Potential financial risk faced by the International Monetary Fund

Exceptionally large exposures of the International Monetary Fund (IMF) and their concentration among a very few large debtors have led to a consensus in the international community to reduce these exposures. However, this will be possible only in the medium to long term as, in the short term, recent repayment commitments have had to be revolved once again to avoid imposing an excessive balance of payments burden on the affected countries. Once country-specific repayment obligations have reached a critical mass both for the balance sheet of the Fund as the creditor and for the debtor's balance of payments, this raises the question of a potential default risk or of a need for provisioning. At the same time, however, the IMF was deliberately designed as a "risk-free" mechanism and hence has no need to price a risk premium into its lending rates, thus providing support to the debtor as intended. However, large and entrenched exposures do entail financial risks of a specific nature to the Fund, where the usual banking (ie statistically empirical) concept of default risk cannot be applied. The avoidance or control of such risks is also an element of a broadly based strategic review of IMF policies in international fora.

High credit concentration at the IMF

The historical development of the Fund's credit portfolio can be described as follows. During the first stage – up until the mid-1970s – the Fund's members were, at different times, both creditors and debtors, in a rotation scheme akin to that of a credit union. The largest debtors were industrial nations. In a second stage – between the mid-1970s and the mid-1990s – the IMF found itself in a more polarised position, with developing countries and emerging economies as its "borrowers" and the industrial countries (more precisely, the G10 and Saudi Arabia) as its "depositors". This made the Fund more akin to a bank. In the second half of the 1990s, a series of dramatic balance of payments crises occurred, resulting in unprecedented large IMF exposures to emerging market economies that were controversial from a systemic standpoint owing to "moral hazard". In some of the cases, these loans remained short-term and were repaid on schedule. In other cases, however, the repayment of these exceptional loans proved to be difficult. Since then, the Fund's loan portfolio has been more strongly concentrated on exposures (three in particular) to emerging economies which, by any standard, are exceptionally large and deeply entrenched. This has been given the name "credit concentration" in the international discussion. (See the table on page 77.)

Credit concentration cannot be judged in isolation from the amount and duration of the exposures ...

In mid-2005 the volume of outstanding IMF credit (excluding undisbursed commitments) stood at US$78 billion. Of this figure, 64% was accounted for by only three borrowers. Admittedly, this oft-cited percentage is relatively meaningless in isolation. After all, the Fund's job is not to diversify its loan portfolio but to deal with actual balance of payments needs without discriminating against any country. If the number of cases of need remains small, the IMF's lending is accordingly "concentrated"; this would appear to be a rather positive sign of a relatively crisis-free global economic environment. Credit concentration therefore cannot be examined in isolation from the amount and duration of the exposures.

... and especially its share in revolving IMF financial resources

It is therefore more meaningful to state that, as at mid-2005, the three largest exposures accounted for 28% of the consolidated quotas of the traditional donor countries (G10 and Saudi Arabia). (In mid-2003 this figure had peaked at an all-time high of 41.7%.) Here, too, the decisive factor is not the arithmetic concentration on the assets of the IMF's balance sheet but instead the percentage of the revolving IMF financial resources which is being tied up by a very small but unchanging group of borrowers over a relatively long period of time.

If "large" (by this definition) and entrenched exposures were to harbour a default risk, this could impair the IMF's capacity to provide new loans to cover other members' new balance of payments needs (through, for instance, the need to accumulate reserves that would have to be subtracted from the total funds available). In that case, such a "credit concentration" would entail financial risks to the ability of the IMF to function as a credit union.[1]

1 In the IMF's internal accounting terminology, unused financial resources available for new lending are called the "forward commitment capacity". Its definition differs only marginally from that of the indicator known as "IMF liquidity".

IMF has no nominal default risk

The IMF's lending terms are pegged to the industrial countries' risk-free money market rates. They are therefore not related to market rates for the debtor countries. Precisely therein lies the support for debtor countries in crisis situations, in which the only other alternative would be for those countries to refinance themselves at prohibitive market rates on the international capital market (leaving aside in this specific context developing countries without capital market access).

IMF lending rates intentionally devoid of country risk premia

The intentional absence of country risk premia in the IMF's lending rates is also designed to safeguard the spirit of solidarity within the Fund community. All member countries have equal access to IMF support (for the same balance of payments needs and the same credit facilities). The IMF, in turn, protects itself against country risk by attaching the appropriate conditionality to the adjustment programme, but not through country-specific interest and maturity terms, such as would have to be applied by commercial lenders.

IMF not an insurance mechanism

Since individual country risks are not supposed to be reflected in the lending terms, the IMF is not an insurance mechanism in the private sector sense. Since there is no "minimum credit standing" that could be invoked to deny a country membership of the Fund, the IMF cannot be defined as a "mutual insurance

IMF: Comparison of credit concentration

Time and country	IMF loans			
	US$ billion	In % of quota	In % of GDP [1]	In % of exports [2]
End-1965				
United Kingdom	1.9	97.8	1.9	13.8
End-1977				
Italy	1.9	158.1	0.9	4.2
United Kingdom	4.1	119.3	1.5	6.7
Peak levels				
Argentina (Sep 2001)	14.6	534.8	5.1	55.3
Brazil (Sep 2003)	33.4	769.4	7.3	55.3
Turkey (Apr 2003)	22.9	1,720.2	13.0	66.4
Uruguay (Aug 2004)	2.6	575.9	23.5	117.5
End-2004				
Argentina	14.1	428.6	9.3	40.9
Brazil	25.0	530.9	3.8	25.9
Turkey	21.5	1,436.5	6.7	34.9
Uruguay	2.7	562.9	18.6	91.0
May 2005				
Argentina	11.8	378.1	7.6	34.3
Brazil	22.6	505.8	3.1	23.5
Turkey	18.3	1,288.5	5.8	29.7
Uruguay	2.4	532.9	15.3	81.8

Sources: IMF: IFS; Bundesbank calculations. — **1** Where figures cover less than one year: comparison with previous year's GDP. — **2** Where figures cover less than one year: comparison with previous year's exports.

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community" either.[2] The systemic requirement of offering uniform lending terms irrespective of country risk is therefore inconsistent with recent proposals to the effect of providing precautionary, yet risk-proportionate IMF credit lines irrespective of an acute need.

Firstly, if the financial terms were to remain uniformly favourable, all countries would be given an incentive to take advantage of such protection (ie there would be no mechanism to limit demand).[3] Secondly, if demand were to be controlled by risk-adjusted terms, an application for such risk insurance would cause the market to look at that country more negatively than at other countries – with potentially unintended, harmful consequences. (For this reason, the Contingent Credit Line (CCL) was abandoned owing to a lack of demand.) Thirdly, if the idea is to minimise the effects on the debtor of a negative market assessment, the effect would be tantamount to an IMF guarantee that private creditors would always be able to recover their assets. Private creditors' expectation of being "bailed out" by the IMF in a crisis, initially "only" speculative, would then become a preordained certainty.

Lending rates without risk premia require elimination of default risk

From the point of view of the Fund community as a whole and the creditor nations in particular, low risk-free lending rates – necessary under the systemic policy goal of acute crisis containment – are acceptable only if default risk is eliminated accordingly. There are two elements to eliminating default risk. Firstly, if a country encounters international financial difficulties and has, for instance, to reschedule liabilities to commercial foreign creditors, IMF loans themselves are not affected by such rescheduling. This absolute seniority of IMF exposures is referred to as the Fund's "preferred creditor status". Secondly, if a country's liquidity situation makes it difficult for it to repay even highly subsidised IMF loans, the Fund can theoretically revolve these repayment obligations indefinitely. Unlike commercial lenders, the Fund is not bound by prudential accounting principles and therefore does not need to form any additional provisions. To offset the absence of accounting restrictions, this type of revolving is generally associated with a tightening of economic policy requirements. In this case, too, potential default risk to the Fund is not covered by imposing risk premia on IMF lending or Fund provisioning; instead, it is supposed to be eliminated through the economic programme conditionality which the debtor country is required to fulfil.[4]

2 The IMF is less of an insurance scheme and more of a social pay-as-you-go system, the difference being that benefit claims cannot be differentiated individually without departing from the principle of uniform contribution payments and uniformly defined balance of payments needs. Membership of the Fund as such does provide a certain type of "insurance protection" in that otherwise access to supporting loans would not be available in a case of need.

3 According to the proposals, the usual IMF interest rates would be levied only if an insurance event were to actually occur. If insurance protection were given, only a "commitment fee", ie a refundable provision fee, would be charged (0.25% on amounts up to 100% of the quota and 0.1% on amounts beyond that threshold).

4 The fact that – to a very limited extent – some countries are in arrears to the IMF does not contradict the conceptual absence of default risk. Such arrears are the result of a conscious assessment by the IMF, as the creditor, that it will not be able to come to an agreement with the debtor on terms for revolving the loan. The costs of such "arrears" are apportioned to the Fund community by adjusting the Fund's global interest rate margin in order to avert the accounting effects on the Fund's capacity to grant new loans. Moreover, for the extreme event of a country leaving, or being expelled from, the IMF, as envisaged in the IMF's Articles of Agreement, a global reserve for the permanent loss of redemption payments is maintained. See also the box on pages 84 and 85.

Historically, this privileged relief of IMF loans from default risk was not only accepted but virtually demanded by commercial lenders, who sometimes have to bear a large default risk themselves. After all, only by being capable of being revolved indefinitely irrespective of commercial risk assessments can IMF lending improve, in a balance of payments crisis, the liquidity conditions for servicing commercial loans that are not revolving in nature. Put differently: if IMF loans were not entirely free of the risk of being subject to a potential rescheduling themselves, they would not make any net contribution to increasing the debtor's capacity to service other debts (which would face rescheduling). Yet this is precisely what is at stake in a typical "crisis". On the Fund's side of this desirable systemic mechanism, however, the task of balancing the unlimited revolving nature of IMF loans through an additionally adapted economic conditionality (as a non-commercial form of "collateral", as it were) still remains. The aim is always to put a clear time limit on any "revolving" in order to maximise the uncommitted, freely available financial resources for the rest of the Fund community as a cooperative union.

It therefore follows from the systemic task of the IMF mechanism that IMF loans have to be free of default risk. In this sense, it is correct to conclude that the IMF has no default risk and that, consequently, no provisions need to be formed for a non-existent risk. One might argue that, systemically speaking, the IMF, as such, is already a "reserve" which offsets inherent risks of the international financial system.

Credit augmentation risk in place of default risk

Since, for the reasons mentioned above, the IMF is not exposed to nominal (statutory) default risk, it also makes little sense to apply the country-specific empirical probabilities of default used by the private banking industry to the IMF's loan portfolio in order to evaluate its "credit quality", as has sometimes been suggested.

However, since potentially endangered IMF loans tend to be rolled over (generally in combination with changes to conditionality), default risk is replaced by permanent rollover risk or the risk of credit augmentations. These types of risk are of the same nature as a budget overrun risk. Consequently, this may very well be regarded as a material financial risk, as unplanned credit augmentations tie up funds (unexpectedly) and thereby reduce – at least temporarily – the remaining available IMF resources for other countries accordingly.

Admittedly, this applies to all IMF loans, and these "costs" are the costs of regular Fund operations. They need to be compared with the financial gains from adjustment in the debtor country. This cost-benefit analysis holds equally for "credit augmentations" and for "initial loans" (see pages 81 and 82 for more on the problem of the long-term nature of Fund exposures). The extent to which IMF lending may be affected overall by the risk of the Fund community sustaining a loss of available funds – even without nominal default risk to the Fund – therefore depends on the size and certainty of these financial ad-

justment gains on the part of the debtor, ie on programme risk and programme efficiency.

Credit augmentation risk is programme risk

An IMF loan is an immediate but only temporary gain in international liquidity for the debtor country. The purpose of this temporary assistance is that the economic policy requirements attached to the loan enhance the debtor country's international liquidity permanently, which means that the IMF loan can be repaid as quickly as changing financial circumstances permit.

Fund's specific risk of loss

The permanent liquidity gains from economic adjustment gradually replace the short-term liquidity gain from the original IMF loan. IMF programme efficiency can thus be conceptualised as a balance between the size of permanent liquidity gains from adjustment and the sum of repayments to the IMF (ie the volume of the original IMF loan). If the permanent adjustment gains exceed the volume of the IMF loan, one could speak of a lasting net gain. A situation in which adjustment gains are exactly equal to the IMF loan is defined as "minimum efficiency" or the "break-even point". The Fund community "sustains a loss" if the adjustment gains fail to match the amount of the original loan. The probability of such a case constitutes the Fund's specific risk of financial loss.

All IMF loans bear such a risk of loss. The IMF has consciously refrained from applying risk-adjusted interest premia and provisions to minimise this risk, opting instead to adapt conditionality and to revolve loans. Adjustments to conditionality ensure that the occurrence of a loss (in the budgetary sense of an "unscheduled prolongation of a loan") is not permanent – ie not a "sunk cost" but only a delayed repayment.

In this sense, the ever-present programme risk of IMF loans does not need to be interpreted as the risk of a "terminal" financial loss to the Fund as long as conditionality – if necessary – can always be tightened.

Risk of permanent financial loss

Consequently, the risk of a permanent financial loss to the Fund community arises only if

- additional adjustments to conditionality no longer seem realistic, either for economic reasons or for reasons related to domestic politics in the debtor country;
- lasting gains in international liquidity achieved to date by the debtor country through economic adjustment have failed to equal the level of outstanding IMF credit;
- IMF exposure to the debtor country is significant from the point of view of the rest of the Fund community – more precisely, if the resulting redemption payments make a significant contribution to the Fund's liquidity position.

If the term "adjustment to conditionality" is replaced by "programme efficiency", one could say that the Fund community faces un-

desired and unforeseen material financial risks from the exhaustion or terminal loss of programme efficiency, while the debtor country's international liquidity is still insufficient.

Such a case is usually classified as structural insolvency (to distinguish it from temporary illiquidity). If financial bridging and the Fund's economic policy conditionality cannot suffice to restore the debtor's international liquidity, the only solution left is debt rescheduling, including the possibility of losses for private creditors.

Illiquidity versus insolvency

A conceptually accurate distinction between illiquidity and insolvency is not always easy for the Fund – in its role as an "international crisis manager" – to maintain in practice. Ignoring the outbreak of crises by arguing that the solvency risk is too great is not an option for the Fund. Where this is the Fund's objective assessment, the best it can do is to work towards linking short-term financial bridging to a call for a structural rescheduling.

Distinction between illiquidity and insolvency difficult in acute crises

In addition, the progressive transition in international capital movements from bank credits to negotiable market instruments has made it more difficult to distinguish between illiquidity and insolvency in acute crises. An abrupt reversal of capital inflows to an emerging market economy – a sudden loss of confidence or a sudden change in risk assessment – will be reflected in a sharp short-term rise in risk premia on that country's international interest payments and probably also in a depreciation of that country's currency. Hence the country would not be able to service its existing foreign debt over the medium term and would therefore be insolvent. However, to what extent is it justifiable to extrapolate the current market data into the medium-term future if they diverge sharply from past averages? What medium-term market valuation assumptions should the Fund community make when distinguishing between illiquidity and insolvency in a manner consistent with the Articles of Agreement when reaching credit decisions?

In today's international market conditions, the distinction between illiquidity and insolvency is, of necessity, a probabilistic concept or – conversely – a risk measure. Seen this way, one could take the previously defined case of a permanent loss of IMF programme efficiency while the debtor remains insufficiently liquid internationally and rephrase it as follows: the risk of the Fund community sustaining a financial loss arises to the extent that IMF exposures which were originally intended as short-term liquidity assistance turn out, over time, to be unintended exposures to structural insolvency situations.

IMF exposures to structural insolvency situations upset balance of interests

This risk of financial loss by having to continue to support an insolvent debtor manifests itself for the Fund not in the same manner as a nominal default risk but in an "upsetting" of the balance of interests between the debtor and the creditors, including the IMF. Put differently, the incentive structure associated with the normal functioning of the IMF reverses itself. The desired elimination of default risk to the Fund (in favour of lending

rates without default risk premia) then creates an offsetting, Fund-specific "shadow risk". This "shadow risk" is manifested in the fact that the Fund may be compelled to inject additional financial resources (budget overruns), thereby diminishing the resources available to all others. It may also be compelled to request the debtor to make increasingly unrealistic adjustments (budgetary waste). Also, the debtor country itself may find it more rational to impose a unilateral moratorium on the repayment of outstanding debt to the Fund instead of discussing the terms of revolving the loan with the IMF because the leeway thus gained in terms of international liquidity exceeds the potential gains to be expected from an additional adjustment of IMF programme conditionality. Finally, private creditors may come to believe that the additional positive effects of the extension of an IMF programme are so small or uncertain that they would be more likely to recoup a larger value of their loans through the inclusion of the IMF's exposure itself in a rescheduling. All such risk variants (and any attendant costs of balance sheet provisions) ultimately reflect the risk of a loss of additional IMF programme efficiency.

Potential implications for IMF policy

Exposures which have to be revolved in order to suppress default risk but which no longer ensure additional ("marginal") programme efficiency are at odds with the Fund's financing mechanism itself and therefore also with the agreed terms of reference between the Fund and its creditors. These terms stipulate that deposits with the Fund are liquid and risk-free and can therefore continue to be entered as part of the "official foreign reserves" of the depositor countries. The use of such deposits for what are essentially (after multiple revolving) long-term and increasingly risky credit exposures is, as a general principle, not permitted under this financing mechanism. This therefore raises the question as to how the Fund should deal with exposures that have unintentionally turned into "long-term risky exposures".

The global reserves which the Fund has been accumulating for payment arrears for some time now may quickly prove to be insufficient under unfavourable conditions. (See the box on pages 84 and 85.)

There are three conceivable strategies for a fundamental review of the IMF's risk management practices: firstly, to reduce risky exposures as quickly as possible to ensure continued compliance with the Fund's financing mechanism; secondly, to adapt the financing mechanism to the requirements imposed by risky exposures; and thirdly, to remove risky IMF exposures from the Fund mechanism and transfer them elsewhere.

Although these three strategies represent a clear conceptual delineation of the options, the operational decisions faced by the Fund community in day-to-day operations are not always as clear-cut. When it comes to practical implementation, hybrid solutions and compromises are essential, either for lack of time or because different Fund shareholders have different preferences.

There are three specific approaches that could be pursued for managing unintended financial risks in the Fund: firstly, to tighten debt sustainability analysis and increase its role both in lending decisions and in assessing programme efficiency; secondly, to apply indicative absolute upper lending limits not as a percentage of debtors' IMF quotas but relative to debtor-specific macroeconomic indicators (eg exports, foreign currency debt); and thirdly, to create special refinancing mechanisms for unintended risky exposures.

Debt sustainability analysis

Currently, the IMF staff analysis defines the objective of a sustainable external debt and uses it to derive a consistent policy target for the primary government balance (overall balance minus interest expenditure). This means that fiscal policy is being used as the key instrument in controlling the current account balance or, more precisely, the external financing need. It is the associated sensitivity analysis that lends to the debt sustainability analysis its particular importance as a basis for a probabilistic "risk assessment" for the Fund community as a whole. This is understood as the quantitative analysis of how quickly, and by how much, a debt sustainability threshold would be exceeded in the event of unforeseen shocks (exchange rates, international interest rates, oil prices etc).

Analytical gap in the sensitivity analysis of debt sustainability

It is still normal Fund procedure to assume in the analysis that the original fiscal policy target (normally a primary surplus as a percentage of GDP) will always be reached, in order to test whether this target will also be sufficient to ensure or restore the sustainability of foreign currency debt even in the event of a shock-related change in foreign currency debt. What is not analysed, however, is what additional fiscal policy measures would be necessary to ensure continued compliance with the predefined fiscal policy goal even under unfavourable conditions, or how realistic such additional measures would be. This analytical gap could be closed by basing the sensitivity analysis not on meeting a fiscal balance target which is fixed by assumption but on unchanged public expenditure levels and tax rates (ie on a "no-policy-change" assumption), with the balance (primary surplus) varying endogenously depending on the shock involved. This would make risks to debt sustainability, and thus potential financial risks to the Fund, easier to recognise from the outset.

Financial risks to the Fund in the event of doubtful debt sustainability could also be contained more easily if Fund programmes set indicative upper limits for external debt servicing. To avoid conveying the impression of direct interference in creditor-debtor relationships, such upper limits could be formulated in a suitably implicit manner, for instance, as a percentage of exports or as an interim target for the current account balance less debt service (interest and redemption payments). At all events, it would be desirable for the Fund to state explicitly the debt sustainability assumption that is being used, in compliance with the Articles, to justify its lending.

The IMF's current approaches to controlling financial risk

For some time, the IMF has been accumulating relatively small precautionary balances in its balance sheet, which are not correlated with credit risk, to offset possible arrears (which are in violation of the Articles). These balances are composed of the General Reserves and the Special Reserves as well as the Special Contingent Account (SCA-1).

The difference between the two types of reserves is in their use: the Special Reserve, established in 1957, safeguards against deficits in the Fund's operations, whereas the General Reserve, created in 1958, meets capital losses. Moreover, the General Reserve can be refunded to the member states in proportion to their quotas by a 70% majority of the voting power in the Executive Board, whereas no distribution of the Special Reserve is permitted (as long as the Fund continues to exist). For IMF members, the reserves represent an indirect asset; in the event of the Fund's liquidation, reserves would be distributed among members in proportion to their quotas. The reserves are accumulated by retaining income. At the end of the financial year, regular net income is transferred to the Special Reserve. The net income target, which is reset annually, is 5% of the reserves at the beginning of the financial year, unless otherwise decided by the Executive Board. Other income, especially income from surcharges, is transferred to the General Reserve. This income is more volatile as it is dependent on the uncertain movement of the SDR interest rate and the volume of outstanding credit.

The SCA-1, established in 1987, was designed to protect against the financial consequences of protracted arrears. It meets potential income losses to the IMF resulting from the ultimate default of the borrower. The funds of the SCA-1 are accumulated in the burden sharing mechanism. This mechanism is designed to spread the financing burden evenly among creditor and debtor countries by slightly increasing the charges paid by debtors on IMF loans and accordingly reducing the remuneration received by creditor nations. Once overdue payment obligations to the IMF have been met, the financial resources accumulated in the SCA-1 are refunded to member countries. They can also be refunded earlier if so decided by a 70% majority of the voting power in the Executive Board. Funds must be refunded in proportion to each member's contribution to the SCA-1.

At the end of April 2005, the IMF's precautionary balances reached SDR 7.3 billion, of which SDR 5.7 billion were reserves and SDR 1.6 billion were SCA-1 funds. In view of the increased risks to the Fund's overall balance sheet, in November 2002 the Executive Board decided to increase the precautionary balances to SDR 10 billion over the medium term, double the stock in November 2002. This figure was not derived analytically or risk-appropriately but instead negotiated politically.

In addition to precautionary balances, there are several other approaches for internally protecting against risks from IMF lending. Prudent lending practices remain the key instrument. Self-imposed access

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Overview of the IMF's current approaches to internal risk reduction

Instruments	Features	Limits
Reserves	Reserve for income/capital losses	Total amount: currently SDR 5.7 billion
SCA-1	Reserve for default	Total amount: currently SDR 1.6 billion
Access limits	100% of quota pa, 300% cumulatively	Political deliverability
Fees	Volume-related or time-related surcharges, special fees	Not risk-oriented
Burden sharing	Offsetting of arrears	Lower limit for the rate of remuneration
Preferred creditor status	Preferential repayment of IMF claims	More difficult to deliver politically given a large IMF share of debtor's total indebtedness

rules restrict a debtor country's access to IMF resources to 100% of the quota per year and 300% cumulatively. Higher access is permitted only under strictly defined exceptional cases. Four criteria need to be met simultaneously: exceptional acute capital account pressure, medium-term debt sustainability, the prospect of regaining capital market access during the IMF programme, and a strong and politically deliverable adjustment programme.

Furthermore, the IMF uses a system of surcharges and special fees to limit access to IMF credit and create incentives for the early repayment of disbursed funds. There is, however, no risk-adjusted differentiation of fees. Instead, a volume-based approach is applied, with outstanding credit in excess of 200% of the quota subject to a 1% surcharge, the figure going up to 2% from 300% of the quota and up. There are also time-dependent surcharges on purchases under the Supplemental Reserve Facility (SRF) of between 3% and 5%. Commitment fees are levied for unused credit tranches. If applicable, special fees equivalent to the difference between the rate of charge and the SDR interest rate apply to overdue repayment obligations to the IMF's General Resources Account that are less than six months outstanding.

The IMF's burden sharing mechanism not only generates income for the SCA-1 but also protects the IMF from income losses arising from overdue charges by compensating for the shortfall through temporary increases in the rate of charge while lowering the rate of remuneration. This way, the IMF's debtors and creditors alike pay the overdue charges of the defaulting debtor. Burden sharing capacity is limited, however, as the remuneration rate cannot be any lower than 80% of the SDR rate. Although the rate of charge is not legally subject to an upper limit, a sharp increase is likely to encounter insurmountable resistance from debtor countries – especially if it is not accompanied by a simultaneous reduction of the remuneration rate. As such, the procedure provides only limited protection against the non-payment of charges and does not cover overdue repayment obligations.

Debt sustainability risks, and hence potential financial risks to the Fund, could be balanced more deliberately and systematically with tranche disbursement risk. The (mostly quarterly) disbursement of credit tranches under agreed lending programmes could be predicated more strongly on whether the original debt sustainability assumptions are still met.

Credit limits

Unusually turbulent capital account crises in the past ten years have led the Fund community to create the option of granting short-term financial support at levels which – under specific, clearly defined conditions – have no longer needed to be limited by the applicant country's IMF quota ("exceptional access").[5] It still makes sense to have such an option in exceptional crisis situations. In the meantime, however, the experience of actual recourse to this option has shown that such extraordinarily large IMF financial packages – even under optimistic assumptions or where objectives of economic policy adjustment have been successfully achieved – can overstretch the debtor's balance of payments and ability to repay the loan. The consequence has been a repeated rollover of exceptionally large IMF loans despite the fact that the statutory conditions for exceptional access to Fund resources no longer exist.

This experience raises the question as to whether the – still desirable – quantitative detachment of access to loans from the country's own IMF quota in certain crisis situations should not, at the same time, also be balanced out by another type of upper limit for Fund loans, expressed as a percentage of macroeconomic indicators for the debtor country such as exports, GDP and total foreign currency debt in order to prevent excessive "repayment stress" but also in the interest of reducing the risk to the Fund community. In the past, this question had already been discussed within the Fund community and initially been rejected; however, recent experiences (unplanned revolving, repayment obligations to the Fund as the principal balance of payments problem) have caused this question to resurface.

It would make sense if the Fund's indicative macroeconomic upper lending limits were defined not by one single indicator (eg repayment obligations to the Fund as a percentage of exports) but instead in terms of the simultaneous reaching of several indicator levels (see above). In particular, the duration of the overshooting of critical threshold levels should play a decisive role. After all, in order to assess overall financial risks to the Fund community, it is not the short-term, temporary ability of the Fund to react to acute crises that is important but the risk of an unexpected entrenchment (and associated "repayment uncertainty") of IMF exposures once the crisis has been overcome.

5 Four criteria have to be met simultaneously before a country is eligible for exceptional access to IMF resources. These criteria are: exceptional acute balance of payments pressure on the capital account, a debt that is sustainable over the medium term, the prospect of regaining access to financial markets in the near future, and a convincing and politically deliverable adjustment programme. The objective is to restrict exceptional access to IMF loans to rare exceptions.

Under the Fund's specific stability mandate, "upper credit limits", as an additional risk policy instrument, could only be an indicative, not a prohibitive instrument. This gives rise to the question what should be "triggered" by reaching or exceeding non-prohibitive upper credit limits. For instance, indicative, non-prohibitive upper credit limits could, in balance sheet terms, trigger the formation of provisions or reserves, known as "precautionary balances" in Fund terminology. A similar effect would be achieved by deducting expected redemption payments from risky Fund exposures from the budgeted "available" Fund resources for new lending (the "forward commitment capacity"), ie reducing the available budgetary resources as a precautionary measure.

The reaching of indicative upper credit limits could trigger precautionary premia – not country-specific but duration-specific or level-specific – on the interest rates for loans to the affected debtors. Higher debit interest rates on outstanding exposures once indicative upper credit limits have been reached or within the context of a slide in probabilistic programme efficiency could be linked to a "non-borrowing" programme with adjusted conditionality, but without new financial lending commitments and without revolving outstanding loans, ie with no additional financial risks to the Fund.

Reaching indicative upper credit limits could also generally trigger a modification of programme conditionality. For instance, the reaching of indicative upper credit limits could lead to the complementing of existing programme conditionality by means of additional upper debt servicing limits as a percentage of exports (potentially with an implicit rescheduling requirement).

Changes in the IMF's financing mechanism and the off-balance-sheet transfer of "problem loans"

It is not "normal" programme risk, but rather only the ultimate loss of programme efficiency, that would burden the assets of the IMF's balance sheet with a kind of rollover or credit augmentation risk which would not be consistent with the liquid, risk-free nature of the liabilities of the Fund's balance sheet. Members' IMF "deposits" (quotas) could then no longer be regarded as liquid, "readily available" official foreign currency reserves. The fact that this risk would tie up funds would also be detrimental to other potential Fund borrowers.

To resolve such an unintended contradiction, "problem exposures" – which are no longer associated with programme efficiency but have to be revolved to suppress nominal default risk – could be removed from the Fund's regular balance sheet and transferred either to another international institution (for instance, a multilateral development bank that grants long-term loans) or to a new "special account" at the Fund itself. These exposures – and therefore also the default risk or risk of perpetual rollover – would be funded out of the government budgets of the members of the Fund or World Bank. The extent to which these countries would then adjust the lending

terms to a level commensurate with risk or identify the risks explicitly in their budgets would then be a conscious and transparent decision made on development policy and budget policy grounds.

One potential alternative would be to link the rate of interest on problem IMF loans not to the (fixed and risk-free) financing costs of the Fund but to the international market rates applicable to the debtor. There are a variety of levels where such a peg could be set. The pure market solution or full commercialisation of these exposures would be represented by a rate of 1 to 1. However, such a peg could also be set at a level somewhere below 1 to 1, which would mean that IMF interest rates on "problem exposures" would remain subsidised. The statutory principle of "equal treatment" and "uniformity of lending terms" for all IMF borrowers would then no longer be interpreted as "the same level of interest" but as "the same interest subsidy component". Exposures with rates of interest that are pegged to market-valued risk premia could admittedly no longer be covered by risk-free currency reserves. The costs of subsidising interest rates in this fashion would then have to be covered by the members' national budgets. The systemic advantage of switching from uniform IMF interest rates to uniformly subsidising (variable) market rates of interest for risky IMF exposures is that the costs of this risk would be immediately transparent.

Outlook

In the recent past, a certain systemic policy conflict has emerged between the IMF's refinancing mechanism (where deposits with the Fund are sufficiently liquid and risk-free that creditors can continue to report them as foreign currency reserves in their balance sheets) and the Fund's actual lending policies. This conflict will have to be resolved in the near future – if possible, by a lending policy that takes a more critical view of risk – in order to maintain the functional viability of the Fund in its role as a systemically beneficial stabilising mechanism.

Although the discussion has already begun, it is still in its early stages. In the relevant international fora, it is embedded in a more broadly based debate on the IMF's future strategic orientation (referred to as the IMF strategic review), which is also intended to cover the pure economic policy surveillance function of the Fund without lending, the division of responsibilities between the IMF and other multilateral institutions, and the Fund's internal governance rules. A first step in strategic reform has already been agreed in the form of the "exceptional access framework" which, in the event of exceptional capital account crises, makes it possible, under certain conditions (especially debt sustainability), to grant loans irrespective of normal, quota-related access limits. Especially in today's world of deregulated capital markets, such an "emergency mechanism" is, and remains, a beneficial feature as long as there is always a clear "definition" of the necessary conditions. Looking ahead, and given recent diffi-

culties encountered by several former crisis countries in actually repaying their exceptionally large loans from the IMF, it would be equally desirable to agree on certain risk control principles, such as macroeconomic upper limits for borrowing from the IMF. This would ensure that the Fund's credit policy continues to follow a consistent systemic policy orientation.