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POLICY BRIEF
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THE IMF'S PREFERRED CREDITOR STATUS: DOES IT STILL MAKE SENSE AFTER THE EURO CRISIS?

SUSAN SCHADLER

KEY POINTS

- The IMF's preferred creditor status (PCS) has long been seen as central to the Fund's role in sovereign debt or balance-of-payments crises. The IMF provides a public good — putting its resources, at below market interest rates, behind carefully crafted adjustment programs with a high probability of success. PCS facilitates its funding of that role.
- The justification of PCS holds up to scrutiny only if the IMF lends in support of adjustment programs that conform to the IMF's mandate: to promote policies that avoid measures destructive of national or international prosperity and catalyze private lending (or, in more dire circumstances, position the country to regain market access expeditiously). In the absence of clear adherence to these objectives, PCS can actually undermine the IMF's mandate, as it appears to have done in Greece.
- For PCS to be viable, the IMF needs a firm framework to ensure that its members approve only lending arrangements with a high probability of success. But as part of the approval of the Greek arrangement in 2010, a permanent change to the framework left it significantly weakened.
- Without a restoration of a credible framework to discipline IMF lending decisions and prevent the IMF from succumbing to political pressure to lend into unsustainable circumstances, markets will eventually test the viability of the IMF's PCS.

INTRODUCTION

Throughout the history of IMF lending, the institution has had PCS — that is, distressed countries borrowing from the IMF are expected to give priority to meeting their obligations to the IMF over those to other (private or official) creditors. This status is a defining characteristic of the IMF's role in financial crises: it provides a high degree of confidence that IMF resources are safe even when other creditors of the distressed country face substantial uncertainty

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about whether they will be repaid in full. In other words, the IMF, which lends to some of the riskiest countries in the world, faces minimal risk that its resources could be compromised by a debtor country's difficulties in servicing its debt. It does so, however, with the confidence that comes from its role in helping to formulate and monitor a program of policies that are strongly expected to return the country to stability.

The value of the IMF's PCS is not often questioned.[1] There is something of a mantra within the Fund, and among many Fund watchers, that PCS is appropriate to protect the resources of an institution that is the closest thing to an international lender of last resort in the current global order. It permits the IMF to help distressed countries formulate policies necessary for restoring economic stability and a manageable level of debt, and to have credibility-enhancing "skin in the game" while putting the financial resources provided by members at minimal risk. Without PCS, it is argued, the Fund would have to be more cautious to whom it lends (in order to contain its risk profile) and could, therefore, be reluctant to play a full role in some of the most severe debt crises. Moreover, the IMF lends at very low interest rates when risk premiums are typically very high: PCS is, in a sense, compensation.

Yet, changes to the IMF's practices during the euro crisis cast PCS in a new light. The case for PCS assumes that the IMF will lend only in conditions when the underlying policy program (including upfront debt restructuring when necessary) is expected to restore stability and a sustainable debt burden. But in 2010, when the IMF committed €30 billion to Greece — the

1 Notable exceptions are Martha (1990) and Raffner (2009). Martha, who provides the most thorough review to date of legal considerations underlying PCS of the IMF, calls attention to the absence of any "compulsory standard of conduct requiring the preferential treatment of any external creditor, including the Fund."

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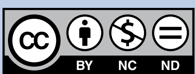

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largest amount ever to a single country — it introduced a permanent option to waive the normal criteria a country needs to meet in order to receive large loans.[2] The waiver can be applied when there is a "high risk of international systemic spillover effects" (IMF 2010). This waiver allowed the executive board to approve the loan despite the widespread view that Greece was likely to need to restructure its debt at some point during the program period.

This option of waiving the criterion on debt sustainability while maintaining PCS raises several questions. By facilitating IMF financing of a pre-restructuring bailout of some private creditors, does PCS in fact have the opposite effect to the intended catalytic role of the IMF? By lowering the Fund's stakes if a program fails to return a distressed country to sustainability, does PCS reduce the Fund's accountability? Finally, if the Fund repeatedly lends with PCS when restructurings are ultimately needed, how long will markets desist from challenging PCS during restructurings? In sum, are the traditional arguments for PCS for the IMF still valid after the introduction (and use) of the new option for waiving the requirement that IMF programs be highly likely to produce debt sustainability?

This brief starts with a short history of the IMF's PCS. It then examines new issues concerning PCS that arose in the euro crisis and the questions they have raised about the viability and basis for PCS. The final section draws conclusions.

2 See Schadler (2013) for a full analysis of this change in the Fund's lending framework.

WHAT IS PCS AND HOW HAS IT WORKED?

The IMF's PCS is de facto rather than de jure. The conventional wisdom within the international community is that PCS, along with conditionality on the agreed policy program of a borrower and "safeguards assessments,"[3] is a critical part of the Fund's mandate to require "adequate safeguards" on its outstanding credits. However, it is an agreed principle among, rather than a legal requirement on, its members.[4]

PCS is not mentioned in the IMF's Articles of Agreement. Indeed, Martha (1990) argues that the original Articles of Agreement implicitly envisage that at least some private creditors should have precedence in a country's debt servicing over the IMF. Only in 1988 did PCS receive a formal — though not legally binding — endorsement from the IMF board of governors' interim committee, which at that time, was the effective seat of key IMF policy decisions. Then, in the context of efforts to address a growing problem with arrears of low-income countries to the IMF, the committee "urged all members within the limits of their laws to treat the Fund as a preferred creditor" (Boughton 2001).

More recently, the de facto/de jure distinction has attracted attention for its possible relevance to determining whether drawing on IMF resources constitutes a debt restructuring due to the subordination of existing bondholder claims. If so, it was argued, the drawing should trigger activation of credit default swaps (the "insurance" bondholders can buy to cover losses from a default). This was actively considered by

3 Safeguards assessments aim to provide reasonable assurance to the IMF that a central bank's framework of reporting and controls is adequate to manage resources.

4 See Martha (1990) for a full discussion of the absence of a legal basis for the IMF's PCS.

the International Swaps and Derivatives Association (ISDA), in response to an anonymous submission following Ireland's 2010 borrowing arrangement with the IMF. In part because of the de facto (rather than de jure) status of the IMF's PCS, the ISDA decision rejected the argument that Ireland drawing on its IMF Stand-by Arrangement constituted a restructuring event (Cotterill 2012).[5] PCS also affects the provision of resources to the IMF. Member countries have several different arrangements for funding and accounting for their quota subscriptions (or outright loans) to the IMF, but many are heavily influenced by the (perceived) protection that comes from PCS.

Throughout the IMF's history, PCS has worked well. Rarely has the IMF not been paid on time, and even less frequently has it not been fully repaid. Apart from what is likely to be a genuine commitment to the spirit of the de facto PCS, two specific factors mitigate against reneging on obligations to the IMF.

First, traditionally, one of the main goals of Fund lending to distressed countries has been to catalyze private lending: having adopted an IMF-approved and -financed program of policies to correct economic imbalances, countries expect renewed or better access to private-market financing. An active IMF program — crucially signalled by the periodic approval of the executive board for the country to draw on tranches of the funds committed under the program — constitutes a statement to markets (and other official creditors) that a country is in conformance with its commitments under the program and that the program is on track to achieve its goals. Markets regard a break in IMF support for the program as a bad sign, but a failure to repay the IMF — with the threat it carries of ineligibility to use Fund resources or even expulsion from the Fund — would devastate actual or prospective market access. As the IMF now increasingly lends larger amounts to countries that have lost market access, the catalytic role of IMF support has diminished. Yet, the stigma, grown of historical experience, of failing to repay the Fund in a timely fashion would probably still be quite negative in terms of regaining access to markets.

Second, when a country's adjustment takes longer than initially envisaged and the threat of arrears or non-payment is acute, the Fund almost always at least tries to work with the country to put a follow-up lending arrangement in place. In effect, this is evergreening. However, it is in the context of a new program to strengthen policy adjustments to ensure that economic stability and the capacity to repay the Fund are restored, even if on a delayed schedule.

The major weakness in the record of countries repaying the Fund was among low-income borrowers, especially during the 1980s. In the early 1980s, a bulge in lending to low-income countries gave way to a spate of arrears during the late 1980s and early 1990s. Most of the countries involved either did not implement the adjustment programs agreed upon, borrowed through a low-conditionality facility or encountered severe economic or political setbacks. Boughton (2001) points to "conventional wisdom" that the arrears problem arose from "the IMF under political pressure…being lax in controlling its lending in the early 1980s."

Addressing these arrears cases brought forth a significant effort to set penalties (ranging from "naming and shaming" to ineligibility to draw on Fund resources to potential expulsion from the Fund) and establish procedures for assisting countries in arrears. The latter involved strengthening adjustment programs, finding

5 See also the anonymous letter to the ISDA (n.d.) requesting consideration of Ireland's drawing on IMF resources as a restructuring event and the ISDA (2011) decision.

official creditors to provide financing to reduce arrears to the Fund and then providing fresh IMF funding through newly established concessional facilities at the IMF — in effect, restructuring IMF credits.

Also vis-à-vis low-income countries, in 2005, the IMF put a mechanism in place — the Multilateral Debt Relief Initiative — for outright debt relief for qualifying low-income countries. As these were poor and therefore small borrowers, the amounts involved were not a significant burden for member countries to finance.

IMF PCS AND THE EURO CRISIS

The euro crisis has put the role of the IMF's PCS in a new light. The central justification for PCS is to facilitate the IMF's role in supporting corrective policy programs in distressed countries with its own resources. There is obviously the risk that PCS could also allow the IMF, under political pressure, to loosen its standards for programs because its resources are not at risk should rescue efforts fail to prevent the need for debt restructuring. Insofar as the IMF weakened its standards for lending during the euro crisis, it is sensible to ask whether the existence of PCS contributed to undisciplined lending and program assessment.

The scope for moral hazard stemming from PCS was evident from the beginning of the IMF's involvement in the euro crisis. Publicly available records indicate that the IMF's PCS was explicitly reiterated in the executive board discussion of the May 2010 approval of the Stand-by Arrangement with Greece: "The US chair (supported by Brazil and Switzerland) emphasized that, because of the [PCS], the Fund's loan will be senior to bilateral loans from E.U. countries pooled by the European Commission. Staff confirmed that this is the case, because of the public good nature of Fund financing, and in accordance with Paris Club's rules" (Catan and Talley 2013).

This request for explicit acknowledgement of the Fund's PCS arose from concerns about whether IMF resources provided to Greece would be compromised in the event of a (widely expected) default or restructuring. Had past practices been followed, the IMF would not have been able to lend to Greece when the probability of default was significant. Presumably, this means that the IMF would have had to insist on an up-front debt restructuring.[6]

Preventing loans in such circumstances was precisely the objective of the four criteria for exceptional access adopted in 2002. The criteria require that: the borrowing country experiences "exceptional balance-of-payments pressures"; a "rigorous and systematic analysis indicates that there is a high probability that the member's public debt is sustainable in the medium term"; "the member has prospects for gaining or regaining access to private capital markets within the time frame when Fund resources are outstanding"; and the country's policy program "provides reasonably strong prospects of success" (see Schadler 2013). However, in approving the lending arrangement for Greece, the executive board introduced an option for waiving one of the four criteria — specifically, the one requiring a high probability that the program of policies would lead to public debt returning to a sustainable level. Because of the significant probability of a debt restructuring in the future, the Fund's resources would have been at risk in the absence of a clear commitment to PCS.

A second concern that undoubtedly prompted the call for reaffirmation of the IMF's PCS was the position

6 It would also have been possible for another country or countries to have ensured debt sustainability through grants or provision of collateral. See IMF (1944, art. V, s. 4).

of IMF credits relative to official European lending to Greece.[7] Indeed, obligations to the European Central Bank (ECB) and national central banks were excluded from the March 2012 restructuring. The official justification for such treatment, which was announced in July 2011 as European creditor countries made the decision to start restructuring discussions, was that the loans had been made for "policy purposes." Moreover, the formation of the permanent European Stability Mechanism (ESM) in 2011 (used thus far only for Spain and Cyprus) includes a form of "next-in-line" PCS.[8] The "High Level Principles for Risk Management" in the ESM's originating documents that its "loans to member states will enjoy [PCS] in a similar fashion to those of the IMF, while accepting [PCS] of the IMF over the ESM" (ESM 2012). This "next-in-line" PCS of the ESM is, like the IMF's PCS, a mutual understanding without specific legal status.

While the IMF's PCS was hardly, if at all, called into question in the Greek restructuring, the decision to exclude European creditors did attract attention. The IMF (2012) itself did a telling analysis of the impact of the ECB's Securities Market Program (SMP) on prices and yields of bonds issued by the periphery countries in light of the 2011 decision to exclude purchases from the 2012 restructuring.[9] The analysis pointed out that bond purchases (or the possibility of bond purchases) that would be placed outside the reach of any future restructuring had two competing effects on bond prices: they increased subordination risk (by an amount depending directly on the level of default risk, the *ex ante* expected loss in the event of default and the proportion of SMP holdings of a country's debt), and they provided a positive liquidity effect, particularly if markets had confidence that interventions would be large enough to stabilize markets. The analysis found evidence that subordination risk increased at the point, in July 2011, when the ECB announced that all Greek debt held by European central banks (including that purchased under the SMP) would not participate in any Greek restructuring.

There is an obvious parallel between these effects of euro-area bond purchases and those of IMF support. IMF lending with PCS raises subordination risk while, in principle, lowering default risk. The net effect depends on the size of the IMF loan relative to a country's total debt, and the effectiveness of the IMF program in giving confidence to markets about debt sustainability. In other words, unless the IMF lends (especially very large amounts) only when there is a high probability that the program of policies (including an upfront debt restructuring when necessary) will produce a sustainable level of debt, PCS could have a net negative effect on bond prices. This would happen if increased subordination risk outweighed confidence-enhancing effects of an IMF lending arrangement.

CONCLUSIONS

The IMF's PCS is well-justified, provided the IMF is charged with, and capable of, carrying out its role as a catalyst of market finance or, when market access has been totally closed down, as a facilitator of early return to market access. Direct IMF financial participation

7 During 2010-2011, most official European credit to Greece took the form of bilateral loans coordinated through the ECB or national central banks. The European Financial Stability Fund (EFSF) took over after the March 2012 restructuring.

8 The ESM is a crisis resolution mechanism, established by the 17 countries of the euro area, which will ultimately replace the EFSF. It is empowered to raise funds in a number of ways, including tapping private markets and providing support, subject to conditions, to debt-distressed countries.

9 The SMP was a program through which the ECB purchased sovereign bonds of countries facing unsettled market conditions and was used principally to purchase Greek debt mainly during two periods between 2010 and 2012.

in funding a program enhances the credibility of a program, and PCS provides protection for Fund resources should unexpected adverse developments derail the program.

Nonetheless, there is no way around the fact that PCS can create moral hazard. By minimizing risks to Fund resources, PCS can facilitate decisions by members, motivated by political considerations, to provide support inconsistent with the responsibilities of the Fund in economic crises. Further, such decisions, by both undermining the credibility of the IMF's responsibility to support a country's path to debt sustainability or economic stability and creating subordination risk, would constitute a reasonable case against PCS for the IMF.

This issue takes on new importance in the wake of the euro crisis. The approval in 2010 of a Stand-by Arrangement with Greece required the introduction of a permanent option for waiving the requirement that a borrowing country have a high probability of debt sustainability going forward. All subsequent releases of tranches of that loan have appealed to that waiver. That IMF members regarded the Greek loan as excessively risky is reflected in the call for a reaffirmation of the Fund's PCS at the executive board meeting approving the loan. Should resorting to this waiver (used also for loans to Ireland and Portugal) become a viable precedent for the Fund's involvement with severely indebted sovereigns, the case for the IMF's PCS is likely to be questioned.[10]

Ultimately, the case for or against PCS for the IMF comes down to how members wish to maintain discipline over IMF lending. There are two choices: discipline through rules, that is, a clear framework specifying minimum standards for the credibility that IMF programs will return a country to market access, or discipline through market forces, that is, subjecting IMF loans to the same risks of default or restructuring as private market lending. Until the euro crisis, the rules governing IMF policies were clearly consistent with PCS. The softening of those rules in the course of the euro crisis greatly weakens the case for PCS.

10 The questioning has in fact already started. See, for example, Spink (2013).

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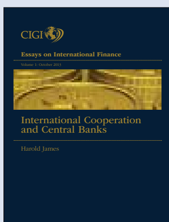

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Harold James
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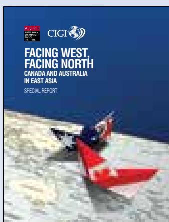

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Leonard Edwards and Peter Jennings, Project Leaders
February 2014

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PAPERS

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Richard Gitlin and Brett House
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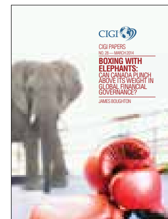

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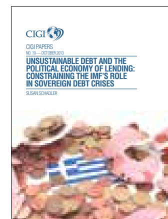
CIGI Papers No. 28
James Boughton
March 2014

Canadians have long harboured a desire to "punch above their weight" in international diplomacy, an aspiration justified by Canada's position in the world both geographically and culturally. This paper examines Canada's role in international financial governance, particularly within the IMF. The key issue for the future is whether Canada will continue to have the capacity and will to take leading positions and actions in the face of increasing competition from the growing emerging market countries.



Unsustainable Debt and the Political Economy of Lending: Constraining the IMF's Role in Sovereign Debt Crises
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Susan Schadler
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POLICY BRIEFS

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A Failure to Cooperate? Raising the Risks and Challenges of Exiting Unconventional Monetary Policies
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March 2014

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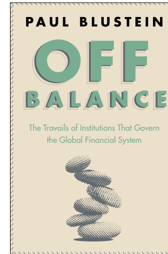

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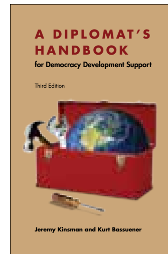

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