CIGI

POLICY BRIEF
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IMF LENDING PRACTICES AND SOVEREIGN DEBT RESTRUCTURING

JAMES BOUGHTON, SKYLAR BROOKS AND DOMENICO LOMBARDI

KEY POINTS

- The IMF has tried for decades to develop a set of lending practices that, while balancing creditor-debtor interests, aim to provide well-defined rules that can be tailored to specific country contexts.
- In doing so, it has experimented with various arrangements to optimize economic outcomes, some more successful than others.
- Recently, the Fund's handling of the Greek debt crisis raised serious questions about the credibility of its lending practices, highlighting the need for a consistent framework to guide its own lending decisions.
- Going forward, the primary goal for the IMF should be to restore credibility and consistency of the policies underpinning its crisis-driven lending.

INTRODUCTION

The IMF has struggled for decades to develop a set of lending practices that enable sovereign borrowers to resolve serious debt problems and restore economic growth, but also respect the right of private financial markets to enter into and enforce contractual obligations. The challenge has always been to operate under a well-defined set of principles while dealing with each situation in a way that takes account of relevant circumstances. Recently, the international financial crisis that began in 2008 and the subsequent European sovereign debt crisis have raised this challenge to new heights. In providing €30 billion to Greece — the largest financial package ever granted to a single country — the IMF invoked greater discretion in its lending decisions to counteract potential "systemic" crises. By doing so, it entered a program without a restructuring agreement.

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This brief sets the broader context and provides some background into the ongoing review of the IMF lending practices by offering a historical snapshot of the evolution and highlighting areas where urgent interventions are needed.

THE EVOLUTION OF IMF LENDING PRACTICES

The original conception of the IMF as a multilateral lender was that it would act independently of others. If a member country faced a shortage of financing for its balance of payments, it could ask the IMF to fill the gap with temporary credit. Cross-border financing from private-sector institutions was not generally available in the years after World War II. The only substantive question for the IMF was whether the country had a plan in place to strengthen its economic policies enough to enable it to repay the loan from the Fund and put its balance of payments on a sustainable footing.

As countries around the world began to experience economic growth in the 1950s and 1960s, and as more and more currencies were made freely convertible for international trade, balance-of-payments financing became both more complex and more volatile. Although the IMF's Articles of Agreement prohibit the Fund from lending to finance a "large or sustained outflow of capital", the IMF often found itself having to do so in order to prevent the outflow from destabilizing the exchange rate and, thus, upsetting the current account balance (Boughton 2001b). The collapse of the Bretton Woods system of fixed exchange rates in the early 1970s and the advent of generalized floating of exchange rates accelerated this trend. By the mid-1970s, the IMF was often lending to developing countries that were struggling to cope with the uncertain availability of financing from international banks and foreign investors.

Finding an effective means to help borrowing countries stabilize flows from their lending sources became an important part of the IMF's lending practices.

In 1976, the IMF introduced an innovative experiment in response to a borrowing request from Zaïre (now the Democratic Republic of the Congo). International banks had been lending money to the government to finance the country's development of natural resources, but the government had fallen into arrears in its repayments to the banks. The question arose as to whether a loan from the IMF would allow the banks to reduce their own exposure, while doing little or nothing to improve the balance of payments. IMF staff participated in trilateral meetings with government officials and representatives of the major international bank creditors. These meetings, in addition to guarantees offered by bilateral official creditors through the Paris Club, satisfied the international banks that with IMF support Zaïre could service its debt and clear arrears (Rebucci and Mody 2006). The banks continued to lend voluntarily and the IMF-supported adjustment program succeeded reasonably well.

A second, less successful, experiment was made in 1979, when Sudan requested an extended, three-year stand-by arrangement from the IMF. At the time, Sudan was in arrears to commercial bank lenders by some US$1 billion, and the largest bank creditors were threatening to write off the loans and deny further lending to the country. Again, IMF staff intermediated the dispute in trilateral meetings. As one condition for IMF support, Sudan agreed to clear its bank arrears before the end of the first year of the program. The Paris Club of official creditors agreed to reschedule their loans to Sudan. Negotiations between bank creditors and the government dragged on for months, despite help from IMF staff, but in the end Sudan was unable to muster the resources to get current on its growing stock of external debts. The program failed and Sudan fell into protracted arrears (including to the IMF) that continue to the present day (Boughton 2001a).

These experiments were not successful enough to produce a general change in IMF policies. For example, when Turkey requested a three-year arrangement in 1980, the Fund approved it without any requirement for participation by other creditors. Turkey completed the program successfully, but bank creditors gradually reduced their exposure and thereby diluted the economic benefits to Turkey. The lesson was clear: whatever the difficulties might be in trying to "involve" private creditors in the resolution of a country's debt problems, simply ignoring the risks was not a viable option (Boughton 2001a, 275–76).

When Mexico and Argentina were hit by debt crises in the summer of 1982, the IMF finally hit upon a workable strategy for ensuring the cooperation of bank creditors. After an initial 90-day period, during which bilateral official creditors (led by the United States) provided short-term financing to enable the countries to service their bank debts, then Managing Director Jacques de Larosière informed the banks that the IMF would approve three-year financing and adjustment programs, but only if the banks supplied written commitments to increase their own loan exposure (Caskey 1989). Because the outstanding bank debts were large enough that a default threatened the solvency of even the largest banks, the banks were willing (and even eager) to go along.

This strategy, which came to be known as "concerted lending" was successful as long as it was limited to cases where the banks had to cooperate because of the scale of their outstanding loans to each country. Unfortunately, that proved to be a high hurdle. Over the course of a few years most bank creditors were able to build up reserves against loan losses to a point where they could survive future defaults. The IMF successfully employed concerted lending in seven cases from 1982 to 1986, but by then the approach was no longer viable. The power to control negotiations with heavily indebted countries was shifting back to the banks (Boughton 2001a; Sturzenegger and Zettelmeyer 2006).

More experimentation followed. The IMF tried "enhanced surveillance", a practice under which it provided copies of its own confidential country reports to bank creditors as a way to encourage them to keep lending (IMF 2011; Crockett and Goldstein 1987). This lasted only a few years and was not considered a success. The Fund also tried to encourage the use of multi-year rescheduling agreements, in which banks would agree in advance to reschedule loan payments falling due over a period of years extending beyond the end of an IMF-supported program (IMF 2011; Crockett and Goldstein 1987). Without the comfort of knowing that the IMF was setting policy conditions in the out-years, most banks were unwilling to participate in these schemes.

Until 1987, all of these efforts to stretch out repayments to commercial creditors were formulated on the principle that the net discounted present value of the payments stream would not be reduced. In other words, debt service might be rescheduled, but the full value of the original contract would be respected. The problem was that the most heavily indebted countries were unlikely to be able to reduce the debt-to-output ratio to a sustainable level. They could never "grow out of" their debt overhang, and their prospects of regaining access to credit markets were virtually nil (Boughton 2001a).

The next step was for the IMF to begin lending into commercial arrears on a selected basis. If bank creditors were reluctant to negotiate in good faith and the IMF judged that the country had done what it could to resolve its debt problems, then the Fund would consider lending to the country even if it still had outstanding arrears to banks (Erce 2013; Sturzenegger and Zettelmeyer 2006). Notable cases were Bolivia in 1985 and Costa Rica in 1987 — relatively small countries to which the banks' exposure was small enough that they could try to take a firm stand against rescheduling (Boughton 2001a).

A breakthrough occurred in 1989 with the adoption of the Brady Plan. A specified group of heavily indebted emerging market countries could exchange their outstanding bank loans for Brady bonds, with a reduced present value and with the principal guaranteed by the US Treasury (Clark 1993). The role of the IMF was to augment its lending arrangements and set aside part of the credit line to finance the issuance of Brady bonds once the indebted countries had reached a debt-reduction agreement with bank creditors. Over the next decade, 19 countries successfully reduced their debt burdens by issuing Brady bonds (Boughton 2001a).

Post-Brady, sovereign debt restructuring became even more difficult, because capital inflows to emerging market countries increasingly took the form of negotiable securities rather than bank loans (Sturzenegger and Zettelmeyer 2006). In managing the Mexican peso crisis in 1995, the IMF did not prevent holders of the short-term securities known as *tesobonos* from being repaid in full. As a result, the economic cost to Mexico was higher than it needed to be and investors may well have become less sensitive to default risk than they should have been. Only in Korea, at the end of December 1997, were the IMF and bilateral creditors able to engineer a solution that involved private-sector creditors by persuading banks to maintain exposure (Boughton 2012).

OVERCOMING THE CURRENT CHALLENGE

In 2002, the IMF made a serious attempt to rationalize and generalize its policies regarding cases where a debt restructuring appeared to be required to enable the indebted country to get its economy back onto a sustainable path. The new policy specified that to qualify for "exceptional access" (i.e., an unusually large loan commitment relative to the country's quota), there had to be "a high probability that the country's public debt is sustainable in the medium term" and "a reasonably strong prospect of success" for the economic program (Schadler 2012, 6). In the first major test of that commitment, however, these criteria were essentially dismantled in 2010 (Schadler 2012). In deciding to lend €30 billion to Greece — the largest amount ever to a single country — the IMF determined that its lending decisions should not be bound by the normal criteria in the event of a crisis that produces a "high risk of international systemic spillover effects" (IMF 2010). Although it was clear to most observers that Greece had to restructure its debt during the program period to reach debt sustainability, the Fund entered into the lending arrangement without a restructuring agreement. Thus, an essential part of the strategy for a full economic recovery was abruptly abandoned.

Without a credible commitment to ensure that the program is designed to put the economy on the right path, the IMF's lending cannot effectively serve as a "seal of approval." Lacking such credibility, IMF and other official financing is unlikely to catalyze the private-sector support that is essential for lasting success. This problem is magnified by the IMF's implicit status as the preferred creditor because potential investors will understand that the Fund's willingness to lend is predicated as much on its preferred creditor status as on the likelihood of success of the program. If a debt restructuring is needed after the program is approved, other creditors are far more likely to be hurt than the IMF (Schadler 2014). Of course, relinquishing that status would do nothing to enhance the credibility of the program if it is poorly designed and inadequately funded.

While the Greek debt restructuring was in many ways a unique case (Xafa, forthcoming 2014), advanced economies, and the euro zone in particular, face a more widespread government debt problem.[1] In light of weak growth prospects, growth-depressing fiscal consolidation and the lack of national monetary sovereignty in the single currency area, it is believed that more debt restructurings will be required in the near future to restore debt sustainability in some of the most highly indebted eurozone countries (Reinhart and Rogoff 2013). Understandably, the recent Greek experience and the concerns about future debt restructurings — including those stemming from the ongoing litigation over Argentina's debt restructuring in the early 2000s — have reanimated the debate over if and how the international community should govern sovereign debt restructurings (Haley 2014). Central to this debate is the related question of what role the IMF should play in any arrangement aimed at reducing the "moral hazard" and "deadweight losses" associated with sovereign debt restructuring.[2]

Although actively involved in these debates (IMF 2013), the Fund and its membership have not fully clarified the appropriate role of its own lending activities in preventing, pre-empting or even managing sovereign debt restructurings. Indeed, it remains the case that "the

1 See also Pâris and Wyplosz (2014).

2 For an overview of "moral hazard" and "deadweight losses" see Eichengreen (2006).

IMF's toolkit does not include any instrument specifically designed to deal with sovereign debt restructurings" (Erce 2013, 2). And while the lack of such an instrument allows for flexibility in the IMF's approach to individual crises, the flipside of flexibility is inconsistency, which can exacerbate economic uncertainty and unduly politicize crisis management.

Going forward, the primary goal should be to restore credibility and consistency to the IMF's policies underpinning its major crisis-driven lending. If a debt restructuring is needed, it should be incorporated from the outset. Political pressures to deny this reality will always be present and will often be very difficult to overcome, but if the IMF and its membership cannot rise above those pressures, it cannot hope to retain the credibility that it has fought to earn over the past seven decades.

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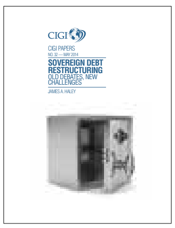

Sovereign Debt Restructuring: Old Debates, New Challenges
CIGI Paper No. 32
James A. Haley
May 2014

This paper outlines the problems impeding timely sovereign debt restructurings, identifies the policy responses proposed and discussed 10 years ago in response to financial crises, and discusses the elements of old debates and how they can remain relevant in dealing with today's new challenges. Three areas for further analysis are identified: expanding the scope of contractual clauses that can help facilitate restructurings; accounting, tax and regulatory frameworks, and identifying possible changes to remove impeding obstacles; and improving the process for negotiating debt restructurings, as well as creating a Sovereign Debt Forum.

Development: Advancement through International Organizations
CIGI Paper No. 31
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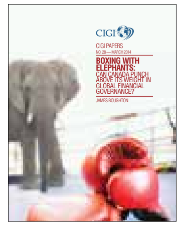
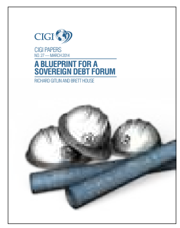
This paper examines the history of international organizations focusing on development, including the Bretton Woods organizations, the UN system and the regional development banks, and considers the parallel emergence of foundations and the role of international development actors.



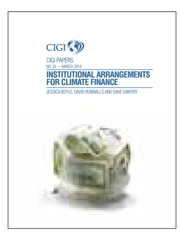
Boxing with Elephants: Can Canada Punch above Its Weight in Global Financial Governance?
CIGI Paper No. 28
James M. Boughton
March 2014

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 one aspect of that effort: Canada's role in international financial governance, particularly within the International Monetary Fund.



A Blueprint for a Sovereign Debt Forum
CIGI Paper No. 27
Richard Gitlin and Brett House
March 2014

This paper outlines a blueprint for the creation of a Sovereign Debt Forum (SDF). The SDF would provide a centre for continuous improvement of the processes for dealing with financially distressed sovereigns and a venue for proactive discussions between debtors and creditors to reach early understandings on treating specific sovereign crises.



Institutional Arrangements for Climate Finance
CIGI Paper No. 26
Jessica Boyle, David Runnalls and Dave Sawyer
March 2014

The most recent report of the Intergovernmental Panel on Climate Change is unequivocal about the magnitude of the challenge posed by man-made climate change. If the world is to avoid exceeding the 2°C average increase in temperature agreed by governments in Copenhagen as the maximum safe level, it needs to move quickly to facilitate the transition to a lower-carbon economy.

POLICY BRIEFS

The UN Declaration on the Rights of Indigenous Peoples: Monitoring and Realizing Indigenous Rights in Canada
CIGI Policy Brief No. 39
Terry Mitchell and Charis Enns
April 2014

Indigenous peoples in almost all countries experience a lack of recognition of their fundamental political and human rights; globally, they share the worst measures on all indicators of health, education, and social and political participation. The Canadian Human Rights Commission should review and address UN Special Rapporteur James Anaya's report, and establish mechanisms for the implementation of the UN Declaration on the Rights of Indigenous Peoples.

China's Long March toward Economic Rebalancing
CIGI Policy Brief No. 38
Hongying Wang
April 2014

After more than three decades of sustained economic growth, China has become the second-largest economy in the world. Chinese policies and behaviour have come to shape the global economy in profound ways. This policy brief examines China's external and internal economic imbalance and analyzes the political obstacles hindering its economic rebalancing.

The IMF's Preferred Creditor Status: Does It Still Make Sense after the Euro Crisis?
CIGI Policy Brief No. 37
Susan Schadler
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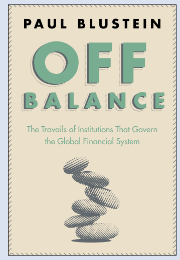
Throughout the history of IMF lending, the institution has had preferred creditor status (PCS) — that is, distressed countries borrowing from the IMF are expected to give priority to meeting their obligations to the IMF over those to other creditors. This brief starts with a short history of the IMF's PCS and then examines new issues concerning PCS.

BOOKS



Off Balance: The Travails of Institutions That Govern the Global Financial System
Paul Blustein
October 2013

Award-winning journalist and author Paul Blustein has received wide acclaim for his books about the inner workings of international economic institutions, notably the International Monetary Fund and World Trade Organization. In Off Balance, he weaves a compelling narrative that details the failings of such institutions in the global financial crisis that erupted in 2008.

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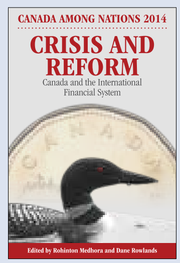

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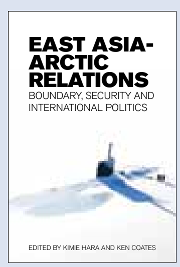

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Kimie Hara and Ken Coates, Editors
June 2014

The Arctic's profile as a region for engagement and opportunity is rising among both circumpolar and non-circumpolar states. In addition to countries like Canada, Russia and the United States, which have expressed a renewed interest in the region, East Asian countries, such as Japan, Korea and China, are now increasingly fixated on prospects offered by the Arctic.

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CIGI was founded in 2001 by Jim Balsillie, then co-CEO of Research In Motion (BlackBerry), and collaborates with and gratefully acknowledges support from a number of strategic partners, in particular the Government of Canada and the Government of Ontario.

Le CIGI a été fondé en 2001 par Jim Balsillie, qui était alors co-chef de la direction de Research In Motion (BlackBerry). Il collabore avec de nombreux partenaires stratégiques et exprime sa reconnaissance du soutien reçu de ceux-ci, notamment de l'appui reçu du gouvernement du Canada et de celui du gouvernement de l'Ontario.

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