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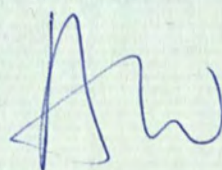
DEBT AND THE IMF

This paper by Vaubel has been prepared for my Committee. It is concise, incisive and, in my view, correct.

The essence is in the first 8 pages where it suggests that IMF conditionality should be a pre-condition of a loan and not a fragile promise of future performance.

This Vaubel type of pre-conditionality would require countries to have both monetary and fiscal control, together with free and open markets, before they qualify for multinational assistance.



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First Draft

THE INTERNATIONAL ORGANISATIONS AND THE INTERNATIONAL DEBT PROBLEM: THE NEXT STEPS

1. The immediate reaction to the international debt crisis of 1982/83 has been a substantial expansion of subsidized public lending to the debtor countries. The most dramatic step was the increase in IMF quotas by more than 47 per cent. As a result, IMF lending adjusted for inflation is now four times larger than in 1970.[1] The ratio of IMF lending to world exports is now more than 50 per cent larger than it was in 1970 or 1980.

   To many observers, this increase in IMF lending appeared to be necessary to ward off a collapse of the banking system. From an economic point of view, this was somewhat surprising; for the prevention of liquidity crises is normally considered the task of the national central banks. The latter are better suited for this purpose because they can act as a lender of last resort to specific banks in difficulty. They would not indiscriminately subsidize the whole banking system by granting concessionary loans to a group of its debtors.

1) IMF lending is defined as the stock of granted loans, regardless of whether they have been drawn or not. Holdings of SDRs are treated as undrawn loans. The figures have been deflated in terms of dollars by the U.S. GNP deflator. See Table 1 on the following page.

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* The author is professor of economics at the University of Mannheim, W. Germany. This analysis has been prepared for the committee on international economic policy constituted in London on November 30, 1984.

TABLE 1

Lending

SDR b. outstanding at the end of	1955	1960	1965	1970	1975	1980	1984
Special Drawing Rights (net cumulative allocations)	-	-	-	3.4	9.3	17.4	21.4
Buffer Stock Facility	-	-	-	-	0	0	0.4
Compensatory Financing	-	-	0.1	0.1	0.7	2.8	7.5
Oil Facilities	-	-	-	-	4.8	1.9	-
Trust Fund Loans	-	-	-	-	-	1.3	2.8
Credit tranche drawings	0.1	0.4	2.9	2.9	1.8	2.6	14.1
Extended facility drawings	-	-	-	-	-	1.1	12.9
Undrawn balances under							
- Standby arrangements	0.1	0.4	0.3	0.2	1.0	2.3	3.6
- Extended arrangements	-	-	-	-	0.1	3.9	3.0
Total IMF Lending							
- in SDRs	0.2	0.8	3.3	6.6	17.7	33.3	65.7
- in 1975 US dollars	0.4	1.5	5.6	9.1	20.7	30.2	36.1
- relative to world exports	.002	.007	.020	.023	.026	.023	.035

Sources: IMF, International Financial Statistics, Supplement on Fund Accounts, Yearbook 1982, and February 1985 issue.

2. These quarrels are bygones. Now that the immediate crisis has been weathered, the perspective has shifted. The time for short-term crisis management is over. It is increasingly necessary to take a longer-term view. Two long-run dangers in particular have to be averted.

First, the handling of the debt crisis must not encourage the governments of debtor countries to become more imprudent in their economic policies. This is the "moral hazard problem".

Second, the experience of the debt crisis must not induce private lenders to stop exporting capital to the developing countries. This is the "capital flow problem".

If those problems are not solved, the debt crisis is likely to repeat itself. In what way can international organisations like the IMF and the World Bank be made to contribute to the solution of these problems?

THE MORAL HAZARD PROBLEM

3. If those who are in trouble because of their own fault, receive aid, subsidized loans or insurance payments as a result, they and all other potential recipients have less of an incentive to avoid such trouble. In insurance economics, this danger is called "moral hazard"; in the context of aid, it has aptly been dubbed "the Samaritan's dilemma"(Buchanan).

Is there any reason to believe that the debtor countries have (at least partly) been responsible for their defaults? There is no doubt that the causes of the debt crisis have partly been external to the debtor countries: the oil price increase of 1979, the appreciation of the dollar, the world recession, the deterioration of the debtor countries' terms of trade, the increase in real interest rates, etc. Most of these were the result of disinflationary monetary policy in the United States. But was it so improbable that U.S. inflation would be fought at some point? At the very least, prudent dollar debtors would have allowed for a considerable margin

of risk.

This interpretation is supported by the fact that a sizable number of debtor countries - especially in Asia - managed to avoid default. The performance of the various debtor countries has differed very considerably. This can also be shown over a longer period: from 1960 to 1982, 14 out of (on average) 114 member countries accounted for 80 per cent of the reschedulings, and 42 countries received 78 per cent of the standby and extended credits from the IMF.[1] This is not the outcome one would expect if the trouble had been due to unfavourable random disturbances. A recent study by Donovan demonstrates that the defaults have to be attributed to the internal fiscal and monetary management of the debtor countries rather than to external shocks.[2]

Finally, there can be doubts whether the debtor countries have done everything in their power to meet their obligations once the crisis had developed. After all, they were not insolvent. For instance, they could have sold public property or mineral exploitation rights, or they could have offered such assets as collateral.

With regard to moral hazard, it is important to note that IMF lending is subsidized in several ways. Standby credits beyond 200 per cent of quota and extended facility credits beyond 140 per cent of quota, for example, are subject to periodic charges which are linked to the yield on certain U.S. government

1) See my "The Moral Hazard of IMF Lending", in: Allan H. Meltzer, ed., International Lending and the IMF. A conference in Memory of Wilson E. Schmidt, The Heritage Lectures, 21, Washington, D.C., 1983; reprinted in: The World Economy, Vol. 6, Nr. 3, London, September 1983; a German version "Wozu IWF-Kredite?" appeared in: Wirtschaftsdienst, Vol 64, Nr. 8, Hamburg 1984. The number of reschedulings and standby or extended credits, respectively, has been weighted in each case by the number of years to which the rescheduling or the credit applied.

2) Donal J. Donovan, Sources of External Servicing Difficulties, International Monetary Fund, December 1983, summarized in: Finance and Development, Dec. 1984.

securities. If a country uses its Special Drawing Rights, it has to pay a weighted average of treasury bill rates in the five major currencies. Since the typical IMF borrower represents a high credit risk, he would have to pay a higher interest rate in the international capital market. In the market, his risk premium may even rise to infinity, i.e., he may not be considered creditworthy at all. Since the borrower would not want loans from the IMF if he could get them more cheaply in the market, they are subsidized almost by definition.

Hence, a moral hazard problem is almost certain to exist.

4. The moral hazard problem can be reduced by attaching policy conditions to the loans. There are two relevant effects. On the one hand, acceptance of conditions can improve the creditworthiness of the debtor and thereby reduce the element of subsidization which the predetermined interest rate implies. On the other hand, policy conditions may prevent the debtor from wasting the money in order to ask for more. However, in recent years, the Fund's performance criteria have actually been fulfilled in only about 20 per cent of cases.[1)]

The present form of IMF conditionality, if effective, could prevent the borrowing governments from staying in trouble in order to get more money. But there is still the problem that the prospect of subsidized IMF credits reduces the cost of getting into trouble in the first place. It weakens the incentive to avoid imprudent economic policies. It strenghtens the incentive to declare default. To minimize this remaining type of moral hazard, it is necessary to reform IMF conditionality.

1) See the study by G. Bird, "The International Monetary Fund and Developing Countries: Retrospect and Prospect", De Economist, vol.131, 1983, pp. 161-195.

IMPROVING IMF CONDITIONALITY

5. At present, policy conditions are only formulated after the "needs test" has been passed. Moreover, they are negotiated on a case-by-case basis; they are not predictable. Obviously, IMF conditionality would be much more effective and efficient, if it did not operate ex post and ad hoc but ex ante and in accordance with general rules. The rules should be announced in advance, apply to all potential borrowers and concern their policies before and after the lending. The general ex ante conditions which the IMF (and any international public lender) could formulate might usefully relate to

   i) the excess of monetary expansion over real economic growth,
   ii) the budget deficit relative to GNP,
   iii) the existence of minimum wages and price and interest controls,
   iv) the extent of trade barriers and exchange controls, and/or
   v) the expropriation of foreign and/or domestic investors.

6. General ex ante conditionality is practiced, for example, by national lenders of last resort, the central banks. Commercial banks have to satisfy certain preannounced conditions in order to be eligible for discounts credits. They would not even be admitted to the banking industry, if they did not comply with these rules.

Civil servants at the international lending institutions are interested in large budgets and the power to formulate policy conditions, but - like all political decision makers - they are more interested in case-by-case discretion than in the mere application of predetermined general rules. If conditionality is to be reformed, the initiative has to come from those who control them: from the national member governments.

It is important that the conditions should relate to policy instruments or easily controllable intermediate targets; for without controllability there can be no responsibility. In particular, the conditions should not focus on remote endogenous economic variables like the current account balance[1]; performance criteria with respect to hardly controllable variables are not only likely to be missed (as IMF experience shows), they are also unlikely to exert much influence on the conduct of economic policy.

7. One of the Fund's favourite policy conditions is devaluation. Thanks to the monetary and the portfolio-balance aaproach to the balance of payments, it is now widely recognized that devaluation increases the current account balance at most, if at all, temporarily, and that its only important lasting effect is a boost to the price level. Moreover, devaluation is not a necessary condition for a larger current account balance. If monetary policy is assigned to the exchange rate target, while fiscal policy is used to lower domestic absorption, net capital imports and the current account deficit can be reduced without recourse to devaluation and additional inflation. If exchange rate fixity meant inflation at home, it would be better, of course, to let the currency appreciate.

1) In the case of the current account, there is the additional problem that this target has no obvious normative significance. A current account deficit and the concomitant net capital imports, for example, may indicate high productivity and creditworthiness rather than a policy problem. Alternatively, where the current account deficit is a problem, it may be due to borrowing from the IMF (which is a form of official capital import and, therefore, tends to increase the deficit).

8. The debtor countries have asked for an additional allocation of Special Drawing Rights, but they are not likely to obtain it in the near future. The reason is that SDRs are unconditional liquidity: no policy conditions may be attached to their use - not even ex post and ad hoc.

Resistence to further increases in IMF lending is justified for several reasons. It is not only that the immediate threat to the banking system is over. There may, it is true, be also humanitarian grounds for additional public lending to these countries (even though the major debtors are among the richest developing countries). But there can be no doubt that the IMF is not the appropriate institution to distribute development aid. The IMF staff is not specialized in this field, and its lending operations take the form of money creation in the donor countries. To declare the IMF responsible for international aid is like assigning domestic social policy to the national central bank.

THE CAPITAL FLOW PROBLEM

9. One of the main consequences of the debt crisis is that (current and potential) private lenders have lost confidence in the creditworthiness of the developing countries. For the time being, some "fresh money" is still provided by the banks because the governments of the developing countries might otherwise repudiate their debt completely and cause several of the creditor banks to collapse. However, as the banks are gradually building up reserves and increasing their equity capital, the threat potential of the developing countries diminishes and their share in new international bank credits is likely to shrink even further.

In these circumstances, the developing countries have to find new sources of finance if they want to continue to import private capital from abroad. One possibility might be bond financing, for bonds can be sold to non-bank lenders that are much less sensitive to their debtors' defaults than the banks. However, as the experience of the 1930s has shown, the probability that the developing countries might also default on their bonds, is by no means negligible. Thus, the developing countries cannot sell a large amount of bonds, even if they offer very high real interest rates.

A more promising source of finance is direct and portfolio investment by foreigners. From the point of view of foreign investors, it possesses the advantage that the governments of the developing countries do not have to service it. Political risks remain - notably the risk of expropriation. But it is one thing to default on one's debt service, and quite another to violate the right of property by expropriating foreigners. It is therefore important to ask whether existing obstacles to direct and portfolio investment in developing countries can be reduced in an efficient way. One suggestion that has to be considered is the World Bank proposal of a "Multilateral Investment Guarantee Agency" (MIGA)[1].

MULTILATERAL INVESTMENT GUARANTEES

10. The World bank proposes the establishment of an international public agency which sells insurance cover against non-commercial risks to foreigners investing in developing countries. Non-commercial risks include currency transfer risk, expropriation risk, the risk of breach of legal commitments by the host government and the risk of war or "civil disturbance" (Art. 11). At least initially, the agency is to focus

1) Draft Outline of the Convention Establishing the Multilateral Investment Guarantee Agency, World Bank, Legal Department, Washington, D.C., October 1, 1984.

on new private direct investments that serve a developmental purpose and are authorized by the prospective host country (Art. 12-15).

The agency starts its operations when at least ten developing countries and five industrial countries have joined it and have paid ten per cent of their subscriptions to its capital. In addition to operations based on share capital and reserves (accumulated fees), members may sponsor investments for guarantee, incurring loss-sharing liability for them on a pro rata basis with other sponsoring members (Art. 25-27). The agency would also reinsure national or regional investment guarantee agencies and private political risk insurers (Art. 19-21).

All members of the World Bank and Switzerland may join the agency (and its sponsorship fund). In the agency's council, the developing countries and the industrial countries would each have 50 per cent of the votes (Art. 45). The President of the World Bank would be ex officio chairman of the agency's board of directors. He would have no vote except in the (likely) case of an equal division (Art 38). The president of the agency would be nominated by the chairman of the board and be appointed by the board.

Where the agency compensated an investor under the contract of guarantee, it would assume his legal rights to collect damages from the host country (Art. 18). Disputes with host countries would ultimately be settled by a tribunal in which an arbitrator appointed by the Secretary General of the International Center for the Settlement of Investment Disputes (ICSID) is likely to have the casting vote (Annex, Art. 4). The Secretary General of ICSID is Vice President of the World Bank.

11. What arguments are there in favour of a multilateral public agency that insures foreign direct investment in developing countries against political risk? Why not leave this task to the private political risk insurance market which has rapidly grown in recent years?

One possible answer, which is given by the World Bank staff[1], is that many investments are not and cannot be insured in the market: private insurers normally limit their cover to three years, shy away from large projects, and are reluctant to cover war risks. This answer will not do. As one of the major controversies in post-war economics (Pauly et al. v. Arrow) has shown without doubt, the cost of insurance can often exceed its benefits. The absence or unavailability of insurance cover for certain risks is no proof of market failure and hence no reason for governments to step in.

The only argument which may carry some force is that, ultimately, a multilateral public agency might develop economies of scale in its risk diversification which the private insurance market cannot achieve. Empirically, it is not clear that this argument applies, but it is conceivable. However, if economies of scale are the justification, the agency need not subsidize its product on a long-term average.

12. Subsidized public provision of political risk insurance is not only unnecessary it is also clearly detrimental; for it would reward the developing countries to the degree that their governments generate political risks. Exchange restrictions, expropriation and breaches of legal commitment are not natural desasters but acts of policy. A public insurance which subsidized political risk bearing,

1) Cf. Multilateral Investment Guarantee Agency: Questions and Answers, World Bank, Washington, D.C., July 3, 1984.

would weaken the politicians' incentives to reduce political risk. The probability of damage would increase. Once more, avoidable moral hazard would be created. [1)]

Does the World Bank proposal provide for subsidies? The draft outline does not indicate how the insurance premiums and fees are to be determined; it merely states that

> "the terms and conditions of each contract of guarantee shall be determined by the Agency subject to such rules and regulations as the Board shall issue" (Art. 16)

and that

> "the President shall, pursuant to general policies to be established by the Board, determine premiums to be charged for guarantee and reinsurance operations and fees and charges for services rendered by the Agency (Art. 32).

According to Article 31,

> "the Agency shall carry out its activities... with a view to maintaining to the extent possible its ability to meet its financial obligations without resort to the callable portions of members' subscriptions".

The World Bank's Commentary to the Draft Outline interprets this statement as follows:

> "It is fully anticipated that the Agency will ultimately finance itself from its own revenues and will operate at no cost to its members" (p. 13).

1) For moral hazard to exist, it it not necessary that the insurance alters the behaviour of the insured. It is sufficient that the insurance increases the expected value of the damage. Unemployment insurance, for example, creates a moral hazard not only by altering the behaviour of the insured but also by affecting the behaviour of the trade unions.
The only type of subsidy which would not create moral hazard would be a subsidy paid by the host country itself. However, if this was the only aim, there would be no need for a public insurance agency;the developing countries could simply offer to pay part of the insurance premia which private political risk insurers demand.

But this commentary is not part of the draft convention. The agency must be obliged by its charter to avoid any subsidisation of political risk insurance - at least on a longer term average (to be defined in the Convention).

The Vice President of the World Bank has agreed that

> "the agency must become self-sustaining over the medium term. Administrative expenses and claims would have to be met through premium revenues and returns on invested reserves"[1)]

It ought to be noted, however, that this is not sufficient to avoid subsidisation on a longer term average. This is because, according to the draft outline, the member governments would not receive a market rate of return on their capital subscriptions, neither on the funds they have paid in nor for the liabilities they undertake. They would risk their taxpayers' money for nothing in return.

Even if the agency earned a market rate of return on its capital and allocated its net income to its reserves (Art. 33), member countries which chose to withdraw from the agency would not be entitled to (their) part of the accumulated earnings. Art. 56 merely states that

> "the Agency shall enter into an arrangement with such a state for the settlement of their respective claims and obligations".

Finally, if the agency is to operate without subsidies and on an equal footing with private political risk insurers, it must not be "exempt from all taxes and duties" (Art. 52).

1) Ibrahim F.I. Shibata, "Increasing private capital flows to LDCs. An examination of the proposed multilateral investment guarantee proposal", Finance and Development, December 1984, p. 8.

The convention has to be altered to exclude any form of subsidisation on a longer term average. Otherwise, the agency would reward mistaken policies in the host countries and obtain an unjustified competitive advantage over private insurance companies.

Is a Multilateral Investment Guarantee Agency likely to avoid subsidisation over a longer run? The World Bank Staff emphasizes that very few national investment guarantee schemes have made losses over a longer term.[1] What is less clear is whether this could also be said if the national agencies had to pay a market rate of return to the taxpayers and taxes to the government.

13. A multilateral insurance against political risks need not weaken the political incentive to reduce political risks. If properly designed, it may even strenghten this incentive. This would be the case if the agency could use sanctions against those member countries which expropriated direct investors from abroad without adequate compensation, which imposed exchange controls or which failed to honour their legal commitments. The following sanctions in particular would be easy to implement:

- if the host country does not fully compensate the investor (or, after subrogation, the insurance agency), its subscription to the agency's capital is used as a pledge;
- if the host country does not pay full compensation for damage, it is excluded from any further investment guarantees;
- if the host country does not pay full compensation, it is excluded from any further loans of the World Bank Group and the IMF.

1) Multilateral Investment Guarantee Agency: Questions and Answers, op. cit.

Article 55 of the draft outline states that

> "if a member fails to fulfill any of its obligations under this Convention, the Council may suspend its membership".

Since the draft convention does not oblige the host countries to avoid political risks or to always pay full compensation for them, it has to be clarified whether the draft would permit the first two sanctions. Moreover, deterrence would be more credible and effective, if the council were not merely permitted, but obliged to impose these sanctions. The third type of sanction (exclusion from World Bank and IMF loans) is not envisaged by the draft convention at all.

Perhaps it ought to be emphasized that the first and the third sanction could be introduced regardless of whether a multilateral investment guarantee agency is established. For the first sanction to become available the government of a developing country would merely have to be willing to deposit a pledge with a foreign public or private institution in order to increase foreign confidence in its own policies. Since the governments of developing countries have not chosen this route in the past, one may doubt that they would want to join a multilateral institution that could impose such sanctions.

15. The Multilateral Investment Guarantee Agency proposed by the World Bank would discriminate between direct investment by foreigners and direct investment by residents. Even if the agency's insurance cover was not subsidized, it would introduce an economic distortion.[1] The most probable effect of this distortion

1) It might be argued that some discrimination in favour of foreign investors is justified because their political risks are larger. In this case, however, non-discrimination would imply that only the foreign investors' <u>excess</u> political risk be insured.

is that the additional capital imports would largely be offset by additional capital exports of LDC residents. As the experience of the last decade has shown, considerable offsetting of this type is likely, even if neither insurance discrimination nor free convertibility exists.

The World Bank staff has recognized this problem and suggested that "if MIGA members so desire, its operations might be extended to domestic investors in certain situations."[2] Will many members agree to such a solution?

15. International agencies, like all bureaucracies, are constantly in danger of succumbing to Parkinson's Law. Their staffs grow, unless limits are imposed from the outside. In the present case, no such limits are set. On the contrary, the draft convention defines MIGA's tasks very broadly: it should

> "carry out research and disseminate information on investment opportunities in developing countries ...and ..., upon request of a member, provide advice on improvement of the investment climate in its territory" (Art. 23).

Most of these services are already provided (free of charge) by other multilateral development institutions. Moreover, since it is very important that MIGA should offer its insurance services on strictly commercial terms, it might be advisable to prevent it from providing <u>any</u> free or partly subsidized services. Otherwise, the non-subsidisation principle would be difficult to enforce in MIGA's insurance activities.

1) Multilateral Investment Guarantee Agency: Questions and Answers, op. cit., p. 43.

If the establishment of a multilateral investment guarantee agency is to represent a shift of emphasis in the international development effort - a shift in response to the debt crisis rather than an attempt to devote more public resources to development policy - , then the staff of the new agency might be usefully recruited from the personnel of the World Bank Group which would shrink correspondingly.

It is true that, under certain conditions, a multilateral investment guarantee agency could serve "to improve the efficiency of worldwide resource allocation", as the World Bank suggests.[1] However, it seems doubtful that these conditions are satisfied by the World Bank's proposal.

1) Multilateral Investment Guarantee Agency: Questions and Answers, op. cit., p. 6.