The IMF as an International Lender of Last Resort

by Edwin M. Truman | October 12th, 2010 | 10:44 am

The G-20 leaders' meeting in Seoul should endorse a series of steps to move the International Monetary Fund (IMF) closer to becoming an international lender of last resort. The classic lender of last resort has the capacity (1) to lend unlimited amounts of funds to solvent institutions (2) on appropriate terms. Thus, to transform the IMF into a more effective international lender of last resort involves two components: design of the appropriate terms and financing.

With respect to the design component, a number of elements of an improved global financial safety net are at various stages of approval. They are:

- a further relaxation of the amounts available from and terms of access to the flexible credit line (FCL) for countries with very strong economic and financial policies;
- the establishment of a precautionary credit line (PCL) for countries with sound policies that do not qualify for the FCL and would be accompanied by limited, streamlined conditions (ex post conditionality) on their policies; and
- a global stabilization mechanism through which, in a crisis, the IMF temporarily could use an expanded tool kit. That expanded tool kit could include the unilateral offer by the IMF of FCLs for multiple qualifying countries as well as other special facilities and relaxations of existing facilities.

The first two of these three elements have already been approved by the IMF executive board and a moderate version of the third may be approved before the Seoul Summit. The G-20 leaders should endorse this progress and call for the further elaboration of the global stabilization mechanism.

However, this enhanced capacity to lend must be embedded in a broader policy framework that would address systematically the moral hazard issue facing all lenders of last resort. When central banks lend to solvent financial institutions, they in principle combine essentially unlimited access to funds with close supervision and regulation of the potential recipients of those funds; those are the "appropriate terms." The aim is to limit the potential for a financial institution to add excessive risk to its portfolio and then turn to the central bank for liquidity support when the institution is in fact insolvent or close to that condition.

For the IMF, this involves not only appropriate conditions attached to its loans but also tying IMF lending more tightly to ongoing surveillance and supervision of members' policies. The objective would be to combine the availability of different facilities to IMF members in a range of possible circumstances with the IMF's role in bilateral, and potentially multilateral, surveillance via comprehensive prequalification.

Comprehensive prequalification would work as follows:

Every member of the IMF is obligated to have an annual Article IV consultation and review of its economic and financial policies by the IMF staff and executive board. As an integral part of these reviews, the IMF staff should, in the future, indicate the policy terms for lending to every member country potentially eligible to borrow from the Fund.

For a country with very strong policies and a track record of policy performance, the staff would state its judgment that the country would be eligible to borrow under the FCL. For the country with sound policies. The staff would also state what changes in policies or policy commitments would be necessary for it to qualify for lending under the PCL. For the country with weak policies or a weak track record, the staff would outline the necessary changes in policies as part of a traditional stand-by arrangement (SBA), or perhaps a high-access precautionary SBA (HAPA).

This framework would apply to all countries. The IMF executive board could comment on the staff recommendation, as it now does on the staff policy assessment. But the board would not be required to act on the staff recommendation. Implementation of the approach should be supported by a commitment to make these staff reports public promptly and without significant modification. Under this framework, it would also be necessary to link the Article IV consultations more closely to financial sector assessments and to the work of the Financial Stability Board (FSB).

For example, the staff report on the US Article IV consultation might state that in the staff's judgment the United States would only be eligible for a PCL, not an FCL, and a PCL would be subject to policy conditions with respect to a longer-term fiscal plan to place US public debt on a sustainable path. Such a plan would include further concrete actions to control healthcare costs. The policy conditions would also include implementation of planned and additional financial sector reforms. Action in each of these areas was recommended in the most recent staff report for the US Article IV consultation. It would be necessary to make those recommendations more concrete and link them to a staff judgment about where US policies put the United States on the spectrum from FCL to PCL to SBA.

The multilateral consultation process would be introduced into the proposed framework via assessments of the global economic and financial environment. These assessments could lead to a staff recommendation with respect to support for a group of countries, as with the multilateral lending facility or global stability mechanism.

The comprehensive prequalification approach as a whole should help to reduce the stigma problem of borrowing from the IMF. Countries would in effect be responding to an invitation from the IMF staff to borrow on specific terms subject to the approval of the executive board.

A softer and more limited version of this approach was presented to the IMF executive board in March. Most executive directors reportedly were not enthusiastic. They were reported to have disliked the feature that, along with a positive list of countries qualifying for an FCL, there would also be a negative list of countries that did not even qualify for a PCL. This reluctance to accept supervision and regulation in the form of IMF surveillance illustrates the moral hazard problem with a more expansive approach to IMF lending. The two aspects—financing and ex ante surveillance—must be tied together.

There is also the issue of insolvency or illiquidity. Here countries are different from banks and businesses. Most countries' problems involve inadequate access to international liquidity and weak economic policies. Establishing the insolvency of a sovereign government is technically, as well as politically, challenging. This fact is underappreciated by those excessively concerned about the moral hazard associated with IMF lending. They want to rush countries into bankruptcy-type solutions in order to make an example of the countries' political leaders and punish investors.

Regarding the financial component of the IMF's lender of last resort role, the challenge is that, unlike national central banks, the IMF cannot issue its own liabilities in unlimited amounts. It relies upon the quota subscriptions from members and its ability to draw from the New and General Arrangements to Borrow (NAB and GAB) or on ad hoc borrowing arrangements. These ex ante financial resources are roughly $750 billion at present.

The IMF, however, requires the availability of financing on a much larger scale if it is to be credible in its role as the international lender of last resort. To that end, the G-20 in Seoul should endorse a doubling of IMF quotas. In addition to providing the Fund with at least $250 billion in new financing, bringing its total ex ante lending capacity with the enlarged NAB to $1 trillion, a doubling of IMF quotas would have other advantages.

Doubling IMF quotas would rebalance the IMF toward its traditional structure of a quota-based international financial institution. It also would provide each member of the IMF—in 2012, the earliest at which the increase in quotas would take effect—with an increase in its quota for the first time since 1998. In the period since then, global GDP is projected to have increased by more than 125 percent, global trade more than 200 percent, and global financial transactions by substantially more than that. This would just match the historical average annual rate of increase of IMF quotas—5 percent. But the IMF needs more financial resources if it is to enhance its role as the international lender of last resort.

Therefore, in addition to the steps already outlined here, the G-20 leaders in Seoul should encourage the IMF to put in place the procedures and mechanisms to borrow in international capital markets, which is permissible under the Articles of Agreement. They should also endorse an amendment of the IMF Articles that would allow the IMF to approve a special, temporary allocation of special drawing rights (SDR) in a crisis. Such a provision could perhaps be subject to endorsement by the International Monetary and Financial Committee (IMFC) prior to action by the executive board and not require an 85 percent weighted majority vote of IMF governors. A reduced supermajority of, say, 60 percent by the executive board might be required. The subsequent cancellation of the SDR over a five-year period would follow a declaration of the end of the crisis and might require only a majority vote.

Finally, the G-20 leaders in Seoul should endorse an amendment of the IMF Articles of Agreement that would authorize the IMF temporarily to exchange specially allocated SDR to the central banks issuing international currencies in the SDR basket in return for their own currencies. Those currencies would be used by the IMF to lend to other central banks to support their financial institutions. This specific proposal has four advantages:

- The mechanism would temporarily augment the IMF's financial resources as an international lender of last resort.
- It would help to centralize in the IMF this type of lender of last resort lending. At the height of the recent crisis, this type of support amounted to more than $600 billion actually lent via the swap lines of the Federal Reserve, principally, and the European Central Bank. It is at best uncertain whether the Federal Reserve will be comfortable in repeating such operations on a comparable scale in the future.
- The mechanism would permit the issuing central banks to use the SDR to obtain foreign currencies if they need them to offset exchange rate pressures resulting from the liquidity support operations.
- The mechanism, along with the other features I propose, would enhance the role of the SDR and hopefully limit somewhat the precautionary demand for increases in international reserves.

This posting was adapted from a paper prepared by Mr. Truman for a workshop on Regional and Global Financing Arrangements *in Washington, DC, on October 11, 2010, organized by the German Development Institute and the Rethinking Bretton Woods Project/Center of Concern*. *The proposals were also discussed in* The G-20 and International Financial Institution Governance*, Peterson Institute for International Economics Working Paper 10-13, September 2010.*