

## Reflections on the Function and Facilities for IMF Lending

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In providing financial support to its member countries from its general resources, the International Monetary Fund is what it is supposed to be—the primary official international **lender of final resort** to member 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 the power to create and cancel Special Drawing Rights (SDRs), in strict proportions to member's quotas, the Fund has a means to augment or reduce the general supply of international reserves.

In these remarks, I will 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. They 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 to members are appropriately used for the fundamental purpose of helping to resolve balance-of-payments difficulties in a 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 will 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 will 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 ever to insist that very poor countries should repay outstanding loans, I will 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 will 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.

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 assure 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 its need for Fund credit.<sup>1</sup> Instead, the Fund has established (and often modified or eliminated) a variety of “facilities” under which loans with uniform maturities and schedule of may be provided to meet broad categories of need.

An important subject of these remarks 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 the Stand-By Arrangement (SBA), the Extended Fund Facility (EFF), and the Supplemental Reserve Facility (SRF) provides pretty much what the Fund needs for general resource lending, together with a separately financed facility (presently the Poverty Reduction and Growth Facility or PRGF) to handle concessional lending to poor countries. One might also consider what I like to call the Deadbeats Refinancing Facility (DRF) 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 (CCL)—with pre-qualification 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 resource lending effectively constitutes the mandate for the IMF to function as the primary official international “lender of final resort.”<sup>2</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 pay this role for countries at the international level. The particular features of IMF general resource lending—high

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<sup>1</sup> The Fund sometimes authorizes “outright purchases” which 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.

<sup>2</sup> Stanley Fischer 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 (see *Journal of Economic Perspectives*, vol. 13, No.4, Fall 1999, 85-104). My perspective on this issue is somewhat different. 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.

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 resource 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 Resource 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 many years to describe the basic function of IMF general resource 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 system. In contrast, the IMF does not, and was never intended to, pump in large amounts of general liquidity into global financial markets to help avert a worldwide financial crisis.

Rather, 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 purposes of these activities as follows:

“To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguard, 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 the maladjustment” 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.

### **Lenders of Final Resort within Nations**

It is important to recognize that this “lender of final resort” function of the IMF does have analogs with national economies, both in official sector activities and in the private sector. 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 and arrangement for its takeover by Bank of America in 1985 is an example of this. More commonly, governments (rather than central banks) provide credits or credit guarantees as methods of "last resort" financing (e.g., New York State and federal guarantees to help New York City avoid potential default in the mid 1970s or the loan guarantees provided by the US government to Chrysler Corporation in the early 1980s or to some US airlines in the aftermath of 9/11, or innumerable examples of 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—almost always subject to tough conditions that the creditors impose and with agreement for their close monitoring of the businesses' activities by these creditors. Alternatively, a business in difficulty may seek a "white knight" lender/investor who will inject new equity and/or credit and help renegotiate terms with existing creditors in exchange for meaningful power to influence the business's operations. Or, 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>3</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 or 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 businesses' 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' owners, but also for its creditors, employees, suppliers, and the general public (including lost tax revenue). If the business is fundamentally sound and capable of meeting its obligations in the longer-term but fails because of short-run inability to meet cash requirements, then a good deal of the losses sustained in the failure are unnecessary from both a private and 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 lender/investors, whether or not in the context of formal bankruptcy protection, the strong presumption and

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<sup>3</sup> The way bankruptcies are handled in the legal system influences how things are done when there is not resort of 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 to involve a wider set of claimants (workers with contracts, pensioners, suppliers) in a write-down.

expectation is that desirable private and public purposes are being served. Of course, private lender/investors of final resort may make mistakes in diagnosing that the nature of a firm's difficulties is illiquidity or recoverable insolvency when the firm truly is "worth more dead than alive." But private lender/investors of final resort often take substantial losses when they make such mistakes—offset against gains they make when they get the diagnosis right. Private lender/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 lender/investors of final resort achieve perfect economic efficiency. More generally, the mechanisms available within countries to deal illiquid or insolvent enterprises, including the legal system of bankruptcy, also cannot be presumed to achieve perfect efficiency.<sup>4</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 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 "last resort" assistance. 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. Rather, the taxpayer is stuck with the bill many years later, often without a clear understanding of how he got stuck or who really was responsible for it.

Despite these concerns, public "final resort" lending can be justified when there are important public purposes 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

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<sup>4</sup> Bankruptcy laws vary considerably across different jurisdictions and have changed markedly over the years (e.g., we no longer have debtor prisons). Surely not all of these widely varying approaches to bankruptcy can be perfectly economically efficient. Moreover, there are many examples where one can see significant inefficiencies in bankruptcy statutes. The 1978 amendments to US bankruptcy law (the deadbeats relief act) made it very much easier for individuals to declare personal bankruptcy and still protect (especially in some states) a significant part of their assets. The massive increase in personal bankruptcies in the United States (to over 1.5 million in the economic boom year of 1999 with many declaring 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 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.

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 desirable.

Of course, it is also 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 have significant generate significant economic inefficiencies through the mechanism of “moral hazard” (which is discussed below). 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 while 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 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 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 and/or crushing constraint on the domestic economy to fit international currency needs within available resources.

For a number of reasons, however, private sector lender/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, which is essential for “final resort” lending. Also, 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 to other governments. 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 the bilateral approach, particularly when there is not a single country that 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* multi-country packages of support when no single country is prepared to undertake alone the 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 creditors is resolved by the agreed principles through which the IMF taps these general resources. The IMF is also very 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 less than would be encountered with efforts to design and implement appropriate and acceptable conditionality in an unstructured array of *ad hoc* bilateral and multilateral arrangements for final resort lending.<sup>5</sup> In this regard, it is noteworthy that when bilateral or multilateral 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.

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

One other 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 EFF, within 15 years. Sometimes the maturities of IMF loans need to be extended before repayment is finally made. And, there are a few cases where countries have gone into “prolonged arrears” on their IMF loans. These cases, however, are the basket-case countries (Liberia, Sierra Leone, Somalia, Sudan, Zaire, and Zimbabwe) where civil war and/or economic disintegration have unraveled the basic fabric of a functioning society. 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 the Sudan (which has by far the largest prolonged arrears to the Fund) has done

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<sup>5</sup> In the aftermath of the crisis of 1997/98, the political leaders and general popular opinion in several Asian countries remains 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.” While 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 (IEO)), it is absurd to suggest that the crisis was primarily or even modestly 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 (of 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 in the IMF’s *Interim Assessment of the World Economic Outlook* released in December 1997. Subsequent analyses have refined, but not fundamentally altered, the conclusions of that early assessment.) Indeed, at least in the case of Thailand, the IMF warned the authorities quite forcefully that serious trouble was brewing nearly a year before the crisis started.

for many years and as Zimbabwe has just agreed to do.<sup>6</sup> Sometimes even these hard-nut prolong arrears cases are successfully resolved with repayment of Fund loans, as happened with Peru and Nicaragua in the 1990s and more recently with Zaire (now once again the Congo). If the resolution involves new Fund loans under its concessional facilities, then it is probably fair to say that there is some implicit financial loss for the Fund; and there are still cases outstanding where the cost of ultimate resolution is uncertain. Nevertheless, as compared with the total cumulative volume of IMF lending, losses to Fund from nonrepayment of loans and nonpayment of interest are very small.

This repayment record contrast sharply with that of private lenders to 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 recently, there have been restructurings of private loans to Ecuador, Russia, Ukraine, and Uruguay that have involved significant losses to private creditors; but, 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.

Recently under the Highly Indebted Poor Countries (HIPC) initiative, the preferred creditor status of the IMF and the other IFIs has been modified with respect to 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 a modest volume of general-resource loans still outstanding from many years ago. I will return to this topic later. For the IMF’s general-resource 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 are not, it is appropriate that the IMF charge a quite low interest rates on its loans. Private creditors typically charge much higher interest rates to developing countries—if these countries can access private credit at all. But private creditors do not enjoy the strong security that the IMF has for its

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<sup>6</sup> The IMF’s Executive Board devotes a great deal of attention to cases of prolonged arrears to the Fund and is very seriously intent on pressing countries with prolonged arrears to repay the Fund. This is evident, for example, in the amount of space accorded to this issue the regular publication of the IMF’s Legal Department, *Selected Decisions and Selected Documents of the International Monetary Fund*.



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.

However, contrary to the views of Alan Meltzer, Adam Lerrick, the Congressional Budget Office, and a host of others who apparently do not understand this issue, it is not appropriate to use interest rates charged by private creditors as the standard for what the IMF should charge on its loans. 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.

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 resource available to service the country's other obligations. Meanwhile, the IMF will prosper from collecting high interest rates on its highly secure loans—but to what end?

### **Outrageous Moral Hazard**

Perhaps the most frequent complaint from critics of the 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 out to sustain when imprudent over-borrowing and the necessarily associated over-lending leads 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 encourages excessively risky behavior. Indeed, some have even suggested that expectations of IMF "bailouts" was a principal cause (perhaps even *the* principle cause) of the destructive emerging market financial crises of past decade.

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 an interest rate 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. If the government changes a fully appropriate interest rate, there should then be little or no problem of moral hazard. Such loans, however, would be perceived as not supplying much relief, either by 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 while 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. Presumably expectations of such relief 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 due to problems in meeting their international payment 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 (who represent their 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 creditor borrowing costs, administration costs, and modest premia 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 its function lender-of-final-resort, with high assurance of repayment and with appropriate interest charges, do not generate significant moral hazard.<sup>7</sup>

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<sup>7</sup> “Moral hazard” is a very broad concept that has many applications in economics. I have argued elsewhere that there are important aspects of IMF operations that 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.

## **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), then one might reasonably ask: What purpose do they 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 exposed themselves to greater risks of disturbances from external sources and especially to risks associated with potential interruptions in their ability to meet their international payment 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.

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 (e.g. 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. 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 is not an alternative. But there is real hazard to a country from the economic and financial disruptions typically caused by an interruption in the ability to meet their international payment obligations, or even to the serious threat of such an interruption.

For example, the countries principally involved in the emerging market financial crises of the past decade suffered cumulative real output losses ranging from about 10 percent of annual GDP to over 100 percent. And, 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 initially thought to be in potential balance-of-payments difficulty. Spillover and contagion spread the crisis 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—which is anathema to most IMF creditor countries—confirms the high degree of concern.

The world economy and the international monetary and financial system 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 resource 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 resource 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 has changed considerably. It 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. A time will hopefully come when the availability of IMF general resource lending is much less needed than it has been recently. That time is not yet.

### **The Flexible Stand-By Arrangement**

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 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 discretion to draw on its reserve tranche in essentially the same way as 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 over-draft facility, which allows a member considerable leeway in borrowing up to 75 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, Article V Section 4 permits members to obtain IMF loans beyond the first credit tranche at the "discretion" of the Fund "and on terms which safeguard its interests." The legal basis for most of the structure of Fund facilities and their associated terms and conditions rests primarily on this provision and on the general specification of Article V 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 Stand-By Arrangement (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 terms of the decision during a specified period and up to a specified amount."

For many years, SBAs consistent with this definition have been 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 of the IMF. This is usually associated with conditionality directed at structural problems underlying balance-of-payments difficulties which typically require longer times for resolution than problems addressed under SBAs. The Supplementary Reserve Facility (SRF) adopted in 1997 allows 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 review procedures have been established for IMF programs involving the SRF.

Together, the standard SBA, the EFF, and the SRF constitute a consistent package of IMF facilities that are well-structured 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 an SBA (or EFF, possibly supplemented by the SRF) has been approved reinforces and makes concrete that general notion that IMF support is available to members who face balance-of-payments difficulties. The conditionality associated with an agreed SBA 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 policies to address these difficulties.

Because the resources committed under an SBA (associated facilities) is usually disbursed in quarterly or semi-annual phases, rather than all-at-once upon approval, there is the possibility that the IMF may 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 adjustment 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.

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 a SBA with the IMF that is intended (by the member and the Fund) to be precautionary. The agreed SBA provides the member with assurance that IMF support will be available provided that the specified conditionality continues to be met. And, it announces to others the commitment of IMF support and the IMF's approval of the member's policy commitments. Little or no disbursement of IMF loans may actually occur, but the member builds up rights to draw the committed tranches of IMF support as it continues to satisfy the conditionality specified in the agreed program. If the member suddenly experiences balance-of-payments difficulties, it can draw the tranches for 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 2001/2002 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 Cardoso and 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 assured that Brazil would earn access to up to about \$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 about \$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 the condition that the outgoing Brazilian government maintain the sound policies to which it was already committed. Substantial additional IMF resources were pledged for after the election, provided that the new Brazilian administration maintained sound policies at least as ambitious as its predecessor. In the event, Lula was elected as Brazil's new president; but contrary to the fears of many, his administration announced and pursued very 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 to the seriousness of the new government, downward pressure on the exchange rate of 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 successfully resolved without massive disruption of Brazil's economy and financial system and without the necessity to draw all of the IMF resources committed under the augmented SBA.

Beyond the potential use of a formally agreed 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 and SBA (or EFF). A staff-monitored program does not involve commitment of IMF resources, and there is no "letter of intent" from the countries authorities formally committing 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 situation and other key issues. The IMF staff assesses the country's compliance with the agreed set of policies. If performance is satisfactory and there is a potential balance-of-payments need, 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/SRF provide a very flexible mechanism for the IMF to pay its essential role as the primary official international lender of final resort to members facing actual or potential external payments difficulties. The relevant remaining questions are—what else might be necessary or useful in this endeavor, and whether it is 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 and how the access limits of different facilities interacted is a long and complicated one, and is not particularly relevant to the discussion here. Suffice it to note four key facts. Access for most Fund programs is usually well below the formal access limits. Since the early 1990s, the access limit for the SBA/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 (which is permissible in “exceptional circumstances”) really began with the IMF program for Mexico agreed in January 1995 which provided for cumulative access of up to 600 percent of Mexico's IMF quota (or about \$18 billion). Since then there have only been 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.

Despite their small number, these large access cases have been both very important in 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 in Ted Truman's overview paper, 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 super-majority vote of the IMF Executive Board.<sup>8</sup> Many of the proposals that would keep open

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<sup>8</sup> My friend and colleague Morris Goldstein 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 assure this outcome (such as requiring super-majority votes of the Executive Board to approve exceptionally large access). While I agree with Morris on many issues, including many of his criticisms and suggestions for improvement of the IMF,



the possibility of very large access in very limited circumstances insist that it be combined with much more rigorous “Private Sector Involvement” (PSI). 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 a essential condition for IMF approval of exceptionally large access.

There is no doubt that the restructuring and write down of the claims of private creditors are sometimes 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 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 PSI, 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 prolonged crisis. Similarly, in Brazil in 1999 and again in 2002, exceptionally large IMF financing and especially adept policy management, without PSI, proved to be the road to success (although the second episode was a very close call). In Turkey 2000/2002, despite my considerable skepticism, exceptionally large Fund support (up to a record breaking 2100 percent of Turkey’s IMF quota) and very determined policy adjustment ultimately won through.

There is an important general lesson to be learned from this experience. There is no general rule for handling cases that potentially involve exceptional large access to Fund resources. There is no magic formula, no precise set of guidelines, no procedural mechanism that can determine how individual cases with widely varying characteristics should be handled.<sup>9</sup> They require astute analysis, careful judgment, and courageous decision making—most importantly by the Managing Director, aided by the staff and supported by a sympathetic by 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/EFF/SRF and staff-monitored programs, the IMF has over the years established and maintained other facilities that, at least arguably, are relevant to the

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I largely disagree with his views on exceptional access. There are vital substantive issues that must be addressed on a case by case basis in deal with exceptional assess. It is a mistake to believe that there is a procedural mechanism for resolving these vital substantive issues.

<sup>9</sup> The IMF has adopted new guidelines and procedures for dealing with cases of exceptionally access that are useful reforms. They do not provide definitive rules that would likely determine the outcomes in individual cases, although they might make a mistake like that in the Argentina case in the summer of 2001 somewhat less likely.

Fund's lender-of-final-resort function. In general, these other facilities have been directed toward "special balance of payments problems" which Article V Section 3(a) recognizes as potentially calling for "special policies" for IMF general resource lending.

Among the facilities that have been designed to deal with "special balance of payments problems," I noted in the introduction that the Systemic Transformation Facility (STF) established in 1992 was 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, it was a key priority of the international community 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 program.

For many years, the IMF has provided assistance to countries afflicted by natural disasters and, more recently, disasters due more to human action such as in East Timor. Usually such assistance has been provided through the Fund's standard facilities and sometimes (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) and Fund assistance for debt restructuring, as a set-aside within an SBA (established in and formally terminated in 2001(?)). The Supplementary Financing Facility established in 1977 was not really a new facility but rather 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 of 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 concerns the difficulties encountered by countries highly reliant on volatile export earnings from primary products or highly vulnerable to fluctuations in costs of key commodity imports, especially oil. 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 to this issue. These facilities have had a long and tortured history. The special balance of payments problems which these facilities seek to address are real, and the notion of a Fund facility that might address them is attractive.

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 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 of substantial policy adjustment as the 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. Persistent experience with these difficulties has led the IMF (rightly in my view) to terminate or suspend its special facilities directed at of export earnings or import cost volatility. Proposals to revive them in some form are made from time to time; but long experience indicates that there is little to recommend such proposals. The Fund's standard facilities remain available to help members deal with these problems; and there is no compelling evidence to suggest that, used with proper flexibility, these standard facilities are not adequate for the task.

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. And, it is even possible 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.

### **The Deadbeats Refinancing Facility**

One issue that has recently arisen 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 these arrears.<sup>10</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. These creditors were not too pleased with this change in Fund policy, but there was a sweetener in 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

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<sup>10</sup> 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; see *Selected Decisions and Selected Documents of the International Monetary Fund*, 24<sup>th</sup> edition, June 30, 1999, p. 106. 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.

new Fund programs and then expeditiously negotiated restructurings of their private external debts.

Argentina was 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 percent 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—about \$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. Taking account of 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 courts have effectively expropriated most of the equity value of foreign investments in Argentine banks and public utilities.

The Fund's program with Argentina effectively lapsed in 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. There was no doubt that the policies of the Argentine government fell well short of what would normally be needed in an SBA program meriting Fund financial support. 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 about a 25 percent decline 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. 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 mean 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 which would rollover 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 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—hopefully sometime relatively soon. 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, then it was not unreasonable for others also to accept delays. 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 to domestic creditors and investors.<sup>11</sup>

Arguably, a new Fund facility, which I like to call the Deadbeats Refinancing Facility (DRF), would have been helpful in pursuing this alternative approach. Despite the considerable flexibility with which the IMF has used the SBA over the years, there is understandably very great reluctance to say explicitly that 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. But 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, 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.

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<sup>11</sup> As Ted Truman notes in his overview paper, 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 Ted (and many others) that while 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 the ex post application of this policy to private creditors who had relied on the Fund's established practices and officially stated policy on lending into arrears.

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 a facility that allows 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 lapses as circumstances improve. Attaching a stigma to use of the facility (for instance by giving it an unattractive name) would also be useful.

Of course, if Argentina turns out to be a unique case, then 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 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 in an effort to show creative new thinking about ways to deal with emerging market financial crises which had reached epidemic proportions. Many of the ideas involved in the CCL had been around for years. The rationale for the CCL itself was essentially the following.

There are some countries, particularly among the emerging market group, that maintain very sound macroeconomic policies and that 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 negotiate a (precautionary) program before a crisis because of the stigma that generally attaches to countries with Fund programs. Nevertheless, these countries would benefit from the positive signal sent to financial markets by a large commitment of Fund support based the Fund’s general assessment of their very sound policies and practices, but without all of the usual paraphernalia of standard Fund conditionality. 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 be a winner all around.

Indeed, at the time of its adoption, there was considerable optimism about the likely success of the CCL. One very high Fund official told me that he expected that by the middle of the next decade (which is now), the CCL would account for over a 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, rings eternal; and there are new proposals to resurrect something similar to the CCL.

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 very reluctant to negative messages to financial markets about one of its members (for example in the cases of Argentina and Russia). But, 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. 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), the problem must be regarded as serious.

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. But if the qualification standards are set very high, 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 of the side of laxity is dangerous.

Third, realistically assessed, there is little that can be accomplished by something like the CCL that cannot be done with the SBA/EFF/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 that there is 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 emergencies, it can usually borrow substantial amounts of foreign currency 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 basis difficulties in mind, it should be asked, why the continuing search of an IMF facility like the CCL? In my view, this is because many associated with the IMF perceive that the CCL or something like it is the Holy Grail. It is the perfect

facility that will help to 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 have become severe, and that will involve the Fund more constructively and cooperatively (rather than confrontationally) with a wider group of members than those who immediately require the Fund's financial assistance. These hopes, in my view, are in vain. There is no perfect Fund facility that will accomplish these things—or even come close.

### **Broadening the Mandate for IMF Lending**

Over the years there have been many suggestions, and there are proposals today, to expand 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.

No matter how laudable and appealing may be the objectives of a broader mandate for IMF lending, there are very important reasons to keep the IMF focused on its primary task of lender of final resort to members facing external payments difficulties. Virtually no one who knows the 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 operations. Already there is concern about confusion and inefficiency resulting from overlap between the two institutions, especially in the realm of structuring programs and providing financial assistance to the very poor developing countries. Broadening the IMF's mandate further into areas that are or should be the primary domain of the World Bank can only add to these problems and be dysfunctional for 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 where countries with large obligations to the IMF because of these loans would face severe difficulties in meeting their obligations to the IMF. There would be two alternatives. Either the countries could be strongly pressed to maintain the high security of IMF loans, despite very severe economic problems and the necessity to write down substantially both private and bilateral non-IMF loans. Or the international community could back down from the long-established principle that (except possibly for some, but not all, basket-case countries) IMF loans must be fully repaid. As recent experience with debt relief for poor developing countries suggests, the first alternative is unacceptable to much of the world community and unlikely to be implemented.



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 repeatedly been made by senior officials of the US Treasury when arguing for quota increases before the US Congress. It is not quite the absolute truth, as indicated by the preceding discussion 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 Structural Adjustment Facility (SAF) in the early 1980s. The resources for the SAF 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 SAF provided moderate-size loans to a number of developing countries with a very low interest rate (1/2 percent per year), fairly long maturities, and (by the standards of other Fund facilities) mild conditionality.

As resources for the SAF ran out, the question of a successor facility inevitably arose. The SAF was popular with developing countries but not with most of the large creditor countries of the Fund. 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 Extended Structural Adjustment Facility (ESAF) to be funded by contributions from members to the ESAF Trust and subsidy account (administered by the IMF) and by resources from repayment of SAF loans. The ESAF featured firmer conditionality than the SAF along the lines of the SBA and EFF, but with particular attention to structural policy problems thought to be inhibiting the growth of poor developing countries. The ESAF was less popular with developing countries than the SAF, but more popular with the countries supplying the resources. 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. 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 was progressively increased. By the late 1990s, the Fund, World Bank, and other IFIs

were under pressure to join the party and agree to significant write downs in their loans to the poorest developing countries. The Highly 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 Bank under the HIPC. The resources for the Fund's operations under the PRGF come from the remainder of the ESAF resources and from monies derived in a complicated and nontransparent manner from a flim-flam operation involving the revaluation of some of the IMF's gold. Most recently, the G-8 Summit proclaimed the total write-off of all official loans to the poorest developing countries, including those of the Fund and other IFIs. How this grand gesture is to be paid for remains somewhat of a mystery.

From the IMF's experience with concessional lending, I draw two main conclusions. If the IMF is to continue with this practice after the current round of debt write downs and write offs, then it is very important to maintain a clear separation between concessional lending using resources specifically provided for this purpose and lending utilizing the Fund's general (quota-based) resources. I see no problem with selling a significant amount of the IMF's gold (as proposed by my colleagues Nancy Birdsall and John Williamson) and using the proceeds to benefit poor developing countries through grants or new concessional loans administered either by the Fund or the Bank. The agreed 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. In agreeing to supply these resources to the IMF, members have been assured in the Articles of Agreement and by repeated statements of senior public officials that the resources will be used for the purposes intended and that taxpayers will not be exposed to significant cost or risk of loss on account of the operations of the Fund. Without an explicit amended of 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 are clearly very bad ideas.

More generally, I also conclude that in an environment where political leaders and senior public officials are so 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/ESAF/PRGF in maintain Fund involvement with many of its poorest members, in assisting 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 other institutions

have tended to wimp out. It also recognizes that while the World Banks 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 a country deal with a temporary balance-of-payments problem by using grants rather than loans.

Nevertheless, it now seems clear that the international community is not prepared to enforce loan repayment on the poorest developing countries. Of course, the proposed general debt write off for the poorest countries 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 presently outstanding loans, it is reasonable to expect that a similar conclusion will be again be reached later when today's new loans are coming due for repayment. And, the performance of the poorest developing countries over the past three decades does not offer much hope that most who are in this category today will leap out of it within the next decade or two. Accordingly, what starts out as a concessional loan to a poor developing country today appears likely to transform itself into a grant by the time that 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 necessarily very insistent on repayment in its key lender of final resort function, should surely not be in this business.