

How should IMF resources be expanded?

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Among the more striking aspects of the IMF is how little its financial structure has changed since its inception in 1944. For while over the past sixty years the world economy has changed beyond recognition, the IMF has retained its basic structure as an international financial cooperative. Within that structure, IMF member countries' borrowing rights and voting power are determined by their quota contributions. At the same time, the predominant way in which the IMF's expanded lending operations continue to be funded is through periodic increases in its members' quota contributions¹.

The IMF's heavy reliance on quota increases has contributed to the following set of problems:

- (a) Increased political resistance and delays, which the IMF has experienced in raising additional resources through quota increases;
- (b) Questions of equity in the way in which the subsidized cost of the IMF's lending operations are distributed amongst member countries;
- (c) Problems associated with a lack of transparency in the IMF's operations; and,
- (d) Issues of a "moral hazard nature" that have arisen from the IMF having at its disposal a large pool of loanable resources, which are not subject to effective legislative oversight between the periodic quota increases.

Any future increase in the IMF's funding should be mindful of the problems that have arisen from the IMF's past heavy reliance on quota increases as its principal source of funding. They should also be mindful of the fact that potential resistance to IMF quota increases, particularly in the United States, is not likely to abate anytime soon. Accordingly, this chapter suggests that the IMF might entertain the idea of large scale private sector borrowing and gold sales to augment its loanable resources. It also suggests that the IMF might usefully merge its general account and its SDR accounts along the lines recently suggested by Jacques Polak in

¹ While quota increases remain the primary way that the IMF is funded, since its inception the IMF's financial structure has changed from being one based on gold and the dollar to one now based on about 50 different currencies plus the Special Drawing Right.

order to extend the range of countries able to provide useable resources to the IMF.² These alternative sources of financing might relegate the role of future quota increases to that of addressing the issue of the present under-representation of Asian countries in the IMF.

The remainder of this chapter is organized as follows. The first two sections briefly describe the sources of the IMF's resources and the nature of the IMF's lending operations. A third section looks at the cost of the IMF's subsidized lending and the manner in which this cost is borne by creditor countries. A fourth section considers the relative merits of private sector borrowing, while a fifth section considers the issue of IMF gold sales. A final section examines the relative merits of merging the IMF's General and SDR Accounts along the lines suggested by Jacques Polak.

Source of the IMF's Resources

Stripped of all its technicalities, the IMF remains the equity-funded financial institution that it has been from its inception in 1944. More specifically, in keeping with its nature as a lending cooperative, the IMF is mainly a pool of currencies and reserve assets built up from members' fully paid in capital subscriptions in the form of quotas. As in a cooperative, these quotas determine importantly both the voting and borrowing rights of each member. The overall size of the quotas themselves are reviewed, and possibly increased, every five years in the light of the IMF's expected need for loanable resources. The last IMF quota increase was in 1998 and the present size of the IMF's quotas is SDR 214 billion, or around US\$300 billion.

The composition of the IMF's resources flows from the way in which its member countries pay in their quota subscriptions. A quarter of member quotas have to be paid in the form of "reserve assets", which initially were defined exclusively as gold. Since 1978, however, these "reserve assets" have been defined as either the IMF's Special Drawing Rights or else those currencies determined by the IMF as being usable currencies. The remaining three quarters of member countries' subscriptions are paid in their own currencies. As a result, around 15 percent of the Fund's currency pool consists of resources that are not useable in the IMF's lending operations. This is the case because the balance of payments position of the countries providing those currencies is not sufficiently strong to allow the IMF to use them in providing support to members in need of hard currency.

Member countries acquire a claim on the IMF in exchange for the reserve assets which they provide. This claim, referred to in the IMF as a country's "reserve tranche position", is by definition equal to the member country's quota minus the IMF's holdings of that country's currency. The IMF pays interest on member countries' reserve position at slightly below the SDR interest rate other than on that part of the reserve tranche paid in gold. The SDR interest rate in turn is determined weekly as a weighted average of the three-month government interest rates in the United States, Europe, Japan, and the United Kingdom.

In principle, the IMF may supplement its resources by borrowing from official and private sources as needed in order to forestall or cope with a threat to the stability of the

² J.J. Polak, "Streamlining the Financial Structure of the IMF", Princeton Essays in International Finance, No.216, September 1999.

international financial system. However, the IMF, constrained by the preferences of the major creditor countries, has only borrowed sparingly from the official sector. At present, the Fund has in place the General Arrangements to Borrow (GAB) and the New Arrangements to Borrow (NAB). Under the GAB, which was originally established in 1962, the IMF may borrow up to SDR 18.5 billion, or around US\$25 billion, from 11 industrial countries and from Saudi Arabia. Under the NAB, which became operational in 1998, the IMF may borrow up to a total of SDR34.5 billion, or US\$50 billion, from 25 official lenders under the combined GAB and NAB. The interest rate on borrowing under the GAB is the SDR rate, while the interest rate under the NAB may be at or higher than the SDR rate.

A further, albeit very limited, way in which the Fund's pool of resources has been increased has been through additions to its precautionary balances. These balances comprise the IMF's reserves as well as resources that have been set aside in a special contingent account. This latter account, which presently is in the amount of around US\$2 billion, has been collected from debtor and creditor members to deal with the persistence of overdue obligations to the IMF by countries with intractable balance of payments positions.

The IMF's Lending Operations and Interest Charges³

In considering how best to fund any future increase in IMF resources, careful attention needs to be paid to the major way in which the IMF's lending operations have changed over the past sixty years. In addition, one should be mindful of the subsidized nature of the IMF's lending and to focus on the question as to how best the burden of that subsidization should be distributed amongst member countries.

During the 1950s, 1960s, and 1970s, the preponderance of IMF lending was to industrial countries and was temporary in nature. This lending was principally made by the IMF to help industrial countries address short-term external current account problems, which arose from the Bretton Woods system of fixed exchange rates. The general way in which such lending was extended was through a stand-by arrangement⁴ under which repayment was expected within 3 to 5 years.

By contrast, since the 1982 Mexican peso crisis, the major part of resources lent by the IMF has been to a select group of emerging market economies and has in practice been of very much longer duration than before. This lending has mainly been directed at helping those emerging market countries address balance of payments problems arising principally from capital movements associated with the liberalization of global capital markets.

In reflection of the more deep-seated nature of the balance of payments problems experienced by emerging market economies following the 1994 Mexican peso crisis, the IMF

³This chapter confines itself to IMF lending in the General Resource Account, which accounts for around 95 percent of the IMF's overall lending. For a fuller discussion, see IMF, "Financing the Fund's Operations—Review of Issues", April 11, 2001

⁴A stand-by arrangement is a decision of the IMF that assures a member country that it can make currency purchases for specific amounts from the IMF during a period of time, provided that the member country observes the terms set out in the arrangement.

has resorted to a variety of lending facilities, which have different maturity and interest rate terms. The three principal lending facilities used have been as follows:

- (a) **Stand-by arrangements**, involving the use of the credit tranches, have been used to deal with temporary balance of payments problems. Use of resources under these arrangements have been expected to be repaid within 2¼ to 4 years unless the country's external position allowed it to repay these borrowed funds at an earlier date;
- (b) **The Extended Fund Facility (EFF)**, which was introduced in 1974, was used for countries with longer-term balance of payments difficulties resulting primarily from structural problems. Borrowing under this facility has a repayment period of 4 ½-7 years; and,
- (c) **The Supplemental Reserve Facility (SRF)** was introduced in 1997 to supplement resources made available in the credit tranches and the EFF. This was thought necessary in order to provide financial assistance to countries for "exceptional" balance of payments difficulties owing to a large short-term financing need resulting from a sudden and disruptive loss of market confidence. This facility provided the bulk of the IMF's lending to Argentina, Brazil, Indonesia, Korea, Russia and Turkey during the second half of the 1990s. Repayments under this facility are expected to be made within 1-1½ years.

While the interest rate charged on IMF lending differs across its various lending facilities and includes a surcharge, these interest rates are subsidized in the sense that they are considerably below the rates at which the borrowing countries could raise funds in the market. For normal borrowing under stand-by arrangements, countries pay a small margin above the weighted three-month government interest rate of the major countries, which the IMF pays on the reserve tranches of creditor countries. The small margin added to the basic interest rate is calculated to cover the IMF's administrative costs and to fund additions to the IMF's reserves.

For borrowing under the credit tranches and the EFF at high levels of credit outstanding,⁵ the IMF adds a surcharge of 100-200 basis points to its basic lending rate. This surcharge is intended to discourage unduly large use of Fund credit. For borrowing under the SRF, the IMF adds a surcharge of 300-500 basis points, which is intended to encourage early repayment to the IMF.

The Cost of Subsidized IMF Lending

IMF lending to the emerging market economies at the rates described above constitutes a subsidy to those countries. The cost of bearing this subsidy is not spread evenly amongst member countries. Rather, it is borne disproportionately by those creditor countries having reserve tranche positions with the IMF, which in effect provides the IMF with its loanable resources. In

⁵ Use above 200-300 percent of quota

recent years, three countries alone – the United States, Germany, and Japan—have borne the lion’s share of the IMF subsidy to the emerging markets. These three countries, which in aggregate hold 45 percent of IMF quotas have on average accounted for 60 percent of the IMF’s reserve tranche position and have accordingly borne around 60 percent of the IMF’s implicit subsidy to the emerging markets.

While it is generally recognized that the IMF lends at below market interest rates, there is considerable divergence of opinion as to the magnitude of the implicit interest rate subsidy. At the low end of these estimates are Zettelmeyer and Joshi, who calculate that between 1973-2003 IMF rates of return on lending to high and middle-income countries were on average 30-150 basis points lower than comparable lending rates paid by industrial countries.⁶ Over the same period, they calculate that IMF lending to poor countries was subsidized by around 400 basis points and lending to HIPC countries was subsidized by around 600 basis points.

The strength of Zettelmeyer and Joshi’s calculation is that it is based on realized cash flows to the IMF as well as repayment projections. However, as the authors themselves recognize, a weakness of their estimates is that they could be downwardly biased by the assumption that in the end countries fully repay the IMF. In today’s world, where as much as 70 percent of IMF loans outstanding are to Argentina, Brazil, Indonesia, and Turkey, that assumption could prove to be too strong.

At the high end of the spectrum is Adam Lerrick, who makes the assumption that the preferred creditor status of the IMF is only worth 50 percent of the private sector credit spread as measured by the JP Morgan Emerging Bond Index.⁷ In Lerrick’s view, the IMF’s lending subsidy to the emerging market borrowers can be viewed as occurring through two channels:

- (a) First, the surcharges that the IMF levies on its upper credit tranche and SRF lending falls short of 50 percent of the spread between emerging market long dated bonds and those of the United States. Whereas the maximum surcharge that the IMF imposes on its lending is between 300 and 500 basis points, the average emerging market spread in relation to US Treasuries has been 780 basis points as measured by the JP Morgan Emerging Market Bond index.
- (b) Second, while the IMF funds itself at the three-month government rate in the major industrial economies, its lending to the emerging markets is typically for long periods of time. In this context, one only need recall that as of mid-2005, some five years after the bulk of this emerging market borrowing had been contracted, Argentina, Brazil, Indonesia, and Turkey still had outstanding loans to the IMF in the amount of US\$50 billion. While there is certainly some premium in the IMF’s lending rates over its funding rates, this premium hardly matches the typical spread between short-term and long-term interest rates in the industrial countries.

⁶ Jeromin Zettelmeyer and Priyadarshani Joshi, *Implicit Transfers in IMF lending, 1973-2003*, IMF Working Paper, January 2005.

⁷ Adam Lerrick, “Funding the IMF: How much does it really cost?” *Carnegie Mellon, Quarterly International Economics Report*, November 2003.

On this basis, Lerrick calculates that for the United States Treasury, the IMF's implicit interest rate subsidy in lending to emerging market economies has amounted to US\$1.9 billion a year over the period 1999-2003. Around two thirds of this amount reflected 50 percent of the difference between the IMF's lending rates and those which emerging market countries would have had to pay in the market. The remaining one third reflects the average 300 basis point difference between the blended three-month government interest rate at which the IMF remunerates reserve tranche positions and the blended industrial government bond rates for those maturities at which the IMF effectively lends to the emerging market economies.

The IMF rationalizes its subsidized lending to the emerging markets on the grounds that such lending should be viewed as a public good. According to this line of reasoning, were the emerging markets not able to borrow in an emergency at the subsidized rates offered by the IMF, they would be more likely to default. That in turn would raise the systemic risk of contagion, which is worth heading off by subsidized lending in much the same way as central banks act as lenders of last resort to their domestic banking systems.

While there is certain plausibility to the public good argument, one could equally well argue that extraordinarily large-scale IMF lending to emerging markets has often constituted moral hazard.⁸ This would particularly seem to have been the case in the IMF's lending to Argentina in late 2000 and mid-2001 where such lending encouraged further reckless private sector lending to Argentina and which in the end did not stave off Argentina's eventual default.⁹ As such, one might question the wisdom of very large scale IMF lending at subsidized rates in the absence of the country's adherence to very strict prior conditions

Private Sector Borrowing

Until recently, the IMF had few options available to it to increase its resources. Either it could avail itself of the periodic and cumbersome five-yearly quota increase exercises or it could resort to very much more limited official borrowing under either the General Arrangement to Borrow or the New Arrangements to Borrow. However, as the 2003 12th five-yearly IMF quota review exercise proved, the IMF has now run into increasingly strong resistance to further quota increases, particularly in the United States Congress.¹⁰ In part, this resistance has reflected a philosophical antipathy to large-scale multilateral lending on moral hazard grounds. In part, this resistance has reflected a natural aversion to "foreign aid" and the perception that this would involve a large budgetary outlay even though as an "exchange of assets" the formal budgetary treatment would not require an outlay. These reasons would presumably also make it difficult for the IMF to increase the size of either the GAB or the NAB.

The difficulty and delays in increasing IMF resources through quota increases or official borrowing would suggest the need to explore alternative avenues for raising capital. In this respect, one must be struck by the IMF's reluctance to date to have availed itself of private sector borrowing as a means to increase its resources. This is particularly the case since the IMF could

⁸For a fuller discussion, see the Meltzer Commission Report, 2000

⁹Michael Mussa, *Argentina and the Fund: From Triumph to Tragedy*, July 2002.

¹⁰For a discussion of earlier resistance by the US Congress to IMF quota increases see Chapter 17 of James Boughton's *Silent Revolution: The International Monetary Fund 1979-1989*, 2001.

very well have resorted to such borrowing without the need for any change to its Articles of Agreement.¹¹ While such borrowing on any large scale might have been difficult in the early years of the IMF, when global capital markets remained underdeveloped, it can hardly be the case today where international capital market bond issuance now runs into the trillions of US dollars on an annual basis.

On the basis of the World Bank's experience, Adam Lerrick argues persuasively that the IMF could over time structure a private sector borrowing program in the amount of up to US\$100 billion based on an AAA rating from the international bond rating agencies.¹² The principal assets that would back such borrowing would be the IMF's US\$300 billion in currency holdings, its 103 million ounces of gold, and its \$50 billion loan portfolio. In the latter respect, the IMF's preferred creditor status, which places borrower obligations to the IMF above all other indebtedness, would enhance the value of this loan portfolio in the market's view.

Judging by the World Bank's experience with private sector borrowing, it would be reasonable to expect that the IMF could borrow over time as much as US\$100 billion in the private capital market. It could do so at highly favorable rates that might allow it to earn a significant spread on its associated investments.¹³ As such, IMF charges to its borrowers would not need to be changed to cover the cost of its private market funding.

Presumably, if one wanted to limit the risk of moral hazard lending by the IMF that a readily available supply of loanable resources would encourage, one could limit the IMF's initial resort to private sector borrowing to around US\$30 billion. This initial borrowing would provide the IMF with a cushion to meet unforeseen and sudden lending requirements. After building up this precautionary cushion, the IMF would subsequently approach the private market on a needs be basis after a careful case by case assessment of the potential future demands on the IMF's resources.

A distinct advantage of private market borrowing over continued reliance on quota increases to fund expanded IMF loan operations would be that it would obviate the delays and uncertainties associated with having to obtain US congressional approval for quota increases. Moreover, it would save significant amounts of budgetary resources to the treasuries of those

¹¹ Under Article VII of the IMF's Articles of Agreement, "the IMF may, if it deems such action appropriate to replenish its holdings of any member's currency in the General Resources Account needed in connection with its transactions.... propose to the member that, on terms and conditions agreed between the Fund and the member, the latter lend its currency to the Fund or that, with the concurrence of the member, the Fund *borrow such currency from some other source either within or outside the territories of the member*, but no member shall be under any obligation to make such loans to the Fund or to concur in the borrowing of its currency by the Fund from any other source."

¹² Adam Lerrick, Private Sector Financing for the IMF: Now Part of an Optimal Currency Mix, Bretton Woods Committee, April 1999.

¹³ At the end of fiscal 2004, the World Bank's outstanding borrowings from capital markets exceeded US\$103 billion (net of swaps). The World Bank is still able to borrow on highly favorable terms in large part reflecting the capital commitments of its sovereign shareholders and the preferred creditor status accorded by its borrowing members that support its AAA credit borrowing. During 2004, the Bank's cost of new borrowing averaged 38 basis points below the London Inter-Bank Offered Rate.

creditor countries, which now bear the burden of the cost of the IMF's subsidized lending. A further advantage of private sector borrowing is that it would force a greater degree of transparency and accountability in the IMF's financial operations.

Over the years, a number of objections have been raised against the IMF resorting to private sector borrowing.¹⁴ However, these objections would appear to have lost validity as both the IMF and the international financial markets have evolved. Among the more often cited objections is that private sector borrowing by the IMF would impair the liquidity of member countries' reserve tranche positions, which they count upon in their international reserve holdings. This is purported to be the case since these reserve tranche positions would in some sense now need to be maintained as collateral against the private sector borrowing.

One might ask, however, how liquid are creditor countries' reserve tranche positions in today's IMF where so much of its loan portfolio is tied up in but a few emerging market countries, which are very unlikely to repay the IMF anytime soon? Or is it not the nature of the IMF's past lending practices, rather than the way in which it has been funded, that has rendered the IMF's balance sheet illiquid? So long as the IMF did not engage in irresponsible emerging market lending, there would seem to be no reason to worry about the IMF's private sector borrowing impairing the liquidity of reserve tranche positions.

Another objection often cited against IMF private sector borrowing is that one would not want the IMF to be competing with its member countries in the international capital market. While this objection might have had plausibility in the earlier years' of the IMF, it would seem that capital markets today are of such size and scope that any envisaged Fund borrowing in the markets will have an insignificant effect on the market terms and conditions available to its member countries.

Gold Sales

A further, albeit limited, way in which the IMF could raise additional resources would be to mobilize its present gold holdings of 103.4 million ounces. These holdings, which the IMF acquired mainly through member countries' payment of 25 percent of their initial IMF quota subscriptions, are presently valued on the IMF's balance sheet at around US\$9 billion, or at an average price of US\$87 an ounce. At current market prices, the IMF's gold is worth around US\$45 billion. Sale of this gold could potentially provide the Fund with an additional US\$36 billion in loanable resources.

Subject to an 85 percent majority vote, the IMF's Articles of Agreement allow the IMF to sell its gold outright on the market on the basis of prevailing market prices. The Articles also allow the IMF to accept gold in the discharge of a member country's obligations at an agreed price based on market prices at the time of acceptance.¹⁵ It was in this latter manner that, in 1999 and 2000, the IMF mobilized around 12.9 million ounces of its gold holdings through a series of separate but closely linked transactions with two member countries (Brazil and Mexico), which

¹⁴ For a fuller discussion of these objections see Lerrick *ibid*, 20-22.

¹⁵ While the IMF might dispose of its gold in the manner cited above, the IMF does not have the authority to engage in any other gold transactions such as loans, leases, swaps, or use of gold as collateral.

had financial obligations falling due to the IMF.¹⁶ The IMF undertook these transactions in order to finance IMF participation in the Heavily Indebted Poor Countries (HIPC) Initiative.

While seemingly a potentially attractive way of further augmenting the IMF's stock of loanable resources, the gold sale route has a number of severe limitations.

- (a) First, at best, the gold solution would be a one-off solution, which at the maximum could raise US\$36 billion in additional resources. Even this latter amount is questionable since the IMF would need to be mindful not to unduly impair its balance sheet position. This is particularly the case given that Argentina, Brazil, Indonesia, and Turkey between them still account for such a large proportion of the IMF's outstanding loans.
- (b) Second, any gold sales by the IMF would need to be staggered over several years if the international gold market is not to be destabilized.¹⁷ As a result, the amount of money that the IMF could raise through gold sales would be rather limited in the immediate term;
- (c) Third, any IMF gold sales would require an 85 percent majority vote in the IMF Board and would in the case of the United States be subject to Congressional approval. This could constitute an insuperable barrier to approval of any meaningful gold sales in much the same way as the IMF is encountering in getting approval for further general quota increases.¹⁸ In the case of gold sales, this would particularly appear to be the case given the power of gold lobbies to prevent further supply to the market;
- (d) Fourth, proceeds from IMF gold sales are in effect collateral for the IMF's borrowing for the trust fund. As such, while IMF gold sales could play a highly useful role in providing debt relief, they would not add to the resources available to the IMF for its more traditional lending activity; and,
- (e) Liquefying the IMF's assets by selling gold could make these assets even more vulnerable to myopic political pressures to solve short-term problems at the expense of long-run institutional solvency.

¹⁶ In the first step, the IMF sold gold to the member at the prevailing market price and the profits were placed in a special account for the benefit of the HIPC Initiative. In the second step, the IMF immediately accepted back, at the same market price, the same amount of gold from the member in the settlement of that member's financial obligations. The net effect of these transactions was to leave the balance of the IMF's holdings of physical gold unchanged. The proceeds from the investment of the profits on these gold transactions were used to pay off IMF borrowing to repay those who lent to the trust fund, which on-lent to the countries that are not now repaying.

¹⁷ Dale Henderson and Stephen Salant make a strong case for not wanting to overly stagger official gold sales on grounds of forgone interest earnings. See Henderson and Salant, "A Note on Government Gold Policies", International Finance Discussion Paper 582, December 1997.

¹⁸ Earlier congressional opposition to IMF gold sales focused on the lack of transparency of such sales, the argument that gold should preferably be returned to the original contributing countries to whom the gold in effect belongs, the damage that IMF gold sales could have for the gold market, and the fact that gold sales could weaken the IMF's balance sheet. See, for example, IMF Gold Sales in Perspective, Joint Economic Committee Study, August 1999.

Streamlining the IMF

At a more radical level, a limited augmentation of the IMF's loanable resources for any given overall quota size could be achieved through a fundamental streamlining of the IMF along the lines suggested by Jacques Polak.¹⁹ In essence, Polak proposes the elimination of the "currency veil", which now characterizes the IMF's operations and which makes these operations so difficult to understand for the uninitiated. He also proposes the merging of the SDR and General Accounts with a view to basing the IMF's financial operations exclusively on the use of Special Drawing Rights rather than on the present hodgepodge of currencies. In addition to making the IMF a more transparent institution, Polak argues convincingly that a move to an SDR based institution would:

- (a) Give member countries that provide resources to the IMF an asset that they have shown that they prefer, namely the SDR, instead of the increases in their reserve tranche positions that they currently receive;
- (b) By providing SDRs in lieu of reserve tranche positions, the IMF would make it possible to extend the range of countries able to provide resources to the Fund. This would effectively increase by about 15 percent, or by around US\$45 billion, the amount of credit that the Fund could loan, given the present overall size of quotas; and,
- (c) Introduce an equitable system for member countries to share in the cost of running the IMF, namely, in proportion to members' quotas rather than in proportion to the useable resources which they provide the IMF.

While admirable in its objectives, the Polak proposal would require a basic amendment to the IMF's Articles of Agreement. On the basis of past amendment exercises, this would prove both politically difficult and time consuming to bring to fruition. Moreover, while the Polak proposal would bring welcome improvements to transparency and equity in IMF burden sharing, it would only increase IMF loanable resources on a one-off basis by around US\$45 billion. As such, if the objective were to substantially increase IMF loanable resources, the Polak proposal would have to be part of a wider menu of options, which included private sector borrowing and IMF gold sales.

¹⁹ See Polak, Streamlining the Financial Structure of the International Monetary Fund.