IMF Reforms and Global Economic Stability

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Chair Huizenga, Ranking Member Moore, and members of the Subcommittee on Monetary Policy and Trade thank you for inviting me to testify at this hearing on "The Impact of the IMF: Economic Stability or Moral Hazard?"

For the International Monetary Fund—or any other international financial institution—to achieve the goal of promoting economic stability, it is essential that it have a clear and predictable framework or strategy for carrying out the goal. Without such a framework decisions become highly uncertain—influenced more by politics than economics—and create perverse incentives, including moral hazard, leading to excessive risk-taking and harmful international spillovers. For institutions like the IMF that can lend exceptionally large amounts supported by taxpayer funds, such a framework is essential for transparency, accountability, and preventing public bailouts of the private sector.

The IMF's Exceptional Access Framework

A dozen years ago such a framework—called the Exceptional Access Framework—was adopted at the IMF as part of a general reform that included the greater use of collective action clauses in sovereign debt. The aim was to improve global economic stability by ending, or at least reducing the likelihood of, the financial crises that had been raging in emerging markets. International monetary and financial policy needed more predictability, more accountability, and more systematic behavior on the part of the official sector. More focus needed to be placed on what public sector actions were likely to be in a given circumstance, on what accountability there would be for those actions, and on what the strategy and the principles behind the actions were.

The exceptional access framework moved in this direction by setting forth criteria that had to be met before the IMF could lend exceptionally large amounts to countries. The criteria included evidence of exceptional pressure on the country's capital account, good prospects that the IMF loans would be temporary, and a strong implementable economic program. Most

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important was the criterion saying that the IMF could not make new loans to countries with unsustainable debts.[2]

The expectation was that limiting loans in this way would reduce bailouts of private sector creditors, contain moral hazard, lower uncertainty, reduce the recipient country's debt burden, encourage more responsible fiscal and monetary policy, reduce spillovers, improve accountability, and thereby create more economic stability. And, in fact, the 2003 framework was accompanied by many such changes. Compared with the 1980s and 1990s there were few crises emanating from emerging markets in the years that followed, and the emerging market countries as a whole weathered the global financial crisis remarkably well. Economic policy in emerging market countries generally improved: Monetary policy focused more on price stability, and fiscal policy relied less on foreign borrowing or debt linked to foreign currencies. So the framework worked well, as long as it was in place.

The Need to Reform the Exceptional Access Framework

Unfortunately, this exceptional access framework has not remained in place. It was abandoned in 2010 when the Greek sovereign-debt crisis emerged and the IMF staff could not establish that the Greek debt was sustainable with high probability. Rather than follow the "no loans to a country with unsustainable debt" rule, the IMF simply changed the rule. It wrote in an exemption saying that new loans could be made in unsustainable or uncertain situations after all so long as there was a "high risk of international systemic spillover." The IMF then claimed, with very little evidence, that spillover risk was high and approved an exceptionally large loan to Greece.[3] The loan was made without any debt restructuring.

As is well known, events in Greece following this 2010 decision have not been pleasant. The Greek economy continued to deteriorate under the burden of the large debt. By February 2012 it was clear to all that a restructuring was essential and Greek debt was written down by 60%. Acrimonious debate over the debt continues today with Greece falling behind in debt service payments to the IMF. By now most of the private sector creditors have gotten out with the IMF and European governments left holding much of the Greek public debt.

The fact that the original framework was broken at the same meeting that the Greek loan was approved provides strong evidence that the framework was broken to allow for the loan.

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[2] Specifically, the original criteria were: Criterion 1: The member is experiencing exceptional balance of payments pressures on the capital account resulting in a need for Fund financing that cannot be met within the normal limits. Criterion 2: A rigorous and systematic analysis indicates that there is a high probability that debt will remain sustainable. Criterion 3: The member has good prospects of regaining access to private capital markets within the time Fund resources would be outstanding, so that the Fund's financing would provide a bridge. Criterion 4: The policy program of the member country provides a reasonably strong prospect of success, based in part on an assessment of the government's institutional and political capacity to implement that program." (See, International Monetary Fund (2002, 2003).)
[3] International Monetary Fund (2010)

Nevertheless, the exemption for systemic risk remains.[4] And because systemic risk is often "in the eye of the beholder," loan decisions are again largely discretionary.

Reforming the Exceptional Access Framework

For these reasons, it is time to reform (actually re-reform) and strengthen the exceptional access framework. A starting place would be simply to repeal the exemption for systemic risk which has causes much of the problem and may have had the unintended consequence of increasing systemic risk.

I have found much support for such a reform in the international community including among IMF management and staff. Some worry about the loss of discretion that eliminating the exemption risk of systemic spillovers would imply. But that very discretion causes uncertainty and the resulting spillovers. Moreover, the expectation that a workout would be more orderly with the collective action clauses—especially now that they have usefully been expanded to aggregate across different debt issues—reduces the chance of systemic spillovers. The exemption is the problem not the solution.

The International Agreement on Voting Reallocation and Quota Increases

Congressional approval of the international agreement (negotiated at a 2010 G-20 meeting) on IMF voting reallocation and quota increases is closely related to exceptional access reform.

This previously-negotiated international agreement would sensibly reallocate voting shares to give more votes to countries that have grown more rapidly (mainly emerging market and developing countries) and fewer votes to countries that have grown more slowly in the past few decades. The United States would lose a bit, but would remain above 17% and thus sufficiently high to be able to block major policy actions that require 85% of the membership.

The agreement would also increase the total value of the quota commitment to the IMF, the central source of funds for IMF lending. The main rationale for the increase is that the global

[4] More specifically, the original Criterion 2 (listed in footnote 2) has been changed to read as follows: "Criterion 2: A rigorous and systematic analysis indicates that there is a high probability that the member's public debt is sustainable in the medium term. However, in instances where there are significant uncertainties that make it difficult to state categorically that there is a high probability that the debt is sustainable over this period, exceptional access would be justified if there is a high risk of international systemic spillovers. Debt sustainability for these purposes will be evaluated on a forward-looking basis and may take into account, inter alia, the intended restructuring of debt to restore sustainability. This criterion applies only to public (domestic and external) debt. However, the analysis of such public debt sustainability will incorporate any potential contingent liabilities of the government, including those potentially arising from private external indebtedness." (See International Monetary Fund (2014)).

economy, international financial markets, and capital flows have expanded. It is important to note that the total amount of credit outstanding by the fund during the global financial crisis, including the exceptionally large loans to Eurozone countries, is far below what available resources would be with the international agreement.

For the United States the quota increase would be by about $63 billion (depending on exchange rate changes). It would be matched dollar for dollar by a reduction in the U.S. contribution to the New Arrangements to Borrow (NAB), another source of funds which was increased by $100 billion in 2009. Thus, after this partial offset about $37 billion of U.S. funding would remain in the NAB. At the time of the Congressional approval of $100 billion NAB increase in 2009, many in Congress viewed the increase as temporary, lasting only 5 years, and thus they question the concept of a partial offset. In reality the NAB can evidently be renewed without action by Congress.

Moreover, the increase in the quota must be scored by the Congressional Budget Office. Thus, approval of the agreement has direct implications for the federal budget which depend on how the Federal Credit Reform Act is applied and may need offsets elsewhere in the budget.

Legislation That Ties the Reforms Together

Given these budget implications, it is appropriate for legislation to tie approval of the international quota and voting shares agreement to exceptional access reform, and thereby provide a degree of accountability and transparency. It is both politically responsible and economically attractive to provide safeguards on how the appropriated funds are used.

Some may complain that it is not the role of the United States to insist on such reforms, but in my experience as an international finance official it is not unusual for the United States to lead on these issues.[5] In fact, many expect the United States to be a leader. The United States, working with key emerging market and developed countries, was a major force behind the enabling collective action clauses and the exceptional access framework in the first place.

Others may worry that any reinstated framework would be broken again. Indeed, some may view the whole issue cynically, perhaps saying that if exceptional access reform is all we need to get the quota increased, then let's do it and reverse the decision later if need be. This fragility is a concern, but the fact that the Congress would tie the exceptional access framework to the quota increase would make the framework more visible and therefore harder to break. In addition, in order to give greater public awareness and accountability regarding the criteria, the Secretary of the Treasury could be required to submit an exceptional access report to the relevant Congressional Committees in cases of exceptional access lending. There could also be additional requirements on the ability of the Congress to vote on renewals of the NAB.

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[5] Taylor (2007)

Conclusion

In this testimony I have argued that in order to achieve the goal of economic stability, the IMF should have a clear strategy for achieving the goal; this is also true for the other international financial institutions and for the international financial system as a whole. I have showed how an effective exceptional access framework provides such a strategy for IMF lending decisions, and that a reform of the current framework is needed. Legislation to approve the international agreement to reallocate votes and increase quotas should be tied to the reform.

With the global financial system in an uncertain state of flux, now is a good time for such a reform. As Paul Volker (2014) has emphasized, recalling “memories of a more orderly rules-based world,” the international financial system is in need of reforms that “can better reconcile reasonably free and open markets with independent national policies, maintaining in the process the stability in markets and economies that is in the common interest.” Approving the international quota agreement in a way that helps ensure that new resources are used strategically, effectively and with accountability—as I showed in this testimony—would be an important pillar of any such a reform movement.

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