to draw on its reserve tranche in essentially the same way an individual draws on demand deposits previously placed in a bank. When a member draws on its reserve tranche, the remuneration it receives on its creditor position in the Fund is correspondingly reduced (but there is no repayment obligation). The first credit tranche is essentially an overdraft facility that allows a member considerable leeway in borrowing up to 25 percent of its quota, for a limited time, without invoking the full structure of IMF conditionality associated with drawings beyond the first credit tranche.

When a member wishes to access the Fund's general resources beyond the first credit tranche, the loan is usually made under a Stand-By Arrangement (SBA) or one of the Fund's other established facilities, including "outright purchases."<sup>17</sup> These facilities provide general guidelines concerning amounts and phasing of loans, loan maturities and charges, policy conditionality associated with the loan, and procedures for reviews of the country's performance under the arrangement. The legal basis for most of the structure of Fund facilities and their associated terms and conditions rests primarily on Article V and, in particular, on section 3 (a):

The Fund shall adopt policies on the use of its general resources, including policies on stand-by or similar arrangements, and may adopt special policies for special balance of payments problems, that will assist members to solve their balance of payments problems in a manner consistent with the provisions of this Agreement and that will establish adequate safeguards for the temporary use of the general resources of the Fund.

The SBA is properly accorded special status in this general provision of the Fund's Articles (as amended in 1978). The fundamental character of an SBA is defined in Article XXX(b):

Stand-by arrangement means a decision of the Fund by which a member is assured that it will be able to make purchases [i.e., obtain loans] from the General Resources Account in accordance with the terms of the decision during a specified period and up to a specified amount.

For many years, SBAs consistent with this definition have been the workhorse through which the Fund has provided (sometimes precautionary) support to members facing, or potentially threatened with, external payments difficulties.

The Extended Fund Facility (EFF), originally adopted in 1974, maintains the essential logic of the SBA but offers longer terms for repayment to the IMF. This is usually associated with conditionality directed at structural

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17. An IMF loan under an outright purchase is provided in a single disbursement immediately after approval by the Executive Board. Certain conditions, including an assessment of balance of payments need, are examined before the loan is approved, but there is no ongoing exercise of Fund conditionality as there is in most Fund arrangements that involve phased disbursements. Support for countries suffering natural disasters is often provided through outright purchases.

problems underlying balance of payments difficulties that typically require longer times for resolution than problems addressed under SBAs. The Supplementary Reserve Facility (SRF) adopted in 1997 allows an exceptionally large commitment of IMF general resources, beyond the normal access limits for SBAs and EFFs (100 percent of quota for any single year and, cumulatively, 300 percent of quota) for countries threatened with very large external payments drains.

Higher interest rates and special evaluation and review procedures have been established for IMF programs involving the SRF. Higher interest rates for large-scale SRF loans were part of the initial design of the facility and were a feature for which I argued at the time. These higher rates are not a penalty rate in the sense of Bagehot.<sup>18</sup> Because the Fund controls directly the quantity of final-resort lending, it does not need to impose a penalty rate to discourage excessive borrowing. Indeed, at the Fund's standard rate of charge and even with the surcharge for the SRF, many members would find it financially attractive to borrow huge amounts from the Fund as these interest rates are well below those faced in private international credit markets. Because the Fund's general resources are limited, however, members making exceptionally large use should properly be charged a "congestion fee" for the constraint that they impose on Fund resources potentially available to other members. Also, high concentration of Fund loans to relatively few members does increase, at least modestly, the financial risks to the Fund from repayment delays or possible losses. Higher charges and a larger buildup of reserves are appropriate responses. Special evaluation and review procedures for large IMF loans under the SRF are a useful additional safeguard.<sup>19</sup>

Taken together, outright purchases, the standard SBA, the EFF, and the SRF constitute a consistent package of IMF facilities that is well structured

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18. Theoretically, when a central bank acts as a classic lender of last resort in a crisis, it is supposed to discount freely but at a penalty rate. Discounting freely can mean that the central bank loses quantitative control of the aggregate supply of liquidity, raising risks of inflation, of large foreign exchange reserve losses, and of currency depreciation. A penalty rate helps to contain these risks by raising the price of liquidity. A lender of final resort (such as the IMF) that controls directly the quantity of its lending clearly does not need a penalty rate for this purpose. Moreover, in practice, central banks acting as lenders of last resort often do not impose penalty rates during financial crises but rather rely on mopping up any excess liquidity creation as the crisis eases. For example, the Federal Reserve cut the federal funds rate and engaged in massive open market purchases in response to the stock market crash of October 1987; it cut the federal funds rate again in response to the turmoil surrounding the Russian default and the Long-Term Capital Management (LTCM) crisis of autumn 1998; and it pumped in massive liquidity, temporarily depressing the federal funds rate below 1 percent, in the immediate aftermath of September 11, 2001.

19. Special procedures for arrangements using the SRF were introduced in the aftermath of the collapse of the IMF support program for Argentina in 2001 and the very large (relative to quota) support programs for Brazil, Turkey, and Uruguay established in 2000–2002. To a considerable extent these reforms followed suggestions I made in *Mussa* (2002, chapter 5).

to fulfill the IMF's essential function as the primary international lender of final resort for its member countries. The clear commitment of the IMF to provide loans (up to a specified limit) once one of these arrangements has been approved reinforces and makes concrete the general notion that IMF support is available to members who face balance of payments difficulties. The conditionality associated with an agreed-on IMF arrangement provides to the member an explicit understanding of the policies required to secure and maintain IMF support. This conditionality also provides assurance to others, who may be concerned about the member's actual or potential external payments difficulties, that the member will pursue reasonable policies to address these difficulties.

Because the resources committed under an SBA (and associated facilities) are usually disbursed in quarterly or semiannual phases rather than all at once upon approval, there exists the possibility that the IMF will suspend support if the member fails to comply with the conditionality specified in its agreement with the IMF. This provides additional assurance that the member will maintain reasonable policies to address its external payments difficulties. If, as is often the case, unforeseen conditions frustrate the member's ability to meet previously specified conditions for continued IMF assistance, the IMF can and does waive or modify requirements that have not been met through no fault of the member. Even if the member is partly at fault, the IMF may agree to modify its conditionality and continue lending, especially if the member agrees to undertake adjustments in its policies to correct deficiencies. If circumstances arise during the course of an IMF-supported adjustment program that require substantially greater IMF financial assistance, the IMF can (and has in several cases) agree to augment the IMF resources available to the member, sometimes well beyond the normal access limits under the provisions of the SRF.<sup>20</sup>

As suggested by the definition in Article XXX, SBAs are sometimes used in precautionary mode. A member may not have an actual balance of payments need but may, for a variety of reasons, be concerned that such a need for IMF support may soon arise. In this situation the member can negotiate an SBA with the IMF that is intended (by the member and the Fund) to be precautionary. The agreed-on SBA provides the member with assurance that IMF support will be available provided that the specified conditionality continues to be met. The SBA also announces to others the commitment of IMF support and the IMF's approval of the member's policies. Little or no disbursement of IMF loans may actually occur, but the member builds up rights to draw tranches of IMF support as it continues to satisfy the conditionality specified in the agreed-on program. If the member suddenly experiences balance of payments difficulties, it can draw the tranches for

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20. Agreement on and operation of an IMF program is a complex process, not a one-time event. The nature of this process is discussed in detail in Mussa and Savastano (1999).

which it has accumulated access. If more IMF resources are needed, the member can approach the Fund for an augmentation of its borrowing. It can expect expeditious consideration of its request—the approval of which may, depending on circumstances, involve strengthened policy commitments by the member.

The IMF's support for Brazil in 2001–02 provides an important example of the flexible use of the SBA and its associated facilities. By the spring of 2001, the deteriorating situation in Argentina raised concerns that spillover or contagion might involve Brazil in a wider balance of payments crisis. Uncertainties associated with the anticipated retirement of President Fernando Cardoso and the presidential election scheduled in Brazil for October 2002 added to these concerns. In light of these concerns, Brazil and the IMF agreed on a precautionary SBA during the summer of 2001. This agreement ensured that Brazil would earn access to up to approximately \$15 billion of IMF support by adhering to the conditionality in the SBA. Actual drawings of this support did not occur until the summer of 2002. By that time, Argentina had collapsed into a deep crisis, and concerns about the result of the upcoming presidential election in Brazil and the policies likely to be pursued by the new administration led to severe downward pressure on the exchange rate of the Brazilian real, large losses of international reserves, a sharp rise in the spreads on Brazil's foreign currency debt in international markets, and the necessity for a substantial increase in Brazilian domestic interest rates. The resources available under the IMF SBA were drawn to replenish Brazil's reserves, but it was clear that this was not enough to stem the developing crisis.

An augmentation of the SBA was promptly agreed between Brazil and the IMF, committing (under the SRF) up to approximately \$45 billion of IMF resources to support Brazil—the largest financial commitment ever made by the IMF. Significant additional IMF resources were made available and disbursed before the election on two conditions: that the outgoing Brazilian government would maintain the sound policies to which it was already committed and that the leading candidates in the October election would maintain a primary budget surplus at least as large as that pledged by the outgoing administration. Substantial additional IMF resources were committed for the period after the election, provided that the new Brazilian administration maintained sound policies at least as ambitious as its predecessor. Luiz Lula was elected as Brazil's new president; contrary to the fears of many, his administration announced and pursued sound monetary and fiscal policies that involved an increase in the primary budget surplus above that targeted by the outgoing administration. As financial markets became persuaded as to the seriousness of the new government, downward pressure on the exchange rate of the Brazilian real abated, reserves flowed back to Brazil, the interest rate spreads on Brazil's foreign debt declined, and the central bank of Brazil was able to reduce domestic interest rates substantially. The Brazilian crisis that

deepened severely in the summer and early autumn of 2002 was resolved successfully without massive disruption of Brazil's economy and financial system and without the necessity of drawing on all of the IMF resources committed under the augmented SBA.

Beyond the potential use of a formally agreed-on SBA as a precautionary arrangement, the IMF has also developed staff-monitored programs as an informal mechanism for preparing a country for potential support under an SBA (or EFF). A staff-monitored program does not involve commitment of IMF resources, and no letter of intent is required from the countries' authorities that formally commits them (to the IMF's Executive Board) to comply with specified IMF conditionality. Rather, the country's authorities and the IMF staff agree informally on a set of economic policies to address the country's balance of payments and other key issues. The IMF staff assesses the country's compliance with the agreed-on set of policies. If performance is satisfactory and a potential balance of payments need exists, the IMF will usually proceed to negotiate an SBA (or EFF) that commits IMF resources and imposes appropriate conditionality. There are a number of examples of how the process of moving from a staff-monitored program to an actual SBA has operated in practice.

With the adjunct of staff-monitored programs, it is clear that IMF programs under the SBA, EFF, and SRF (or outright purchases) provide a flexible mechanism for the IMF to play its essential role as the primary official international lender of final resort to members that face actual or potential external payments difficulties. The relevant remaining questions are: What else might be necessary or useful in this endeavor? Is it appropriate to broaden the mandate for IMF lending beyond its established final-resort function?

## Very Large Fund Programs

From the beginning it was always understood that there were limits to the amount that the IMF would lend to an individual member. This general idea was developed and refined over the years into the specification of access limits (defined in terms of percent of quota) for members seeking to use the Fund's various facilities. The story of how access limits were established and adjusted for various facilities is long, complicated, and not particularly relevant to the discussion here. Rather, it is important to focus on four key facts. First, access for most Fund programs is usually well below the formal access limits. Since the early 1990s, the access limit for the SBA and the EFF was no more than 100 percent of quota in any single year and no more than 300 percent of quota cumulatively. Access beyond the limits (permissible in "exceptional circumstances") really began with the IMF program for Mexico initially agreed in January 1995 that ultimately provided for cumulative access of up to 600 percent of Mexico's IMF quota (or about \$18 billion).

Since then there have been only a few cases of exceptionally large access: Thailand, Indonesia, and Korea in 1997–98; Russia in 1998; Brazil in 1998–99; Argentina in 2001; Brazil again in 2001–02; and Uruguay in 2002.

Second, despite their small number, large access cases have been both very important and quite controversial. It is often argued that these very large access programs provide unwarranted bailouts of a country's private creditors and fundamentally do not serve the best interests of the world economy. As explained by Edwin M. Truman in his overview (chapter 2 of this volume), many critics have argued either that IMF lending above the established access limits should be prohibited entirely or that it should be sharply curtailed and constrained by special rules and procedures such as requiring approval by a supermajority vote of the IMF Executive Board.<sup>21</sup> Many of the proposals that would keep open the possibility of very large access in very limited circumstances insist that this access be combined with much more rigorous private-sector involvement. This means that a country would be required to seek and obtain the agreement of its private creditors to a voluntary restructuring and write-down of their claims as an essential condition for IMF approval of exceptionally large access.

Third, sometimes a restructuring and write-down of the claims of private creditors are necessary to restore a country's external payments viability. By the summer of 2001, this was clearly the case for Argentina. It was a serious mistake for the IMF to augment its support and make another large disbursement to Argentina in September 2001 without at least an announcement of (if not final agreement on) a restructuring and significant write-down of Argentina's internal and external sovereign debt. In Korea, it might well have been better to approach the external creditor banks about a rescheduling (but not a writing-down) of their claims on Korean banks at the start of the IMF program in early December 1997 rather than waiting three weeks to do so. In contrast, in Mexico in 1995, exceptionally large official financing from the Fund and the US Treasury, without a hint of private-sector involvement, was clearly the way to go. If it had been suggested to external private creditors of Mexico's sovereign and its banks that they would need to volunteer for a debt rescheduling and write-down, the result would have been a much deeper and

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21. My friend and colleague Morris Goldstein (2005) is one of those who has argued forcefully for much more limited use of exceptionally large access and for a variety of reforms to help ensure this outcome (such as requiring supermajority votes of the Executive Board to approve exceptionally large access). The report of a task force of the Council on Foreign Relations (CFR 1999), for which Goldstein served as executive director, also takes this general position. Although I agree with Goldstein on many issues, including many of his criticisms and suggestions for improvement of the IMF, I largely disagree with his views on exceptional access. Vital substantive issues must be addressed on a case-by-case basis to deal with exceptional access. It is a mistake to believe that a procedural mechanism can resolve these vital substantive issues.

prolonged crisis. Similarly, in Brazil in 1999 and again in 2002, exceptionally large IMF financing and especially adept policy management, without private-sector involvement, proved to be the road to success (although the second episode was a very close call). In Turkey in 2000–02, despite my considerable skepticism, exceptionally large Fund support (up to a record-breaking 2,100 percent of Turkey’s IMF quota) and very determined policy adjustment ultimately won through.

Fourth, there is no general rule for handling cases that potentially involve exceptionally large access to Fund resources. No magic formula, no precise set of guidelines, no procedural mechanism can determine how individual cases with widely varying characteristics should be handled.<sup>22</sup> Each case requires astute analysis, careful judgment, and courageous decision making—most importantly, by the managing director, aided by the staff and supported by a sympathetic but appropriately skeptical Executive Board. Political leaders and senior officials of member governments should take care not to make this task even more difficult.

## Other Facilities for Lender-of-Final-Resort Financing

Beyond the SBA, the EFF, the SRF, outright purchases, and staff-monitored programs, the IMF has over the years established and maintained other facilities that, at least arguably, are relevant to the Fund’s lender-of-final-resort function. In general, these other facilities have been directed toward “special balance of payments problems” that Article V, section 3(a) recognizes as potentially calling for “special policies” for IMF general resources lending.

Among the facilities that have been designed to deal with special balance of payments problems, the Systemic Transformation Facility (STF) established in 1992 has been a particularly useful creation. The countries that emerged from the collapse of the Soviet Union at the beginning of 1992 generally lacked the institutional mechanisms and the minimal experience with design and management of basic economic policies to be able to comprehend and implement standard IMF conditionality. Nevertheless, a key priority of the international community was for the Fund to begin to supply both financial support and relevant policy advice for these countries as soon as possible. The STF allowed for this to happen without degrading the usual standards for IMF programs.

For many years, the IMF has provided assistance to countries afflicted by natural disasters and, more recently, disasters caused more by human action such as in Bosnia and East Timor. Usually such assistance has been

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22. The IMF has adopted new guidelines and procedures for dealing with cases of exceptional access that are useful reforms. The new guidelines and procedures do not provide definitive rules that would likely determine the outcomes in individual cases although they might prevent a mistake like that in the Argentine case in the summer of 2001.

provided through the Fund's standard facilities and (usually for comparatively modest amounts) through outright purchases. Other examples of special Fund facilities that arguably served some useful purpose include the Oil Facility (established in 1975 and terminated in 1983); also, Fund assistance for debt restructuring, as a set-aside within an SBA, was used by several countries in the late 1980s and early 1990s but has now lapsed. The Supplementary Financing Facility established in 1977 was not really a new facility but, instead, a mechanism for using resources borrowed by the Fund (rather than quota-based resources from creditor members) to help fund SBAs and EFFs and for raising charges to the member using these borrowed resources sufficiently to cover the cost of the Fund's borrowing. The facility lapsed with the approval of substantial quota increases that eliminated the need for Fund borrowing. The Y2K Facility enjoys my special affection as I encouraged my deputy, Fleming Larsen, to press for its establishment. It offered Fund assistance to countries fearing significant financial disruptions associated with Y2K computer problems. The facility was created with a lifespan from November 1, 1999, to March 31, 2000. It was never used and has passed into unlamented oblivion.

One area where there has been a long history of efforts to structure an IMF facility to deal with special balance of payments problems is for countries facing difficulties from volatile export earnings from primary products or highly vulnerable to fluctuations in costs of key commodity imports, specifically oil and cereals. The Compensatory Financing Facility (CFF) and its successor, the Compensatory and Contingent Financing Facility (CCFF), fall into this category. The Buffer Stock Facility (BSF) is also related. These facilities have had a long and tortured history. The special balance of payments problems that these facilities seek to address are real, and the notion of a Fund facility that might address them is attractive. In particular, if these balance of payments problems are truly temporary and naturally self-reversing, then it makes sense to provide Fund financing without imposing significant policy conditionality.

In practice, however, it has proved essentially impossible to design a facility that successfully addresses the presumed problem without creating other important difficulties. As an empirical matter, it is very difficult to know when a loss of export revenues or a surge in import costs is temporary and likely to be reversed. This makes it virtually impossible to know when it is appropriate for the Fund to provide significant financial support without much policy conditionality, and when it is relevant to insist on substantial policy adjustment as a condition for Fund support. Moreover, when the Fund makes available both a facility that affords substantial assistance with relatively weak conditionality and a facility with less or not much greater promised assistance and much tougher conditionality, the choice of members understandably tends toward the high-disbursement, weak-conditionality facility. Also, the contingency element of the CCFF, although theoretically attractive as a means for providing a type of insurance

policy for possible fluctuations in export earnings or import costs, proved extraordinarily complicated to operate in practice. Persistent experience with these difficulties has led the IMF (rightly, in my view) to terminate or suspend its special facilities directed at export earnings or import cost volatility.<sup>23</sup>

Proposals to revive these facilities in some form are made from time to time. Morris Goldstein (2005) has suggested that a revival of the CFF on a significant scale should be considered, and Kristin Forbes's proposal (chapter 18 of this volume) for a shock-smoothing facility falls into this general class. But the long and unhappy experience of the Fund with this type of facility argues strongly against these proposals. It is one thing to try a new idea that seems theoretically attractive; it is quite another to try again something that has already been implemented in several forms—and failed.

More specifically, concerning Kristin Forbes's proposal, I would argue that it is incredibly complicated, totally unworkable, and fundamentally unnecessary. The proposal involves an arrangement under which countries could either receive resources from the Fund or make payments to the Fund depending on variations in commodity prices, interest rates, or other contingencies affecting their economies or balances of payments. In general terms, this is somewhat like the contingency element of the CCFF but substantially more complicated. As a Fund facility, the CCFF proved too complex to be workable; a substantially more complicated version would be totally unworkable. An aspect of Forbes's proposal is that countries might be charged different interest rates reflecting their borrowing costs in private international credit markets. This, however, is now illegal according to Article V, section 8(d), which requires that charges "shall be uniform for all members." This provision is part of the general principle of uniformity of treatment, which is fundamental to the Fund's operation as an international organization; tampering with it by amending the articles would open the floodgates to enormous mischief. Moreover, when countries face meaningful balance of payments difficulties because of volatility in export or import prices or other disturbances, they can always apply to the Fund for assistance under its established facilities—another special facility to deal with this specific set of problems is not really necessary.

Of course, new problems are likely to arise from time to time for which new IMF facilities may be part of an appropriate international response. It is even possible that the new approaches may allow future resurrection of a useful facility intended to help deal with volatile commodity export earnings. It is well to keep a somewhat open mind on these issues. But an open mind is not supposed to be an open sewer. It should neither ignore the lessons of experience nor willingly accept all refuse that is thrown into it.

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23. The CFF continues to exist but is rarely used and then only for quite modest amounts.

## The Deadbeats Refinancing Facility

One recent issue that merits at least some thought about a new facility (or a modification of the standard SBA) concerns how the Fund should deal with members that default on obligations to their foreign private creditors, as occurred with Argentina in early 2002. In accord with the Fund's policy on lending into arrears, a member can establish a new Fund arrangement or continue receiving disbursements under an existing arrangement even when it falls into arrears with its private (external) creditors, but only if the member is making reasonable efforts, in good faith, to reach agreements that will clear those arrears.<sup>24</sup> This policy replaced the earlier policy (in force until 1989) under which the Fund would not disburse to a member with arrears to its private creditors without a negotiated debt extension or restructuring. Private creditors were not too pleased with this change in Fund policy, but a sweetener was added: the Fund's increased commitment of resources to members seeking (under the auspices of Fund programs) to resolve their external debt problems.

Through the 1990s the Fund's new arrears policy worked reasonably satisfactorily. Several countries that defaulted to their external private creditors agreed to new Fund programs and then expeditiously concluded negotiated restructurings of their private external debts.

Argentina since 2001 has been quite different. For two and a half years, foreign holders of Argentina's sovereign debt were paid nothing. The Argentine authorities provided some information to these creditors and outlined an exchange offer to restructure the debt in default, but there was never any meaningful negotiation. In the end, the Argentine government presented a take-it-or-leave-it offer, with the threat that any creditors that refused the offer would never be paid anything. About 75 of the defaulted bonds were exchanged for new Argentine obligations, including a substantial amount of debt held by Argentine (mainly official or quasi-official) entities. About 40 percent of the defaulted debt held by foreigners—approximately \$20 billion in face value—was not exchanged and remains in limbo. The defaulted debt that was exchanged received securities worth about 30 cents per dollar of face value and about 20 cents per dollar of face value and accumulated interest arrears. After accounting for the 40 percent of foreign creditors who received nothing, the average payoff for all foreign holders was less than 20 cents per dollar of face value and less than 15 cents per dollar of face value and accumulated interest arrears. Meanwhile, through a variety of mechanisms, the Argentine government and

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24. The most recent statement of this policy, from the summing up of the Executive Board discussion of January 14, 1999, states that the member must be "making a good faith effort to reach a collaborative agreement with its creditors" in order to merit continued Fund support (IMF 1999). It takes a very tortured stretch of the meaning of this phrase to say that the Argentine authorities have been or are now in compliance.

courts have effectively expropriated most of the equity value of foreign investments in Argentine banks and public utilities. Private domestic creditors of the Argentine government (including currency holders) and depositors in Argentine banks have also generally taken significant losses, but much less so than foreign private creditors and investors. Through a variety of mechanisms, the Argentine government has effectively reduced losses to its citizens by imposing proportionately much greater losses on foreigners—results that understandably enjoy much support among the Argentine public.

The Fund's program with Argentina effectively lapsed during the crisis at the end of 2001 and beginning of 2002. Negotiations for a new Fund program foundered for most of 2002, mainly because the IMF saw very grave deficiencies in the policies of the Argentine government and (to a lesser extent) because of concerns about how the Argentine authorities were treating foreign creditors and foreign investors. For their part, the Argentine authorities believed that they were doing the best they could in very difficult economic, social, and political circumstances; and by the second half of 2002, they were achieving important successes in avoiding outright hyperinflation and seeing some recovery of growth (after a decline of approximately 25 percent in real GDP between mid-1998 and mid-2002).

I have some sympathy for both sides. IMF management and staff were surely right about the grave deficiencies in Argentine economic policies, notwithstanding the economy's bounce off the bottom beginning around mid-2002. Surely those policies fell well short of what would normally be needed in an SBA program meriting Fund financial support. But desperate circumstances often call for desperate measures; and the Argentine authorities were reasonable in arguing that, in view of the politically feasible alternatives, their policies were at least successful in forestalling an even deeper calamity.

In any event, the broader international community, including the political leaders of the major industrial countries, were not prepared to force Argentina into default on its obligations to the Fund and other IFIs—which would have meant effective ostracism of Argentina from the international system. Argentina was not to be placed in the same category with Somalia, Sudan, Zaire, and other international pariahs. The consequence was that the IMF yielded to heavy pressure to agree to an SBA that would roll over the principal and interest payments coming due to the Fund and would allow the other IFIs to provide similar rollovers.

This was the right thing to do, but it was the wrong way to go about it. Instead, the IMF should have agreed to a new program allowing the rollover of principal and interest payments due from Argentina for the coming year, with the explicit statement that this was not a standard SBA and that Argentine policies fell well short of what would normally be required for a standard SBA. Instead, the rationale for the new program was that the desperate economic and financial situation of Argentina made it

reasonable for the Fund to defer collection of interest and principal due to it until the Argentine economy was in somewhat better shape. Argentina's treatment of foreign creditors and investors should have been noted as an issue of concern to the Fund, but with the implicit message that if the Fund was deferring payments on obligations to it (the preferred creditor), then it was not unreasonable for others also to accept delays and eventually debt write-downs. The agreement for the new Fund arrangement should also have stressed that, as conditions in Argentina improved, the government would be expected to strengthen its economic policies as a condition for continued Fund support and would also be expected to improve its treatment of foreign private creditors and investors to put them on a footing roughly equal with domestic creditors and investors.<sup>25</sup>

Arguably, a new Fund facility, which I propose be called the Deadbeats Refinancing Facility (DRF), would have been helpful in pursuing this alternative approach.<sup>26</sup> Despite the considerable flexibility with which the IMF has used the SBA over the years, there is understandably a very great reluctance to say explicitly that the IMF has approved an SBA with a member whose policies fall well short of those normally required for such an arrangement. This tends to weaken the IMF's ability to structure and enforce appropriate conditionality in other cases. However, an explicit statement was needed in 2002 to insist that Argentina's policies were not up to normal SBA standards, that the new Fund arrangement was a special response to very special circumstances, and that as conditions in Argentina improved policies would need to be strengthened significantly and issues relating to foreign creditors and investors would need to be addressed constructively, seriously, and expeditiously. Such a formal statement by the Fund and agreed to by the Argentine authorities when the situation was still desperate would have increased future leverage to insist on better, more equitable performance by the Argentine authorities in subsequent years.

Creation of something like the DRF does face the *Field of Dreams* problem: "If you build it, they will come." The worry is that if the IMF creates

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25. Truman (chapter 2) notes that senior officials of both the Fund and the US Treasury have been quite self-congratulatory about the noninvolvement of the Fund in the (so-called) negotiations between Argentina and its private external creditors. I agree with Truman (and many others) that, although the Fund should not attempt to dictate the details of a restructuring agreement for private creditors, it has traditionally been involved in the process and has a responsibility, consistent with its duty as the primary official lender of final resort, to make clear what it sees as the range of terms of a restructuring that would treat both sides with reasonable fairness. Even those who favor a new policy where the Fund remains completely aloof from restructuring negotiations should be concerned about the ex post application of this policy to private creditors that had relied on the Fund's established practices and officially stated policy on lending into arrears.

26. In Mussa (2002), I suggested "bifurcated conditionality" as a means for dealing with the special problems of the Argentine case. The DRF would be a more formal, institutionalized way of structuring this type of conditionality for this type of situation.

a facility that allows the rollover of payments due the Fund under relatively weak conditionality, many countries with substantial obligations to the Fund will want to make use of it. The solution is to structure the qualifications for use of the facility so that only members in truly desperate circumstances—similar to Argentina’s in 2002—can qualify and to specify that qualification will lapse as circumstances improve. Attaching a stigma to the use of the facility (by giving it an unattractive name, for example) would also be useful.

Of course, if Argentina turns out to be a unique case, structuring a new facility to deal with it after the fact would be useless. Nevertheless, discussion of such a possible new facility might help to focus attention on the disgraceful way that the Fund has managed the Argentine case and might spur useful thinking on how similar but hopefully less extreme problems might be more constructively handled in the future.

## **The CCL and the Search for the Holy Grail**

In 2000, the IMF established the Contingent Credit Line (CCL), partly as an effort to show creative new thinking about ways to deal with emerging-market financial crises that had reached epidemic proportions. Many of the ideas involved in the CCL had been around for years.

The rationale for the CCL was that some countries, particularly among the emerging-market group, maintain very sound macroeconomic policies and also have well-regulated and -supervised financial systems, transparent economic and financial data, rigorous accounting standards and practices, and other key features that help economic growth and financial stability. Through no fault of their own, however, these countries may be thrown into financial crises because of spillovers or contagion from other countries. These countries are reluctant to, or see no reason to, come to the Fund to negotiate a (precautionary) program before a crisis because of the stigma that generally attaches to countries with Fund programs, including the domestic political unpopularity of Fund programs and their associated conditionality. Nevertheless, these countries would benefit from the positive signal sent to financial markets by a large commitment of Fund support based on the Fund’s general assessment of their very sound policies and practices but without all of the usual paraphernalia of standard Fund conditionality. The CCL would do this. Moreover, the existence of the CCL would provide an important incentive to other countries to adopt sound policies and practices so that they too might qualify for the CCL. This would also help to improve the effectiveness of the Fund’s surveillance activities, including its surveys of members’ compliance with various codes of sound policy and good practice, by providing the incentive of qualification for the CCL. Thus, the CCL should have been a winner all around.

At the time of its adoption, there was considerable optimism about the likely success of the CCL. One high-ranking Fund official told me that he expected that by the middle of the next decade (which is now), the CCL would account for more than one-third of Fund commitments to member countries. In fact, despite some modifications to the original CCL to make it more friendly to potential users, there were no takers; and the facility was allowed to lapse. Hope, however, springs eternal, and there have been new proposals to resurrect something similar to the CCL. In particular, the proposal of Tito Cordella and Eduardo Levy Yeyati (chapter 17) for an IMF insurance facility falls into this class. It is needed, they argue, because the IMF's "existing facilities are designed with the purpose of helping countries dealing with crises . . . rooted in weak fundamentals . . . [and] are not suited for preventing self-fulfilling liquidity crises."

In my view these proposals are misguided because they ignore three basic problems that doomed the CCL and that are likely to render anything similar of no more than marginal usefulness. First, when you pre-qualify a country for large disbursements of Fund resources on the basis of its sound policies and practices, you also must have a way to disqualify that country if its policies and practices later deteriorate. This is hard to do. The Fund has always been reluctant to send negative messages to financial markets about one of its members (for example, in the cases of Argentina and Russia). If qualification for the CCL (or something similar) sends an important positive message, then subsequent disqualification would send a very negative message—perhaps just at a critical moment. Of course, the Fund might somehow find the gumption to send these negative signals. But without a credible record of having done so (with the CCL or otherwise), it would be a serious mistake to assume that such behavior is likely.

Second, it is always difficult to know which countries really have exceptionally sound policies and practices to the degree that the Fund should firmly commit to very large disbursements without any further examination of appropriate conditionality. For example, in 1998 Argentina was highly praised for its exceptionally good policies, especially with respect to the regulation and supervision of its banking system, and would conceivably have qualified for a CCL had the facility existed at the time. Such examples imply that there will always be good reason to set the standards of qualification for something like the CCL very high in order to avoid large Fund disbursements to members with inadequate policies. If the qualification standards are set very high, though, few countries that might conceivably benefit from something like the CCL will be able to qualify. Finding the viable middle ground, if any exists, is very difficult, and slipping out on the side of laxity is dangerous.

Indeed, the remarkable series of emerging-market financial crises of the past decade does not reveal a single case of a pure liquidity or contagion crisis where weak fundamentals were not a substantial issue and where

significant policy adjustments (under Fund conditionality) were not needed or appropriate. In December 1994, Mexico badly botched a devaluation necessary to correct a substantially overvalued exchange rate and a current account deficit rising through 8 percent of GDP. Thailand had the same problem in the summer of 1997, together with a financial system that had imprudently borrowed abroad massively in foreign currencies to finance domestic real estate investment. In Korea in late 1997, the sovereign was solvent; but many chaebol and the Korean banks that had lent to these chaebol monies borrowed in foreign currencies from foreign banks were not. Indonesia certainly had massive fundamental weaknesses. In 1998, Russia faced a collapse in the world oil price with a dipsomaniac as president, a totally dysfunctional Duma, and a burgeoning fiscal deficit. Brazil in 1998–99 and 2002, Argentina in 2001, and Turkey in 2000–01 all faced critical policy challenges—not pure liquidity crises. Designing a Fund facility to deal with the supposed problems of an undiscovered herd of unicorns is not a fruitful field of endeavor.

Third, realistically assessed, there is little that can be accomplished by something like the CCL that cannot be done with the SBA, the EFF, or the SRF, or by members themselves. With a precautionary SBA supplemented by the SRF, a member with very sound policies and practices can secure the Fund's firm commitment to large disbursements in the event of need. The difference with something like the CCL is the addition of explicit Fund conditionality with periodic reviews of the member's compliance. Why is this a significant disadvantage for the member? Why would financial markets find this less reassuring than a commitment of Fund resources without explicit conditionality and the possibility of strengthening policies in the event of trouble? Moreover, if an emerging-market country with exceptionally sound policies and practices wants a larger financial cushion to deal with potential (but not immediately visible) emergencies, it can usually borrow substantial amounts of foreign currency for a longer term and hold the proceeds in reserves. This is not costless, but it avoids whatever embarrassment there is from dealing with the IMF.

With these basic difficulties in mind, it should be asked why the search for an IMF facility like the CCL continues. In my view, it is because many associated with the IMF perceive that the CCL or something like it is the Holy Grail. It is seen as the perfect facility that will help improve the effectiveness of Fund surveillance, that will encourage members to adopt policies that will avoid crises, that will tend to bring members to the Fund early before their balance of payments problems become severe, and that will involve the Fund more constructively and cooperatively (rather than confrontationally) with a wider group of members than those that require the Fund's financial assistance immediately. These hopes, in my view, are in vain. Experience teaches that there is no perfect Fund facility that will accomplish these things—or even come close.

## Broadening the Mandate for IMF Lending

Over the years many have suggested expanding the mandate for IMF lending beyond final-resort support for countries facing actual or prospective external payments difficulties. Proposed objectives include supporting growth, development, and poverty reduction across much of the developing world—tasks that the IMF might share with the World Bank and other IFIs. The ability of the IMF to provide credit at relatively low interest rates, even in comparison with the (nonconcessional) loans from the World Bank and other IFIs, is an important if not always explicit part of the rationale behind many of these proposals.

The proposal of Kemal Derviş and Nancy Birdsall (chapter 16) for a stability and growth facility (SGF) is exemplary of this class of proposals. Under this massive new facility, the Fund or the World Bank (or both) would lend vast amounts to middle-income countries with high debt ratios at an attractively low interest rate (equal to LIBOR). The intention would be to replace a substantial part of these countries' existing debts that have high servicing costs with low-cost loans from the Fund and the Bank, thereby reducing overall debt-servicing costs and improving the fiscal balance. Conditionality would seek gradual reduction of debt-to-GDP ratios while it would give priority to social spending and poverty reduction.

How much Fund and Bank lending might be needed for such a facility? To achieve the intended objective, the facility would probably have to replace about half of the domestic and external sovereign debt; that is approximately 30 percent of GDP for the 18 countries suggested by Derviş and Birdsall. Moreover, lending large amounts at LIBOR under relatively weak conditionality would surely invoke the *Field of Dreams* principle. Lending would easily reach a half trillion dollars, probably a trillion dollars. The Fund's share would easily consume all of the Fund's available resources.

Like many proposals to expand the mandate for IMF lending, the suggested SGF seeks to address real problems. Specifically, many middle-income developing countries typically run substantial fiscal deficits and have built up government debt ratios relative to GDP that are well beyond plausible bounds of fiscal prudence. Consequently they face many chronic problems and significantly heightened vulnerability to damaging crises.

No matter how laudable and appealing may be the objectives of the SGF or other proposals involving a broader mandate for IMF lending, there are very important reasons to keep the IMF focused on its primary task—lender of final resort to members facing external payments difficulties. In particular, like many proposals in this class, the SGF would increase the overlap between the activities of the IMF and those of the World Bank. Virtually no one who knows these institutions would dispute that the relatively well-focused IMF is more efficient and effective as an organization than is the World Bank, with its diffuse mandate and wide range of oper-

ations. Already there is substantial concern about confusion and inefficiency resulting from overlap between the two institutions. Broadening the IMF's mandate further into areas also in the domain of the World Bank can only add to these problems and be dysfunctional for both institutions. This would be especially so with a such a massive new facility, which would dominate the lending activities of both institutions.

Moreover, the special privileges and powers that are vital to the IMF's effective functioning as the (primary) official lender of final resort—direct access to quota-based resources from member governments, very strong security for repayment of its loans and payment of charges, and the related ability to charge relatively low interest rates—are not properly extended to broader objectives. If the IMF were to engage in substantial lending other than for final-resort purposes, eventually cases would arise in which countries with large obligations to the IMF because of these loans would face severe difficulties in meeting their obligations to the IMF. This risk would be particularly great if, as under the SGF, large IMF loans were focused on countries with high sovereign debt ratios and records of their inability to manage their debts without resort to hyperinflation or formal defaults and restructurings.

The IMF would have two alternatives to deal with such situations. Either the countries could be strongly pressed to maintain the high security of IMF loans despite very severe economic problems and the necessity of very large write-downs or total write-offs of both private and bilateral non-IMF loans,<sup>27</sup> or the international community could back down from the long-established principle that (except possibly for some very poor countries) IMF loans must be fully repaid. As recent experience with debt relief for very poor developing countries suggests, the first alternative would probably be unacceptable to much of the world community.

Some version of the second alternative is far more likely. This would mean that the IMF would have to absorb substantial losses directly on its books, or IMF members would somehow need to absorb the losses in their budgets in order to bail out the IMF. In either case, the members of the IMF would have been told an egregious lie, and an inexcusable fraud would have been perpetrated on the international community. In the consideration of provision of resources to the IMF through its quotas, members have repeatedly been told that supplying credit for IMF lending is virtually without cost or risk of loss. This point has been repeated by senior officials of the US Treasury as they argue for quota increases before the US Congress. It is not quite the absolute truth, as indicated by the preceding dis-

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27. If the IMF was the dominant international creditor, even a complete write-off of other private and official claims might not be enough to enable full repayment of the Fund. Logic dictates that you cannot be the preferred creditor relative to yourself. Joint lending by the IMF and the World Bank would not help with this problem, except in the unlikely event that the world community would endorse and rigorously adhere to the principle that the IMF is always the preferred creditor relative to the World Bank.

cussion of prolonged arrears cases, but it has been almost 100 percent true. Expanding IMF lending beyond its normal final-resort function in ways that would almost inevitably lead to significant risk of substantial losses associated with IMF activities would be a gross violation of the trust that members have reposed in the institution.

## Concessional Lending Facilities

The IMF's involvement with concessional lending to developing countries began with the Trust Fund in the early 1980s. The resources for the Trust Fund came from the proceeds of IMF gold sales (not from the Fund's general resources), as provided for under the second amendment of the IMF Articles of Agreement. The Trust Fund provided moderate-size loans to developing countries with low per capita incomes, with a very low interest rate (0.5 percent per year), fairly long repayment periods (5½ years to 10 years), and relatively weak (first credit tranche) conditionality. This departure from the general principle of uniformity of treatment, and the specific requirement of uniformity in the rate of charge in Article V, section 8(d), was clearly not authorized under the original Articles of Agreement. Special provisions added in the Second Amendment, specifically Article V, section 12(f)(ii), allow that surplus proceeds from IMF gold sales may be used to provide "balance of payments assistance to developing country members in difficult circumstances, and for this purpose the Fund shall take into account the level of per capita income. . . ."

As resources for the Trust Fund ran out and repayments of Trust Fund loans were anticipated, the question of a successor facility inevitably arose. Another round of Trust Fund loans with little meaningful conditionality was not acceptable to the Fund's creditor members (even if the resources came from repayments of earlier loans made on the basis of proceeds from past IMF gold sales). The Structural Adjustment Facility (SAF) was established in 1986 to provide highly concessional loans to developing countries undertaking structural reforms as well as more traditional macroeconomic measures to strengthen growth and improve their balance of payments. Resources available for the SAF were limited (as high inflation in the late 1970s and early 1980s had substantially eroded the real value of Trust Fund loan repayments). Further gold sales requiring approval of 85 percent of IMF voting power were off the table. The new managing director, Michel Camdessus, who took over in 1987 pressed hard for the creation of the Enhanced Structural Adjustment Facility (ESAF) to be funded by contributions from members to the ESAF trust and subsidy account (administered by the IMF). Partly to attract additional funding, the ESAF featured firmer conditionality than the SAF, along the lines of the SBA and the EFF, but with particular attention to structural policy problems thought to be inhibiting the growth of poor developing countries. The

ESAF became the principal facility through which the Fund provided assistance to many of its poorest members, particularly in Africa.

As popular clamor for debt relief for poor developing countries rose during the 1990s, the official sector came under increased public pressure to grant relief beyond that accorded by lengthening the maturities of bilateral loans under the auspices of the Paris Club and traditional concessional lending by the IFIs. Explicit write-downs for bilateral loans were agreed to be appropriate in some cases, and the percentage amount of these write-downs and the range of eligible countries were progressively increased. By the late 1990s, the Fund, the World Bank, and other IFIs were under pressure to join the party and agree to significant write-downs in their loans to very poor heavily indebted developing countries. The heavily indebted poor countries (HIPC) initiative was created, and a new facility, the Poverty Reduction and Growth Facility (PRGF), was instituted to encompass and coordinate the efforts of the Fund and the Bank to support the poorest developing countries, including those with exceptionally heavy debt burdens that were eligible for the HIPC (expanded now to approximately 35 countries out of the approximately 80 countries eligible for the PRGF).

The PRGF replaced the ESAF and took over its resources, including loans, grants, and remaining surplus proceeds from gold sales and from repayments of SAF, ESAF, and Trust Fund loans.<sup>28</sup> To provide additional resources, many members also contributed their refunds from the termination of Special Contingent Account-2. Further monies were derived from a complicated and nontransparent flimflam operation involving the revaluation of about 13 million ounces of the IMF's gold, which yielded approximately SDR 2.2 billion.

In addition to the concessional terms available under the PRGF, countries in the category of HIPCs earned additional concessions. Upon successfully reaching the completion points of their PRGF programs, HIPCs received significant write-downs in the present value of their obligations to the IMF, to be paid for from IMF resources available to the PRGF. Notably, the debt write-downs for successful HIPC borrowers were not complete write-offs. The objective was to reduce debt to a sustainable level relative to exports or GDP, thereby achieving a viable balance of payments. The special treatment offered under the HIPC program (relative to the plain PRGF or IMF general resources lending) was formally justifiable because it used resources subject to the special provisions of Article 5, section 12 (f) (ii); it used very low per capita income as a key eligibility criterion; and it focused on countries with special balance of payments problems.

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28. Technically some of these resources remained in the Fund's Special Disbursement Account, but upon approval of the Executive Board these resources could be transferred to the special accounts set up to support the PRGF.

In June 2005, the Group of Eight (G-8) summit proclaimed that a total write-off of all official loans to the HIPC borrowers was appropriate, including the loans of the Fund and other IFIs. To pay for this grand gesture, the G-8 pledged to find additional resources to enable the World Bank and the regional development banks (especially the African Development Bank) to carry out their parts without impairing concessional support available to countries not involved in the HIPC program. The IMF was directed to pay for its part out of its already available resources. According to the 2005 annual report of the IMF (2005a), the additional cost of providing a complete write-off of IMF loans to HIPC-eligible countries amounts to approximately SDR 4 billion (or about \$6 billion). This will drain most of the available resources out of the PRGF-HIPC Trust and the Fund's Special Disbursement Account (SDA). Without new contributions or more gold sales, it will not be possible for the Fund to extend much new lending under the PRGF.<sup>29</sup>

The G-8 initiative was generally applauded by advocates of complete debt forgiveness for poor countries, including a number of NGOs, religious leaders, and rock stars. However, it was controversial with many IMF members who resented the arrogance of the G-8 in dictating the use of IMF resources that had been supplied by many donors and were expected to benefit the wide range of PRGF-eligible countries. Moreover, it could not reasonably be argued that complete debt write-offs for HIPC-eligible countries were needed to meet special balance of payments needs. Other PRGF-eligible countries, some as poor or nearly as poor as the HIPC-eligible countries, also had important needs. IMF resources supposed to be available to help these other countries were sacrificed to pay for debt write-offs for the HIPC borrowers beyond the need to reach sustainable external payments positions.

From the IMF's experience with concessional lending, I draw three main conclusions. First, if the IMF is to continue with this practice after the current round of debt write-downs and write-offs, it is very important to maintain a clear separation between concessional lending that uses resources specifically provided for this purpose and lending that uses the Fund's general (quota-based) resources. I see no problem with selling a significant amount of the IMF's gold (as proposed by Birdsall and Williamson [2002]) and using the proceeds to benefit poor developing countries

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29. As of April 30, 2005, there was approximately SDR 2.5 billion in the IMF's SDA and approximately SDR 5 billion of resources in the PRGF Trust. Most of the resources in the PRGF Trust are committed to pay subsidies on already outstanding PRGF loans or to provide a reserve to ensure timely repayment of PRGF borrowings. Writing off PRGF and HIPC loans can make use of reserves allocated to ensure timely repayment of the corresponding PRGF borrowings as well as resources transferred from the SDA. This leaves virtually nothing for new PRGF lending, at least until repayments of outstanding non-HIPC PRGF loans free up some of the reserves now allocated to ensure timely repayment of the corresponding PRGF borrowings.

through grants or new concessional loans administered either by the Fund or the Bank. The agreed-on provisions of the IMF Articles of Agreement allow for this, contingent on approval by 85 percent of IMF voting power. Monies specifically appropriated for these purposes by national legislatures are also fair game.

However, the general resources of the IMF have been provided for another purpose—to support the IMF’s role as the primary international lender of final resort for members facing external payments difficulties. The fundamental principle of uniformity of treatment makes it illegal for the IMF to increase charges for some members using its general resources in order to finance concessional lending of these resources to other members. The Articles of Agreement also prohibit using reserves built up in the general resources account from being used to support concessional lending outside of this account. Also, members supplying general resources to the IMF have been assured in the Articles of Agreement and by repeated statements of senior public officials that the resources will be used only for the purposes intended and that taxpayers will not be exposed to significant cost or risk of loss on account of the operations using the Fund’s general resources. Without an explicit amendment to the Articles of Agreement, and without clear warning that this may involve significant costs to the taxpayers of members supplying general resources to the Fund, it is simply illegitimate to use general fund resources for this purpose. Moreover, by undermining the IMF’s essential role as the primary international lender of final resort, such an amendment and warning would clearly be very bad ideas.

Second, I conclude that, in an environment where political leaders and senior public officials are willing to yield to the popular clamor for debt forgiveness, the time has come for the IMF to get out of the concessional lending business—no matter where the resources come from—at least for the poorest countries now receiving complete debt write-offs. This conclusion recognizes that, despite problems and complaints, the IMF’s concessional lending operations under the SAF, the ESAF, and the PRGF have achieved some success. Moreover, continuing with these operations is useful for maintaining Fund involvement with many of its poorest members as it assists them in dealing with their balance of payments difficulties and other problems, in structuring relevant conditionality for macroeconomic policies and some key structural policies, and in maintaining reasonably firm discipline and applying tough love when necessary. It also recognizes that, although the World Bank and the multilateral development banks can remain constructively involved in the poorest developing countries by administering grants (with or without phased disbursements and conditionality), it is much more difficult to see how the IMF can supply well-structured assistance to help countries deal with temporary balance of payments problems by using grants rather than loans.

Nevertheless, it now seems clear that the international community is not prepared to enforce loan repayment from the poorest developing countries. Of course, the debt write-off for countries counted among participants in the HIPC program applies to existing loans and not (yet) to future loans. But, if the international community has now concluded that it is unconscionable to insist that the poorest countries pay anything on their present IMF loans, it is reasonable to expect that a similar conclusion will again be reached later when today's new loans come due for repayment. The performance of the poorest developing countries during the past three decades does not offer much hope that most in this category today will leap out of it within the next decade. Accordingly, what starts out today as a concessional loan to a very poor developing country appears likely to transform itself into a grant by the time repayment is due.

It is sound, responsible, and honest public policy to make loans to poor countries even when it is known that there is a risk that some of these loans may need to be restructured and written down because conditions do not turn out as well as was reasonably expected. Up-front recognition of the likely cost of restructurings and write-down should, of course, be an explicit part of the consideration of whether the general policy is desirable. It is quite a different thing, however, to make what are called loans to very poor countries when one knows from the start that most of these loans are unlikely to be repaid. This is not sound, reasonable, or honest. The IMF, which is necessarily insistent on repayment in its key function of lender of final resort, should surely not get into this highly dubious business.

Finally, John B. Taylor (chapter 19) argues in favor of IMF nonborrowing programs for poor developing countries, and IMF Managing Director Rodrigo de Rato's new strategic vision appears to endorse this general idea (IMF 2005b). Experience with staff-monitored programs suggests that this approach might have some benefits. One may wonder, however, whether IMF advice and guidance will have much clout if they are not firmly linked to expectations of future IMF financial support. Nevertheless, after looking to a number of the concerns raised by Steven Radelet (chapter 20), one might conclude that getting the IMF out of the business of regular lending to the poorest developing countries, and restricting its role to no more than occasional and temporary balance of payments support, would be a good idea. In any event, without further IMF gold sales or new donations to support IMF concessional lending, the IMF's role vis-à-vis very poor developing countries will likely be limited primarily to nonborrowing programs.

## Conclusion

Despite profound changes in the world economy and in the international monetary and financial systems during the past six decades, the funda-

mental function of IMF lending envisioned in the Articles of Agreement remains relevant and important. Most countries need to use the major international currencies for the bulk of their international commercial and financial transactions but lack assurance of virtually uninterrupted access to supplies of these international currencies with which to meet their payment obligations. The IMF, as the primary international lender of final resort, helps to resolve critical global public-goods problems by making its credits temporarily available to countries facing external payments difficulties under conditionality that reasonably ensures both that its loans will be repaid and that external payments problems will be corrected without undue damage to national or international prosperity.

Consistent with provisions of its Articles of Agreement, the IMF has established policies and practices governing lending of its general resources, which are embodied in various IMF facilities—most notably, the outright purchase, the SBA, the EFF, and the SRF. Through the flexible use of these facilities, as demonstrated by its considerable experience, the IMF is capable of addressing the needs for final-resort balance of payments financing of its members. These basic Fund facilities have evolved over time, adapting to changes in members' balance of payments problems, such as with the relatively recent introduction of the SRF to help respond to major disruptions in capital flows. Special facilities to address special balance of payments problems have been introduced from time to time. The future may see the need for further innovation.

Past lessons should not be forgotten. Although they appear attractive theoretically, Fund facilities that have provided credit to countries facing supposedly temporary shortfalls in export revenues or surges in import costs under relatively weak conditionality have generally not functioned very satisfactorily. A facility providing precommitment of very large IMF loans on the basis of a positive assessment of a country's policies, but without ongoing assessment and application of conditionality, has also been tried (in the form of the CCL) and failed. Reasoned reflection suggests that this failure was not due primarily to the deficiencies of a particular design but instead to intrinsic difficulties and dangers with any IMF facility of this general class. Even more problematic are new facilities, such as the Derviş-Birdsall suggestion for large-scale lending to countries with high sovereign debts, that would extend beyond the IMF's present mandate for final-resort financing for countries facing external payments difficulties. Such facilities entail inappropriate use of the IMF's special privileges and powers (which are attuned to its present mandate) and might expose IMF creditor countries to substantial risks that they have not agreed to undertake.

IMF concessional lending to developing countries has always been separate from general resources lending. Resources for this concessional lending have come from the profits from IMF gold sales or from donations from members—not from the quota-based general resources of the

IMF. This separation is an essential principle that is embodied in key provisions of the Articles of Agreement and in the long-standing policies and practices of the Fund. The G-8 initiative that the IMF write off all loans to HIPC borrowers will virtually exhaust resources presently available for IMF concessional lending. Hence, a significant continued role for the IMF in concessional lending will depend on the provision of specific additional resources for this activity and should be based on a careful evaluation of the appropriateness of such a role for the IMF.

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