IMF FINANCING:
A REVIEW OF THE ISSUES

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United States Congress

March 1998

Executive Summary

This paper reviews key issues relating to IMF financing in the context of the recent Asian bailouts. Several major problems exist with current IMF lending practices. In particular, IMF lending promotes moral hazard, is overly dependent on taxpayer support, involves subsidized interest rates, and is often associated with conditions that are open to question. Furthermore, IMF operations are overly secretive or non-transparent in nature. Accordingly, continued unqualified support from the U.S. Congress is problematic. Whether or not financing is extended, ironclad guarantees are needed to ensure that IMF lending meet certain conditions mitigating the above-cited problems.

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I. INTRODUCTION

The 1999 budget proposal submitted by President Clinton calls for an $18 billion appropriation for the International Monetary Fund (IMF). This $18 billion appropriation request consists of two parts: $14.5 billion for a quota increase, and $3.4 billion for a new IMF credit line called the New Arrangements to Borrow (NAB).[1] The proposed quota increase and NAB commitment represent the U.S. share of a larger package of the proposed IMF expansion. The great majority of IMF lending activities are financed out of the quotas provided by member countries.

The quota increase and NAB are not needed to complete the Asian bailouts already underway; current IMF funds are sufficient to complete this assistance. The new funding would be used to finance future loans in addition to those already announced. Even after the completion of the Asian bailouts, the IMF would hold $30 billion in gold, retain some quota resources, and have access to an unused $25 billion IMF credit line known as the General Arrangements to Borrow (GAB).

The key issue before Congress is whether the IMF should be expanded through government-financed contributions and credit lines. The IMF was established in 1945 to finance temporary balance of payments problems under the fixed exchange rate system in place for most of the post-WWII period through 1973. However, under the flexible exchange rate system existing during the past three decades, IMF objectives have become less clear and focused. To an increasing extent, longer term financing is used for purposes other than short-term external adjustment problems. Recent IMF loan packages, for example, have required long-term restructuring of major sectors of national economies and significant adjustments to economic policy.

This alteration in IMF lending underlines an important change in the nature of IMF objectives. According to Columbia University Professor Charles Calomiris, who has served as an IMF economist and World Bank consultant:

> In the 1990s, the IMF has stretched the notion of liquidity assistance beyond any reasonable definition. IMF programs in Mexico and Asia are now *microeconomic bailouts that restore the solvency of clearly insolvent financial institutions*. That objective

[1] Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1999*, 1998, p. 129.

> has nothing to do with bank or government liquidity, or with temporary imbalances in the balance of payments.[2]

Recently, IMF operations have been the center of growing controversy. Points of contention include:

- **Moral hazard:** IMF bailouts encourage investors to assume additional risk in pursuit of extra-normal returns in the expectation that losses will be absorbed by the IMF and ultimately the taxpayers of affected countries.

- **Exposure of taxpayer funds:** U.S. government funds are used directly and indirectly in subsidized bailouts that promote perverse incentives leading to a more vulnerable financial system.

- **Inappropriate conditions:** Counterproductive policies that undermine economic performance are sometimes imposed by the IMF as loan conditions.

- **Transparency:** The IMF is a closed and secretive organization that operates in a manner inconsistent with openness, as well as U.S. performance and accountability standards.

The lack of transparency makes analysis of the IMF and its performance problematic. As former World Bank Chief Economist (Latin America) Sebastian Edwards has noted:

> For any outsider it is extremely difficult–utterly impossible some would even say–to fully evaluate the functioning of the IMF. Many of its decisions are confidential, as are most of the key documents that set the Fund's policy position. Moreover, the details of specific programs, including… memoranda of understanding, and other documents are also confidential. This makes the evaluation of programs' performance very difficult.[3]

II. IMF Performance and Results

Under the Government Performance and Results Act (GPRA), government programs are to be planned and reviewed using objective and measurable criteria whenever possible. Under the Act, the IMF's appropriation must be evaluated on the basis of its objective contribution to U.S. international economic policy. As the first quota

[2] Testimony of Charles Calomiris before the Joint Economic Committee, Congress of the United States, February 24, 1998, p. 20.

[3] Edwards, Sebastian, "The International Monetary Fund and the Developing Countries: A Critical Evaluation," Carnegie-Rochester Conference Series on Public Policy 31, 1989, p. 9.

increase to be considered after the GPRA went into effect, Congress has an important responsibility to review the current IMF appropriation with a focus on the performance and results of IMF activities.

The size of the current and future bailouts will reduce available IMF resources and ultimately lead to yet another request for more funding. The IMF has already suggested that an even greater quota increase will be needed relatively soon.[4] The magnitude of the recent bailouts, as well as the pending quota increase, suggest that a fundamental reevaluation of the IMF, its operations, goals, as well as its financing, is needed. In recent months, a threshold has been reached in IMF lending that raises basic questions about IMF decision-making, openness, policy advice, performance, and over-reliance on direct government funding.

One diversion in an IMF performance review is the dubious contention that under existing budget rules the IMF appropriation is not a net outlay and therefore involves no taxpayer cost. Although current accounting rules mask the cost of the IMF quota increases to the U.S., economic analysis clarifies the true nature of the transaction: real economic resources are transferred at subsidized interest rates from the U.S. economy to other nations. It is doubtful that these resources will ever be fully recovered. The U.S. may hold a paper IOU or an IMF computer entry, but the nature of the IMF quota increase entails a transfer of economic resources from the U.S. economy. If this were not so, there would be no point in an appropriation in the first place.

Additional costs of these IMF bailouts were delineated by Professor Charles Calomiris in recent testimony before the Joint Economic Committee:

> Three kinds of cost figure prominently: (1) undesirable redistributions of wealth from taxpayers to politically influential oligarchs in developing economies; (2) the promotion of excessive risk taking and inefficient investment; and (3) the undermining of the natural process of deregulation and economic and political reform which global competition would otherwise promote.[5]

One additional reason for concern about IMF intervention is IMF's operations, which are based on below-market funding costs and below-market lending rates. As Sir Alan Walters has indicated:

> By its very nature, IMF assistance [has been] given at a subsidized interest rate, in the sense that the rate charged was below that which the country could obtain on the international capital

[4] Chote, Robert, "IMF Chief Calls for $160 Billion Increase," *Financial Times*, December 13/14, 1997.
[5] Testimony of Charles Calomiris before the Joint Economic Committee, Congress of the United States, February 24, 1998, p. 2.

> markets. The subsidies have both widened and deepened over time.[6]

Economic analysis indicates such taxpayer subsidies to IMF borrowers lead to inefficient results and a misallocation of economic resources. Part of the reason for this inefficiency was identified in the testimony of former Federal Reserve Governor Lawrence Lindsey before the Joint Economic Committee. As Lindsey argued:

> … there is no real assessment of credit worthiness [in IMF lending]. Quite the contrary, an apparent requirement to get an IMF loan is that the borrower is <u>not</u> creditworthy, in that the borrower could not obtain private sector funding.[7]

The IMF's practice of loan subsidies and the resulting misallocation of resources raises serious policy concerns. The recent orientation of IMF lending towards subsidizing loans to insolvent entities is troubling and qualitatively marks an important departure from past practices. Given this change and the significant increases in IMF loans, its compatibility with the objectives of U.S. international economic policy must be considered by Congress. Specific reforms of the IMF are discussed in a later section of this paper.

III. THE IMF AND ASIA

Important questions have been raised by the recent IMF bailouts of South Korea, Indonesia, and Thailand. These IMF loans are tied to a number of conditions in the form of policy changes, some of which involve improved supervision of financial institutions and efforts to eliminate corruption. Additional loan conditions often include tax increases, tight monetary policies, and other guidelines that foster austerity.

On November 20, 1997, a high U.S. Treasury Department official was reported to have designed a framework for future Asian bailouts referred to as the "Manila plan," named for the location of the formative meeting and modeled after the structure of the Indonesian bailout.[8] The Manila plan calls for IMF loans to provide the initial lending support to a distressed economy, supplemented by backup funds contributed by major nations such as the United States. Almost immediately, the Koreans requested IMF assistance that quickly grew into the largest bailout package ever made by the IMF. The

[6] Walters, Alan. "Do We Need the IMF and The World Bank?," Current Controversies, No. 10, Institute of Economic Affairs, London 1994, p. 11 [brackets added].
[7] Testimony of Lawrence Lindsey before the Joint Economic Committee, Congress of the United States, February 24, 1998, p. 2 [brackets added].
[8] Davis, Bob and G. Pierre Goad, "Asia Reaffirms U.S. Primary on Bailouts," *Wall Street Journal*, November 20, 1997.

Treasury Department had a very public role not only in the general design of the bailout framework but also in the specific components of the Korean bailout.

Both the Korean government and the IMF have agreed to the bailout terms. An IMF package of loans amounting to $21 billion will be supplemented by the World Bank, the United States, and others for a total of $57 billion. Unfortunately, the first Korean bailout failed to restore confidence, and a second bailout based on debt restructuring was implemented. The IMF has enough resources on hand to cover the $21 billion committed in the first bailout, and congressional action will have no bearing on whether these funds are disbursed. However, the Asian crisis does provide a useful point of departure for analysis of the major issues.

Brief Background

In recent years, a number of Asian economies experienced rapid capital inflows brought about by the region's fast growth, high returns on investment, and desire for diversification on the part of investors in developed countries. Perceived exchange rate risk was minimized because many of these countries tied their currencies to the U.S. dollar. This capital, in turn, was often allocated by centralized, bureaucratic, and sometimes corrupt government-controlled banking systems into questionable long-term (e.g., real estate) projects.[9] In other words, poorly regulated financial institutions in these countries made long-term loans that were financed by short-term foreign liabilities. The result was large amounts of short-term dollar denominated debt together with maturity and currency mismatches.

Risk Reassessment

For a number of reasons, lenders began to reassess risk. Dollar appreciation against the yen not only forced these economies to tighten monetary policy to defend their currencies but also significantly hurt their export markets. These developments encouraged speculation against the pegged exchange rate. Rapid disinflation, asset price deflation, and declines in collateral value further weakened poorly regulated financial sectors. Heightened exchange rate risk, capital outflows, and eventually exchange rate depreciation resulted.

Possible Contagion

As the exchange rate in these countries depreciates, debt denominated in dollars instantly becomes more burdensome (because the debt now must be repaid in dollars that are more valuable) and financial sector weakness is exacerbated. As a result, risk assessment worsens, leading to an increased demand for limited dollar reserves.

[9] At this earlier stage, the IMF and World Bank should have criticized the banking practices of these countries and made recommendations for reform.

At this point, proponents of IMF intervention argue that if no assistance is provided in the form of short-term dollar loans, further capital flight will occur, resulting in accelerated currency depreciation, interest rate increases, and further asset price deflation. If the trend continues, they argue, these problems may spread: contagion can occur and capital flight can accelerate. The result may be competitive devaluations and the possible adoption of protectionist measures in affected countries that are export markets for the United States. Consequently, there may be a severe slowdown in the local economy and a sharp decrease in living standards. Additionally, the U.S. economy's investors, equity market, export sector, and employment could also be impacted.

IV. IMF Assistance

Advocates of IMF intervention maintain that prompt IMF assistance in the form of short-term hard currency loans can temporarily bolster confidence by providing assurance that back-up lending or emergency liquidity provision is readily available. According to proponents of IMF bailouts, this can work to restore investor confidence and prevent worsening capital flight by guaranteeing a reliable source of foreign exchange reserve loans. IMF lending can temporarily stabilize the situation and stem contagion. In short, the case for immediate IMF lending is to keep the problem from getting worse and to reduce the size of the calamity.

V. Problems with the IMF Bailouts

Despite potential stabilizing effects in the short run, there are a number of major problems with current IMF bailout practices:

- **IMF Lending Creates Moral Hazard:** IMF bailouts not only fail to change incentives to correct reckless lending behavior, but also embody incentives encouraging this behavior. Existing lending practices persist because both borrowers and lenders recognize that if loan problems should occur, a bailout will readily materialize.[10] To change such incentives, some lenders and borrowers should suffer losses and shoulder some of the risks of their poor decisions. Insolvent institutions should be allowed to fail. Necessary

[10] Some economists argue that the Mexican bailout created incentives for future IMF bailouts and, consequently, is partly responsible for current problems in Asia. For example, Allan Meltzer said: "The IMF's programs drive a large wedge between the social risk – the risk borne by the troubled country – and the private risk borne by bankers. This is one source of moral hazard, and one reason we have a crisis-generating system. A common argument in its defense is that Mexico repaid its loans to the U.S. government and the IMF. That argument misses the point. If banks and financial institutions had taken losses in Mexico, they would have exercised elementary judgment about risks in Asia." Testimony of Allan Meltzer before the Joint Economic Committee, Congress of the United States, February 24, 1998, p.3.

adjustments should be allowed to occur. Lending at market-determined, non-subsidized interest rates would also work to minimize moral hazard.

- **U.S. Taxpayer Funds Are Overly Exposed:** Current IMF (and Treasury) bailout practices often expose U.S. taxpayer funds. The Exchange Stabilization Fund (ESF) has been used to provide back-up financing for several IMF bailout packages. Since U.S. taxpayers do not participate in emerging market lending/borrowing decisions, the case for using their funds for these purposes is problematic. This use of the ESF circumvents the congressional appropriations process so that taxpayers have no voice regarding the Treasury's use of their funds. The IMF and Treasury have not seriously considered alternative sources or mechanisms of funding to minimize taxpayer exposure, such as IMF borrowing from the market (like the World Bank and other development banks) or IMF gold sales.[11] At a minimum, Treasury and the IMF should clearly explain why taxpayer-financed lending may be necessary.

- **The IMF Often Attaches Inappropriate Lending Conditions to Its Loans:** The IMF ties several forms of conditions to its loans. Austerity conditions involving tax increases are often part of these lending programs, and these conditions are sometimes applied indiscriminately to countries facing different sets of circumstances. Critics argue that these conditions result from inappropriate use of economic models focusing principally on aggregate demand management and not on supply conditions. Despite rhetoric to the contrary, less emphasis is placed on government restructuring or downsizing as the important element of this conditionality. Additionally, IMF conditionality often impedes the necessary adjustment process, is frequently reactive rather than pro-active, and often involves an unspecified timetable, allowing loan recipients to backslide on required adjustments.

- **IMF and Treasury Policies Should Be More Transparent:** Both IMF and U.S. Treasury bailout policies remain overly secretive, ambiguous, and ill-defined. Because these policies are seldom explained to the public, unnecessary misunderstanding, resentment, and opposition often result. A good deal more transparency is called for from both of these taxpayer-financed institutions. Explicit specification of the IMF's objectives, for example, should be accompanied by clarification of the procedures and practices by which it accomplishes these objectives. At a minimum, full explanations of the conditions, lending terms, subsidies involved, and the rationale as to why such lending is necessary are essential. Additionally, those entities actually receiving taxpayer subsidies should be identified.

[11] Proposals for IMF borrowing from capital markets have been made before. See, for example, The Brandt Commission, *Common Crisis North-South: Cooperation for World Recovery*, MIT Press, Cambridge, Mass., 1983, p. 14.

The notion that IMF policies can be counterproductive is not limited to IMF critics. A recent IMF internal study found that elements of its conditions imposed on Indonesia sparked a bank crisis that deepened the financial crisis in other Asian nations. This IMF analysis underscores the counterproductive potential of IMF policies and highlights its lack of transparency.[12]

VI. Overview of Policy Implications

The Administration's IMF appropriation request may result in a number of alternative outcomes. The entire $18 billion appropriation could be approved without any significant conditions being attached. Alternatively, the entire appropriation could be rejected due to concerns about the effects of IMF expansion, as well as IMF reforms required for continued U.S. funding. Intermediate alternatives could include a range of incremental funding options probably tied to a variety of conditions on the IMF.

Regardless of the status of new funding for the IMF, the recent transition of IMF lending from provision of short-term liquidity to subsidization of insolvency is troubling. Lack of transparency has permitted the IMF to make this transition without much public recognition in the United States.

The adoption of more transparent practices by the IMF is necessary if Congress is to be adequately informed about this important element of U.S. economic policy. Minutes of IMF board meetings should be publicly released (after appropriate editing of any proprietary and intelligence information), loan program documents and staff reviews of loan programs should be made public, and an independent advisory board should be established to annually review IMF activities.

Furthermore, the subsidization of IMF lending at below-market interest rates exposes the fallacy that there is no cost associated with quota contributions. Base IMF lending rates, currently under 5 percent, are, after all, below the rate at which the U.S. government can borrow. Although some IMF loans are made at higher rates, artificially low borrowing and lending rates characterize IMF lending operations. These below-market borrowing rates do not adequately reflect the potential risk posed by insolvent borrowers, and thereby exacerbate the moral hazard problem discussed above. The Congress must decide whether this policy of subsidized loans for insolvent entities is a desirable objective of U.S. international economic policy.

As Walter Bagehot, eminent former editor of *The Economist,* explained in his classic formulation more than a century ago, a lender of last resort should lend freely at a penalty interest rate. Subsidized loans are not necessary to assist illiquid borrowers and are

[12] Sanger, David E., "IMF Reports Plan Backfired, Worsening Indonesia Woes," *New York Times,* January 14, 1998.

counterproductive for insolvent entities. Economic efficiency would be promoted by IMF lending at market interest rates determined in international financial markets.

Accordingly, Congress could stipulate that U.S. funds should not be used to provide subsidized loans. This would help contain the moral hazard problem and encourage the IMF to operate on a more economically efficient basis. Another market-oriented reform would encourage IMF issuance of securities in the financial markets instead of relying so heavily on government funds.

VII. Recommendations

In view of these many problems, any continued or additional U.S. financial support of the IMF should be accompanied by guarantees that the IMF itself meets certain conditions. In particular, to receive U.S. financial support, the IMF should:

- Work to minimize the moral hazard problem both by ensuring that some costs are borne by those lenders and borrowers initiating the ill-fated loans and lending more in accordance with market-determined interest rates.
- Explore alternative funding sources or mechanisms to minimize U.S. taxpayer exposure.
- Promote lending conditions that work to attract capital as well as to foster private sector economic growth, free markets, and smaller public sectors.
- Become significantly more transparent in a number of specific ways. Clearly identifying policy objectives as well as the procedures and practices used to achieve these objectives is essential.

VIII. Conclusion

This paper has reviewed some of the major issues on both sides of the debate over IMF funding. The concerns raised regarding moral hazard, transparency, taxpayer exposure, and conditionality are widely recognized. For example, the Treasury has acknowledged the validity of the moral hazard problem, the IMF has recognized the damage perverse conditionality may cause, and such IMF loan conditions are widely criticized from various points of view. Furthermore, almost all analysts recognize the benefits of a more transparent IMF. Consequently, it appears likely that any congressional action on IMF funding will include conditions intended to mitigate these concerns.

IMF reforms are needed irrespective of what happens to the Administration's IMF appropriation proposal now before Congress. Two IMF reforms are especially needed at this time: improved transparency and increased use of market interest rates. Improved transparency would require the public disclosure of IMF decision-making meetings as well as program documents and related material. Future IMF loans should employ market interest rates, not subsidized rates that exacerbate the moral hazard problem.

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