

## **Seminar on Current Developments in Monetary and Financial Law Washington, D.C., October 23-27, 2006**

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### **International Economic Law and the Lender of Last Resort**

#### Introduction

Traditionally, the main threat to financial stability was the classic bank-run problem, in which a credit institution with a balance sheet principally composed of liquid liabilities and illiquid assets was forced to sell its assets at a deep discount because of a sudden call on its deposit liabilities. Because most of the bank's liabilities were denominated in the local currency, the central bank could intervene to provide liquidity to the ailing institution. Naturally, Bagehot's law would apply, permitting the central bank to lend in an emergency only to banks that were illiquid, but not insolvent, at a penal rate of interest while taking the bank's securities as good collateral.<sup>2</sup> Systemic risk in the domestic economy could thus be controlled.

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<sup>1</sup> The Judge Business School, University of Cambridge. This chapter is based on a paper that was presented at the 'Law and Financial Stability Seminar' of the International Monetary Fund on 23 October 2006. Special thanks to the organizers and participants at the Fund seminar. Special thanks also to my colleagues at the Centre for Financial Analysis and Policy at the University of Cambridge and in particular to Mardi Dungey and John Eatwell for their incites on sovereign liquidity crises and the role of an international LOLR, and to Professor Christine Kaufmann of the Rechtswissenschaftliches Institut, University of Zurich and to the Swiss National Science Foundation for its support, and finally to the UK ESRC for its support on the project 'The Legal and Economic Aspects of Sovereign Debt Restructuring'. All errors are my responsibility.

<sup>2</sup> Walter Bagehot *Lombard Street: A Description of the Money Market*, (1962, [1873]) (Homewood, Illinois: Richard D. Irwin, Inc.). Bagehot described the maxim as 'in a crisis, the lender of last resort should lend freely, at a penalty rate, on the basis of collateral that is marketable in the ordinary course of business when there is no panic'. See discussion in Forrest Capie and Geoffrey E. Wood, *The Lender of Last Resort* pp. 423-24 (Abingdon: Oxon, Routledge). The Bank was an incorporated joint stock company that had competed for business against other London banks in the eighteenth and nineteenth centuries. In 1830, the Bank for the first time allowed bill

Unlike earlier bank-run problems, most modern financial crises arise mainly because of some element of foreign exchange risk. The growing risk to financial stability because of a counterparty default precipitated by a bank or non-bank finance firm with large foreign currency exposures is substantial. The potential contagion through the inter-bank payment system and across jurisdictions and currencies is considerable. If a large bank or G10 country experiences a default, the bank or sovereign debtor will normally have the ability to borrow in its own currency to cover its exposures.<sup>3</sup> The probability of default is lower because a bank can usually access the central bank's discount window or in the case of a sovereign debtor it can issue more bonds but at a higher interest rate, or simply print more money.<sup>4</sup>

In contrast, because most of the international debt obligations of sovereign debtors and large financial institutions in developing and emerging market countries are denominated in G10 reserve currencies, their ongoing access to these funds is limited by demand and supply in the foreign exchange market and the willingness of foreign investors or lenders (including G10 central banks) to extend credit. Essentially, their default obligations are in currencies for which there is no central bank support. The debtors in non-G10 countries have a currency mismatch problem and this restricts their ability to raise capital in a crisis.

How can international financial institutions provide liquidity for these obligations? Admittedly, the International Monetary Fund has limited resources and cannot provide adequate assistance in a major banking or financial crisis.<sup>5</sup> Although there has been much debate regarding the future role of the IMF, the size of today's globalised capital markets dwarf the resources of the IMF and make it unlikely that the Fund could stem a sovereign debt or other financial crisis by acting on its own because its resources are too limited. This chapter explores alternative roles for the

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brokers (the forerunners of the discount houses) to open 'discount accounts' with the Bank. This allowed specialist dealers in bills of exchange to take bills of a certain standard to the Bank to be exchanged for Bank of England notes, thereby providing them with last resort facilities. Richard Roberts 'The Bank and the City' in Richard Roberts and David Kynaston *The Bank of England* pp. 156-157 (1994).

<sup>3</sup> Through the General Arrangements to Borrow of 1962 G10 countries have always had the ability to borrow G10 reserve currencies in times of crisis. See discussion below.

<sup>4</sup> This can create moral hazard on the part of depositors and investors who perceive that the central bank or government will cover the liabilities of the bank or sovereign debtor.

<sup>5</sup> John Taylor, Editorial, *The Wall Street Journal*, (23 Mar. 2006) p. 23. Taylor is professor of economics at Stanford University and former US Undersecretary of the Treasury for International Affairs. He was one of the leading opponents of the IMF's proposed sovereign debt restructuring mechanism.

Fund to act through existing institutional arrangements with G10 countries to provide supplementary resources to sovereign debtors in a liquidity crisis. The role of the Fund will be addressed in terms of how it can coordinate the operation of a lender of last resort mechanism for countries experiencing the equivalent of a bank-run scenario when there is a sudden loss of confidence by foreign investors in which they refuse to renew short-term investments or loans. What mechanism or procedures could be used to allow sovereign debtors that are illiquid but solvent to access adequate foreign exchange to stabilize a crisis situation?

The chapter also suggests that international economic law has an important role to play in promoting financial stability through the application of public international law principles, such as the doctrine of *pacta sunt servanda* that provides that states must adhere to obligations to which they have agreed to comply in international agreements, which can enhance legal certainty in international economic and financial relations. It is argued that legal certainty is a necessary component in the exercise of an effective lender of last resort authority and that globalized financial markets require clearer institutional linkages and legal rules regarding how an international lender of last resort (ILOLR) function would operate. In this regard, the institutional linkages between the IMF and the G10 industrial states should be made more transparent and legally binding under the existing General Arrangements to Borrow so that the Fund has the authority to access adequate currencies to stabilize a financial crisis in a non-G10 country or region. Naturally, the problem of moral hazard should be addressed by a clear rule-based framework with binding legal obligations regarding the allocation of responsibilities for lending by the G10 countries and the Fund's role in ensuring repayment and in facilitating lending in a financial crisis. Indeed, the role of international law in designing an effective ILOLR should be informed by the need to manage the sub-optimal incentives of investors and states acting without adequate information and coordination so that a rule-based procedure can be devised to allow states in exceptional circumstances to access foreign exchange to pre-empt or recover from a financial crisis caused by a sudden loss of investor confidence.

Devising a international legal framework to govern the operation of emergency lending by central banks and the Fund to sovereign debtors can be linked to the financial policy objective of controlling systemic risk in globalized financial markets and preventing the spread of contagion from one country or regions to others

as occurred in the Asian financial crisis in 1997-98. It is submitted therefore that international economic law has a crucial function to play in building a more robust international lender of last resort mechanism that can effectively control the negative externality of cross-border sovereign debt risk. Generally, this would involve developing *ex ante* prudential regulatory structures and *ex post* financial crisis resolution measures.

The chapter focuses mainly on the *ex post* crisis resolution measures that the Fund should take when a non-G10 sovereign debtor is experiencing payment difficulties or related financial distress. In the Asian financial crisis, Fund emergency lending programs proved inadequate to stem the crisis. Since then Fund resources have been under-utilized in part because many sovereign debtors are unwilling to submit to stringent conditionality requirements, which have often exacerbated a borrowing country's economic and financial difficulties.<sup>6</sup> The chapter suggests that the Fund should have enhanced authority in making calls for reserve currency loans from G10 countries through an amended General Arrangements to Borrow (GAB). The GAB was adopted in 1962 primarily as a guarantee that each G10 state would have the ability to borrow reserve currencies (mainly US dollars and UK sterling) from other G10 states in order to smooth the transition to currency convertibility while adhering to the Fund's fixed exchange rate parities. The GAB authorized the IMF to act as intermediary between the G10 states in facilitating consultations and assessing how much should be borrowed and in guaranteeing repayment. The GAB contained a provision, however, that allowed G10 countries to refuse to lend even if the Fund and a majority of G10 countries had approved the loan.

The GAB framework was an appropriate financial policy response to the then exigencies of the international monetary system that required states to maintain fixed exchange rate parities and to adopt currency convertibility. The GAB applied only to G10 states because they had most of the foreign currency reserves and it was necessary for them to cooperate in lending to advanced economies that were gradually liberalising and needed access to reserve currencies to make the transition. Financial crises did not occur often and when they did they were generally contained in domestic jurisdictions by capital controls. Today, financial crises are mainly microeconomic in origin and arise because of bank-run type panics and sudden losses

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<sup>6</sup> See Joseph Stiglitz *Globalization and its Discontents* pp. 43-52 (2002)(London: Allen Lane)

of investor confidence and are exacerbated by asymmetries of information that lead to moral hazard problems. Existing Fund lending programs and the GAB framework are not adequate for effective crisis management in today's globalized financial markets. The chapter proposes two reforms. First, that the GAB be amended so that G10 countries have an obligation to lend once the IMF Managing Director has made a call for reserve currency loans with majority consent of the Executive Board and majority approval of GAB participants. The GAB and its sister lending arrangement, the New Arrangement to Borrow, should be consolidated and the credit arrangements of its present participants should be increased substantially beyond the present thirty four millions SDRs. Second, for countries to be eligible for GAB emergency lending, they must comply with disclosure standards under the Fund's existing programs, such as the Special Data Dissemination Standard, and purchase credit risk protection insurance on all their sovereign debt instruments.

The chapter proceeds as follows. Part I reviews the background to the Fund's involvement in financial crises and how the changing nature of financial crises in globalized financial markets requires an international lender of last resort mechanism. Part II examines the evolution of Fund lending programs and the role of the General Arrangements to Borrow. Part III analyses recent proposals for crisis management and the major issues confronting an international lender of last resort. Part IV examines some *ex ante* and *ex post* regulatory approaches. The *ex ante* approach involves the Fund exercising its conditionality powers to require sovereign debtors to purchase credit protection on the debt instruments they issue and to comply with existing Fund disclosure standards and related financial sector regulatory practices. The *ex post* approach would involve the Fund and G10 states amending the General Arrangements to Borrow and New Arrangements to Borrow programs to allow the Fund to make binding calls on the G10 states to lend currencies up to their prescribed credit limit to the Fund so that it can lend them to sovereign debtors or their central banks in a crisis. Before making calls on the G10 states, the Fund would be expected to exhaust its own emergency loan programs and to ensure that the sovereign debtors receiving assistance have complied with Fund disclosure standards and conditionality programs.

## The Fund's Evolving Role

During the Bretton Woods system, the developed countries of the IMF system had relative policy autonomy in pursuing their domestic macroeconomic economic objectives that included unemployment, interest rate policy and inflation control. The main concerns of central bankers and financial regulators were shaped mainly by macroeconomic imbalances that arose in part from current account deficits and capital flows between countries. The Fund's chief function was to oversee the parity values of its members's currencies and to provide temporary liquidity support to members experiencing macroeconomic imbalances. Most countries sought reserve currencies, such as the US dollar or sterling, to finance current account or capital account deficits. When most G10 countries began to liberalize their current accounts in the early 1960s, there was an increase in the demand for reserve currencies that could be used to finance any resulting imbalances. The breakdown of the Bretton Woods system in 1971 resulted in the floating of the main reserve currencies, as the cost of foreign exchange risk was shifted from the state to the market.<sup>7</sup> As a result, most developed countries and some developing countries have adopted capital account convertibility to allow firms and investors to freely access foreign exchange assets in order to cover their exposure to foreign exchange risk and to speculate in currency values.

Consequently, there has been a dramatic and substantial increase in private sector cross-border capital flows that has led to a deepening of financial markets, but has also resulted in greater financial fragility for many countries, especially developing countries and emerging market economies. Since the early 1980s, there have been a growing number of banking and currency crises in both developed and developing countries and the resulting social costs have been greatly magnified by contagion across markets and by the lack of an effective lender of last resort function for many of these countries. Indeed, the floating exchange rates and liberalised capital markets of the post-Bretton Woods system means that the Fund can no longer directly influence foreign exchange policy and control liquidity creation. Due to this paradigm shift, the Fund found a new role of managing financial crises, mainly in developing and emerging market economies. In the 1980s, the Fund orchestrated the lending into arrears programs that helped stabilize the Latin American sovereign debt crisis and in the early 1990s it provided assistance for some developed and developing countries

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<sup>7</sup> John Eatwell and Lance Taylor (2000) *Global Finance at Risk: The Case for International Regulation*, chapter 3 (Cambridge: Polity Press).

that were suffering currency crises and played the lender of last resort along with the US government in bailing out the Mexican banking system in 1994-95. In return for its financial assistance, the IMF exercised its conditionality powers to ensure that Fund resources were protected by devising economic restructuring programs and policies for members to follow that draw on Fund resources.

The Asian financial crisis, however, demonstrated the difficulties confronting the Fund in providing adequate liquidity to ailing sovereign debtors and central banks in a crisis situation. The slow economic recovery of these countries from the crisis also called into question the economic probity of the recovery programmes the IMF had prescribed for these countries. The growth of global capital markets and cross-border financial liberalisation since the Asian crisis has continued unabated, and the role of the IMF has been called into question because the Fund's limited resources would probably be inadequate to stem a sovereign debt crisis for a major country and would certainly be inadequate to stabilise a cross-border banking crisis involving a major financial centre.<sup>8</sup> Nevertheless, there have been in recent years some monetary and banking crises in peripheral economies in which the Fund played a stabilising role and served as "de facto international lender of last resort".<sup>9</sup>

The role of the Fund therefore has been the topic of policymaker and academic debate regarding whether the IMF should have an expanded role as a global lender of last resort or a more limited role in its lending activities, so that it would not be considered the only or the main lender in a financial crisis.<sup>10</sup> The latter view suggests that the private sector should play a greater role in providing funding to resolve financial crises, whether that might be in the form of bond issuance or other forms of debt offered to the capital markets or through private bank loans, with the IMF merely playing a facilitative role in reducing agency problems between the private sector lenders and the state sector borrowers.<sup>11</sup> This notion is reinforced by the fact that the value of cross-border trading in securities in today's globalised capital markets far

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<sup>8</sup> The Fund's role in liquidity assistance has been reduced even more in the face of the dramatic growth in private-sector-led global capital flows. See Andrew Crockett, 2004, pp. 46-54.

<sup>9</sup> See discussion of de facto international lender of last resort in Rosa M. Lastra, 'The IMF in Historical Perspective', *Journal of International Economic Law* p. 521.

<sup>10</sup> Malcolm Knight, Laurence Schembri, and Andrew Powell, "Reforming the Global Financial Architecture: Just Tinkering around the Edges?," in David Vines and Christopher Gilbert *The IMF and its Critics* (Cambridge: Cambridge University Press) pp. 14-149.

<sup>11</sup> See *Ibid.*, pp. 146-47.

exceeds the limited resources controlled by the Fund. Accordingly, a solution to sovereign debtor liquidity crises must necessarily involve the private sector along with certain public sector actors, such as central banks, who have the resources to provide bridge financing to a debtor state in a crisis.

Despite its more limited role in lending, some academics and policymakers envision a broader role for the Fund that could involve enhanced surveillance powers over the macroeconomic policies of countries and financial systems, including monitoring compliance with the IMF codes of conduct, as well as elaborating and overseeing implementation of some standards of regulatory conduct. In addition to enhanced surveillance, the IMF would offer more intensive technical assistance to developing countries and emerging market economies and would be expected to engage in ‘ruthless truth-telling’ to members who abandon economic fundamentals or fail to achieve financial stability objectives.<sup>12</sup> Finally, in the case of a crisis, the Fund should play the role of a “neutral third-party advisor” in assisting financial negotiations and facilitating a sovereign debtor’s access to emergency finance.<sup>13</sup>

### **Fund Lending Arrangements**

Although quota subscriptions are the prime source of IMF funding, several supplementary borrowing and lending programs are available to the Fund to provide short-term emergency lending to members experiencing temporary economic or payment difficulties. Traditionally, the most important of these programs have been the General Arrangements to Borrow (‘GAB’), the Stand-by Arrangements, and, more recently, the New Arrangements to Borrow (NAB), and the Supplemental Reserve Facility (SRF).<sup>14</sup> These bilateral arrangements are essentially agreements between the Fund and its members who wish to draw on its resources but they are not legally binding, but nevertheless create expectations and conditions regarding the use of the

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<sup>12</sup> Speech by Mervyn King, ‘Reform of the International Monetary Fund’, at the Indian Council for Research on International Economic Relations in New Delhi, India p. 9 (quoting John Maynard Keynes’s phrase at the Bretton Woods conference in 1944).

<sup>13</sup> Knight *et al.*, above note 10, p. 145.

<sup>14</sup> Other short-term borrowing arrangements include the Compensatory Financing Facility and the Exogenous Shocks Facility. Longer-term borrowing facilities include the Extended Fund Facility and Poverty Reduction and Growth Facility. See IMF Financial Activities –Update September 30, 2004. Some joint Fund-World Bank programs include the Comprehensive Development Framework, Country Assistance programs, and Highly Indebted Poor Countries Debt Relief Strategies. See <http://www.worldbank.org/hipc/>

Fund's resources. This section describes these arrangements and examines their role in providing emergency lending assistance to IMF members. These bilateral arrangements provide the institutional framework on which to build a more effective international lender of last resort function for the Fund.

### *Stand-by-Arrangements*

The stand-by arrangement provides the Fund with the opportunity of examining a state's economic activities and policies before entering into an arrangement with the state that would allow it to draw against Fund resources.<sup>15</sup> Article XXX (b) of the Amended Articles defines a standby arrangement as "a decision of the Fund by which a member is assured that it will be able to make purchases from the General Resources Account in accordance with the terms of the decision during a specified period and up to a specified amount."<sup>16</sup> Stand-by-Arrangements enter into force once the Executive Board approves the stand-by in consideration of a Letter of Intent to the Managing Director signed by the Minister of Finance or the Governor of the Central Bank of the applicant state.

The Letter of Intent lays out the undertakings the Fund requires in return for granting the line of credit. The legal status of stand-by-arrangements has been debated. While former IMF General Counsel Sir Joseph Gold argued that a stand-by is an "arrangement" and not an agreement creating legal obligations, others view the Letter of Intent, together with the Stand-by-Arrangements, to "constitute a legally binding agreement."<sup>17</sup>

The Executive Board of the Fund itself has issued a comprehensive decision on "the Use of the Fund's General Resources and Stand-by Arrangements of 1979" which expressly denies any contractual function and binding language of the stand-by-arrangements.<sup>18</sup> For instance, a state which fails without justification to fulfil a

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<sup>15</sup> Sir Joseph Gold, *The Legal and Institutional Aspects of the International Monetary System: Selected Essays* (Washington DC: IMF) pp. 462-466. Stand-by arrangements are the main instrument by which Fund resources are made available to its members. Stand-by arrangements were not contained in the original Articles of Agreement but came about through decisions of the Executive Board (Ex. Bd. Dec. No. 155-(52/57) (1 October 1952)( formalizing the practice of standby arrangements which are recognized today in Article V(3) of the Amended Articles).

<sup>16</sup> Articles of Agreement, Art. XXX (B).

<sup>17</sup> See Andreas Lowenfeld, *International Economic Law*, (Oxford: OUP) p. 516.

<sup>18</sup> The Board's Decision states that "[s]tand-by arrangements are not international agreements and therefore language having a contractual connotation will be avoided in stand-by arrangements and letters of intent," Executive Board Decision No. 6056-

commitment under a stand-by arrangement is not regarded as having breached the Articles of Agreement, thus it would not be subject to sanctions. Nonetheless, non-fulfilment of a commitment may lead the Fund to refuse to renew the stand-by or to limit the state's future ability to draw against the standby. Therefore, it has been argued that "it is not unfair to regard a stand-by arrangement as constituting an obligation of a state on whose behalf a Letter of Intent is signed and to which a stand-by has been granted."<sup>19</sup> This narrower contractual view of the standby, however, does not adequately take into account the broader legal authority of the Fund under Article V of the Articles to impose conditions on its members regarding their use of Fund resources.<sup>20</sup>

### *Precautionary Stand-By-Arrangements*

Precautionary Stand-By Arrangements are facilities that certain states may draw against to prevent a capital account crisis. The country would indicate its intention not to draw upon the Fund's resources unless its economic circumstances deteriorated. The use of these stand-bys was first discussed by the Executive Board in June 2003 to determine whether there was a possibility that precautionary arrangements might replace, to some extent, the IMF Contingent Credit Line (CCL). The CCL was created in 1999 to provide eligible states with "a precautionary line of defense" for members with economic and financial policies that do not put the Fund's resources at risk but which may nevertheless be vulnerable to financial market crises. The CCL had not been used when it expired in November 2003. The newly proposed precautionary stand-by-arrangements replace the CCLs and serve the purpose of promoting crisis prevention.

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(79/38) 2 March 1979. This reaffirmed an earlier decision by the Board in 1968 that '[i]n view of the character of stand-by arrangements, language having a contractual flavor will be avoided in the stand-by documents.' See Gold above note 15, pp. 464-65 citing para. 7, Decision No. 2603-(68/132), September 20, 1968, *Selected Decisions*, 4<sup>th</sup> (1970), p. 31.

<sup>19</sup> See Lowenfeld, above note 17, p. 519.

<sup>20</sup> Article V section 3 (a) of the Articles of Agreement requires the Fund to 'adopt policies on the use of its general resources' . . . 'that will establish adequate safeguards'. It states:

The Fund shall adopt policies on the use of its general resources, including policies on stand-by or similar arrangements, and may adopt special policies for special balance of payments problems, that will assist members to solve their balance of payments problems in a manner consistent with the provisions of this Agreement and that will establish adequate safeguards for the temporary use of the general resources of the Fund.

Among the Executive Directors, views are divided regarding whether or not there remain any gaps in Fund emergency lending instruments following the expiration of the Contingent Credit Line in 2003. The effect of this could potentially be that in a capital account crisis arising from exogenous factors, such as a loss of confidence by foreign investors, a country that maintains strong domestic policies under Fund surveillance may still not be able to avoid a crisis, unless a new emergency funding policy were in place to provide *ex ante* assurances of appropriate financial support.<sup>21</sup>

### *Extended Arrangements*

Another area of IMF reform was its plan to increase affordable funding for developing countries on a longer term basis. The first official initiative in this area occurred in the early 1970s when the Fund adopted so-called extended arrangements in 1974 by establishing an Extended Fund Facility (EFF), whereby member states could conclude stand-by arrangements for longer term assistance both with respect to time (longer periods of borrowing) and quota limits (larger amounts) than under the original stand-by arrangements. In addition to these extended arrangements, the IMF introduced six other types of special conditions for stand-by-arrangements, all regrouped under the term of “special facility”.<sup>22</sup> These extended stand-by

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<sup>21</sup> See IMF Discusses Status Report on Crisis Prevention and Precautionary Arrangements, Public Information Notice (PIN) No. 04/117, October 6, 2004, also available at: <http://www.imf.org/external/np/sec/pn/2004/pn04117.htm>, “[f]undamental differences of view exist about the need for and desirability of a policy for using exceptional amounts of financing under precautionary arrangements...[d]irectors holding this view[desirability to use exceptional amounts of funding] feel that regular precautionary arrangements—while useful in cases where pressures are likely to emerge in the current account—are not an effective tool of crisis prevention for members that pursue sound policies but still remain exposed to exogenous shocks and contagion. They regret the lack of progress in designing a policy on exceptional access under precautionary arrangements, and urge that this issue remain a high priority on the Fund's agenda;” see also Crisis Prevention and Precautionary Arrangements—Status Report, Prepared by the Policy Development and Review Department, In consultation with other Departments, September 3, 2004, also available at: <http://www.imf.org/external/np/pdr/cp/eng/2004/090304.htm>, last visited 7 October 2004, on which the Executive Board’s discussions are based.

<sup>22</sup> These long-term special facilities include the Comprehensive Development Framework (CDF) that seeks to direct the development agenda for a country so that it can meet the United Nations’s Millennium Development Goals (MDGs). Other facilities are the Country-Assistance Programs (CAS), and the Highly Indebted Poor Countries Debt Relief Strategies (HIPC). See <http://www.worldbank.org/hipc/>. A country becomes eligible for HIPC debt relief only when it establishes a poverty reduction strategy program, in which a country may become eligible for either concessional IMF lending for low-income members under the Poverty Reduction and Growth Facility (PRGF) financed by the PRGF Trust, or for debt relief under the Enhanced Heavily Indebted Poor Country (HIPC) Initiative. See IMF Financial

arrangements could be utilized by the Fund to make longer term loans to a country which has suffered a financial shock and as a result has experienced severe economic contraction with a substantial impact on its longer-term economic development. In this situation, the ability to make long-term loans for economic recovery following crisis should be considered to be a complementary policy tool to emergency lender of last resort lending.

#### *General Arrangements to Borrow (GABs)*

By the early 1960s, economic recovery in western economies was leading to a number of structural changes in the international monetary and financial system. The first steps towards currency convertibility for the current account were taken by the six countries that established the European Economic Community in 1957 when they adopted the European Monetary Agreement of 1955.<sup>23</sup> As the Bretton Woods fixed exchange rate regime took full effect for the main Western European countries in 1959 following the termination of the European Payments Union, the IMF began to push for currency convertibility for these countries to promote global trade and to relieve some of the pressure on the IMF exchange parities.<sup>24</sup> Convertibility, however, had the potential to lead to volatile capital movements that could undermine financial stability and could potentially lead to a deficit of reserve currencies (dollars or sterling) for some countries that were trying to finance trade deficits.<sup>25</sup> In response, the Fund issued a decision in 1961 that it had the authority to make its resources available to assist members having balance of payments problems that are caused or exacerbated by capital flows.<sup>26</sup> During this period, IMF membership was growing faster than the increases in its membership quotas, and because the subscriptions of

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Activities—Update September 30, 2004, available at: [www.imf.org/external/np/tre/activity/2004](http://www.imf.org/external/np/tre/activity/2004), last visited 23 July 2006. The PRGF, formerly known as the Enhanced Structural Adjustment Facility (ESAF), provides loans at concessional interest rate to eligible, low-income countries. In contrast, the HIPC Initiative is a debt relief program, whereby the IMF makes cumulative grant commitments to the members eligible under the HIPC Initiative for financial assistance with the requirement that these grants be used to “help meet debt service payments” to the IMF.

<sup>23</sup> This led to a final decision to adopt convertibility by the EEC countries and the United Kingdom in late 1958. P.L. Cottrell ‘The Bank in its International Setting’ in Richard Roberts and David Kynaston (eds.) *The Bank of England* (1994) pp. 130-132.

<sup>24</sup> Ibid.

<sup>25</sup> Ibid. In the early 1960s, the US dollar and sterling financed approximately twenty seven percent of world trade.

<sup>26</sup> Decision No. 1238-(61/43), July 28, 1961, *Selected Decisions*, 4<sup>th</sup> (1970), p. 19.

member states of 75% of their quota did not add to the pool of freely usable Fund resources, the Executive Board began debating the merits of creating a funding source that would allow it to borrow the reserve currencies at market interest rates and to lend these funds to other G10 members to cover their current account imbalances when these imbalances were perceived to threaten the Fund's exchange rate parities.<sup>27</sup>

To address these concerns, the General Arrangements to Borrow (GAB) was created in 1962 by a decision of the Fund Executive Board.<sup>28</sup> The GAB was an international agreement that was interpreted at the time to be a set of bilateral credit arrangements between the Fund and each government or central bank of the then main industrial countries.<sup>29</sup> The Fund's competence to act in the GAB derives from Article VII(1) of the Articles of Agreement, which contains broad language permitting the Fund to borrow currencies from any source whether within or outside IMF member states.<sup>30</sup> The GAB, however, was not part of the Articles, but it had the purpose of supporting the Fund's treaty objective of promoting international monetary stability by giving the Fund access to the currencies of the G10 countries in order to lend them to other G10 members or approved IMF members that were experiencing economic imbalances or temporary payment difficulties on a large-scale that exceeded the Fund's resources.<sup>31</sup> The GAB created a framework whereby the Fund was authorized

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<sup>27</sup> Joseph Gold *Legal and Institutional Aspects of the International Monetary Financial System* (Washington DC: IMF, 1979) pp. 448-455 (discussing origins of the GAB and the role of US economic imbalances).

<sup>28</sup> Para. 4 Entry into Force.

This decision shall become effective when it has been adhered to by at least seven of the members or institutions included in the Annex with credit arrangements amounting in all to not less than the equivalent of five and one-half billion United States dollars of the weight and fineness in effect on July 1, 1944.

<sup>29</sup> These industrial countries formed the G10 later in 1962. They included the Central Bank Governors or Ministers of Finance from Belgium, Canada, the German Bundesbank, France, Italy, Japan, Netherlands, Swedish Riksbank, United Kingdom, and the United States and later the Swiss National Bank. The G10 plus the Swiss National Bank comprise the participants today in the General Arrangements to Borrow, along with Saudi Arabia which became an associated member in 1985.

<sup>30</sup> Article VII, Replenishment and Scarce Currencies, Section 1, *Measures to replenish the Fund's holdings of currencies*.

The Fund may, if it deems such action appropriate to replenish its holdings of any member's currency in the General Resources Account needed in connection with its transactions, take either or both of the following steps:

propose to the member that, on terms and conditions agreed between the Fund and the member, the latter lend its currency to the Fund or that, with the concurrence of the member, the Fund borrow such currency from some other source either within or outside the territories of the member, but no member shall be under any obligation to make such loans to the Fund or to concur in the borrowing of its currency by the Fund from any other source;

<sup>31</sup> The General Arrangements to Borrow, Preamble,

to make calls for currency from the G10 countries (GAB participants), but only after it had consulted with GAB participants and had obtained majority approval of the Executive Board and special majority approval of GAB participants. Once these conditions had been met, the Fund could borrow the currency and lend it to the GAB participant country that had sought the loan to cover an imbalance in its current or capital accounts. Specifically, the Fund's role was to act as an intermediary between the GAB participants to replenish their holdings of reserve currencies by borrowing from participants in surplus and lending to participants in deficit.<sup>32</sup>

The Managing Director's call to borrow currencies can only take effect if approved by the Executive Board.<sup>33</sup> When the IMF borrows under the GAB from a GAB participant, it has a legal obligation to repay the loan to the lending state(s) within five years and to allocate its repayments proportionally to reflect the proportional commitments of each participant.<sup>34</sup> If the IMF does not perform its obligation to repay the loan (eg., late payment of the loan is considered non-fulfilment), it will be considered in arrears. GAB loans are enforceable contracts, with a legally binding effect between the IMF and the lender.<sup>35</sup>

One of the weaknesses of the GAB regarding its role as an effective lender of last resort was that each GAB participant country that was called upon to loan its currency to the Fund was not legally bound to do so, even though the Executive Board and a special majority of GAB participants had approved the loan and the Fund was obliged to repay the loan over a period of up to five years.<sup>36</sup> This created a level of

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'In order to enable the International Monetary Fund to fulfill more effectively its role in the international monetary system, the main industrial countries have agreed that they will, in a spirit of broad and willing cooperation, strengthen the Fund by general arrangements under which they will stand ready to make loans to the Fund up to specified amounts under Article VII, section 1 of the Articles of Agreement when supplementary resources are needed to forestall or cope with an impairment of the international monetary system.'

See IMF, *Selected Decisions, Thirtieth Issue*, (31 Dec. 2005)(Washington DC: IMF).

<sup>32</sup> In contrast, the World Bank replenishes its resources by borrowing money from the private sector, a method which has been suggested for the IMF. To borrow from the private sector, the Fund would not need to amend the Articles of Agreement because it has such authority under Article VII (i).

<sup>33</sup> See Letter from Mr. Baumgartner, Minister of Finance, France to Mr. Dillon, Secretary of Treasury, United States, December 15, 1961. Paragraph C of the letter states, *inter alia*, '[a] favorable decision [to lend] shall require the following majorities of the participants', . . . (1) a two-thirds majority of the number of participants voting; and (2) a three-fifths majority of the weighted votes of the participants voting, weighted on the basis of the commitments to the Supplementary Resources'

<sup>34</sup> Para. 11 (d) states that repayment 'shall be made in proportion to the Fund's indebtedness to the participants that made transfers in respect of which repayment is being made.'

<sup>35</sup> See Sir Joseph Gold, above note 27, pp. 464-466.

<sup>36</sup> Para. 11 Repayment by the Fund

uncertainty regarding whether the Fund could borrow adequate reserve currencies in a financial crisis.<sup>37</sup> The absence of a specific legal obligation to lend was a political compromise for the benefit of the US or any other GAB participant that wanted the flexibility, during ‘the world dollar shortage’ of retaining its dollar assets for national economic policy objectives.<sup>38</sup>

Nevertheless, the GAB created legal relationships between the Fund and the G10 countries by which the latter agreed they would cooperate to strengthen the Fund and the international monetary system.<sup>39</sup> In practice, the effectiveness of the GAB depended on the IMF Managing Director consulting and negotiating with the Executive Board and the GAB participants in advance over the terms and conditions by which the participants would lend their currencies to the IMF.<sup>40</sup> These negotiations addressed a number of issues including whether the currencies and amounts to be called from a participant under its credit arrangements reflected its economic ability to lend its currency and how much of that currency the Fund held along with the allocation of responsibilities across different participants for lending the currencies.<sup>41</sup> The negotiations also addressed the type of transaction through which the Fund would make the funds available – for instance, either an exchange transaction, or exchange

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(a) ‘the Fund, five years after a transfer by a participant, shall repay the participant an amount equivalent to the transfer’

<sup>37</sup> There was a real concern among G10 countries that the US would create a dollar shortage by drawing on its own IMF quota to finance its growing imbalances in the current and capital account. Moreover, the reserve currency status of the dollar and sterling, combined with growing economic imbalances for both countries, caused concern that there would be inadequate reserve currencies available for countries that would need to borrow reserve currencies to finance imbalances in their current and capital accounts. See statement of President Kennedy in February 6, 1961 that the US quota in the Fund of \$4,125 billion could be drawn by the US and that the US quota had to be considered as part of the US’s international reserves. See Joseph Gold *The Legal and Institutional Aspects of the International Monetary System: Selected Essays* (1984) p. 479.

<sup>38</sup> The fear of ‘the world dollar shortage’ was discussed in P.L. Cottrell ‘The Bank in its International Setting’ in Richard Roberts and David Kynaston (eds.) *The Bank of England* (1994) pp. 130-132. See also Gold, above note 27, pp. 479-80.

<sup>39</sup> Gold, see above note 27, p. 457.

<sup>40</sup> Para. 7 *Calls*

(a) The Managing Director shall make a proposal for calls for an exchange transaction or for future calls for exchange transactions under a stand-by or extended arrangement only after consultation with Executive Directors and participants.

<sup>41</sup> Para. 7 (b) states that ‘[t]he currencies and amounts to be called under one or more of the credit arrangements shall be based on the present and prospective balance of payments and reserve position of participating members or members whose institutions are participants and on the Fund’s holdings of currencies.’

transaction under stand-by arrangement or an extended arrangement.<sup>42</sup> Indeed, Gold notes that it was intended but not required that calls would be made under several credit arrangements to provide financing for a participant's borrowing from the Fund or for a stand-by arrangement with the Fund.<sup>43</sup>

A participant was expected to make its currency available upon a call by the IMF Managing Director.<sup>44</sup> The call would be in proportion to the participant's commitment of funds. Between 1962 and 1983, the total value of credit commitments by GAB participants was SDR 6,344 millions, and the country with the largest single credit commitment was the United States with SDR 1,883 millions, which was twenty nine percent of the total commitments.<sup>45</sup> By 1983, several amendments had been made to the GAB to bring it up to date with the Second Amendment of the Articles of Agreement, which became effective in 1978, and this resulted in GAB participants agreeing to enlarge their credit arrangements to enhance the capacity of the Fund to draw on reserve currencies for emergency lending in a financial crisis.<sup>46</sup> The total value of credit commitments was substantially increased to SDRs 17,000 millions and the US remained the largest individual contributor with an individual amount of SDRs 4,250 millions, which was twenty five percent of the total commitments.<sup>47</sup> This means that today if the Fund issued a call for currencies, and if a special majority of GAB participants including the US approved along with the IMF Executive Board, the US would be obliged therefore to contribute twenty five percent of the total value of the approved call.

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<sup>42</sup> Paragraph 7 (a) provides for 'a proposal for calls for an exchange transaction or for future calls for exchange transactions under a stand-by or extended arrangement'

<sup>43</sup> See above note 27, p. 458 (citing GAB para. 7 (b)).

<sup>44</sup> Para. 7 *Calls*

(a) The Managing Director shall make a proposal for calls for an exchange transaction or for future calls for exchange transactions under a stand-by or extended arrangement only after consultation with Executive Directors and participants.

<sup>45</sup> The credit commitments in SDR millions of the GAB members between 1962 and 1983 were: Belgium 143, Canada 165, Germany Bundesbank 1,476, France 395, Italy 235, Japan 1,161, Netherlands 244, Swedish Riksbank 79, and United Kingdom 565.

<sup>46</sup> This was mainly a response to the Latin American sovereign debt crisis and the inability of the Fund to stabilize the crisis without US financial support.

<sup>47</sup> In 1983, the credit commitments of GAB members were increased in absolute terms and reduced in relative terms because Saudi Arabia was approved in 1985 to have an associated arrangement with the GAB. The enlarged credit commitments of the GAB in SDR millions from 1983 to 2008 are: Belgium 595 (.035), Canada 893 (.053), German Bundesbank 2380 (.14), France 1700 (.10), Italy 1105 (.065), Japan 2125 (.125), Netherlands 850 (.05), Swedish Riksbank 383 (.02), Swiss National Bank 1020 (.06), United Kingdom 1700 (.10), and Saudi Arabia 1500 (.09).

Besides increasing the credit arrangements of GAB participants to reflect their size and role in the global economy and capacity to provide loans to the Fund, the revised GAB contained a few other amendments, the most important of which was that the IMF could now borrow under the GAB for the benefit of non-participants. Conditions, however, applied including that members benefiting from such loans must have been approved for adjustment programs with the IMF.<sup>48</sup> The Managing Director may only initiate calls for the benefit of a non-participant if certain criteria are met: that the Fund has inadequate resources to meet expected or actual requests for financial assistance, which reflect the occurrence of an exceptional situation that are associated with a member's balance of payments problems that are of a size that could threaten the stability of the international monetary system.<sup>49</sup> These criteria are more stringent for non-participants than for participants, as there is a requirement for the Managing Director to make a determination that an exceptional situation 'threatens' international monetary stability, which is not required for GAB participants. Moreover, the Managing Director has a responsibility to pay due regard that loans for the benefit of non-participants do not prejudice GAB participants' access to these resources. The rate of interest charged on GAB loans was increased to a minimum of four percent per annum, which provided additional revenue for the Fund to offset any losses associated with fluctuations in exchange rates during the period for repaying the loan.<sup>50</sup>

Since its inception, the GAB has been invoked by the Fund and approved by GAB participants on ten occasions, the most recent of which occurred in 1998 when the GAB approved a Fund request of SDRs 6,300 millions in connection with an extended financing arrangement for the Russian government to support its currency and government bond market, both of which had collapsed in the 1998 Russian

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<sup>48</sup> See discussion in Joseph Gold *The Legal and Institutional Aspects of the International Monetary System: Selected Essays* (1984) (IMF) p. 500 The transactions which the Fund can finance for non-GAB participants are those that are in the higher tranches of the credit tranche policy, and under stand-by arrangements going beyond the first credit tranche, or in the first tranche if the transaction is requested as part of an extended arrangement or stand-by arrangement.

<sup>49</sup> Ibid pp. 500-501.

<sup>50</sup> Also, gold was eliminated as a means of payment and was replaced by Special Drawing Right (SDRs), while a GAB participant's credit arrangements continued to be expressed in its own currency.

financial crisis.<sup>51</sup> After disbursing only SDRs 1,400 millions, the Fund terminated the arrangement in response to the Russian government's default on its government bonds and its failure to fulfill other conditionality commitments.<sup>52</sup> The GAB has resulted in an institutional framework that allows the Fund to play the role of a lender of last resort by borrowing surplus reserve currencies, the value of which far exceed its own resources, so that it can lend them to GAB participants suffering economic imbalances or a financial crisis.<sup>53</sup> The Fund's role as an intermediary in providing short-term emergency loan assistance to GAB members creates coordination benefits between countries and reduces transaction costs in allocating surplus currencies from surplus GAB participants to other participants in deficit and in need of immediate assistance.

The GAB system has worked well for the benefit of the G10 countries and other approved GAB participants<sup>54</sup> which were expected to provide reserve currency liquidity at market rates to the IMF who would then lend the currency to another GAB participant that was experiencing a deficit in that currency. The GAB allowed the Fund to play a limited lender of last resort role by borrowing directly from GAB participants and then lending to GAB borrowers in order to cover temporary imbalances that were putting pressure on the Fund's fixed exchange rate parities.

The GAB system, however, has been criticized as being for the benefit of the "prosperous industrial countries". Developing countries were disadvantaged by not being able to access reserve currency assets on such generous terms. This LOLR function for the G10 seemed to work well for GAB participants but not for the majority of IMF member countries which were not participants in the GAB who were generally not able to access reserve currencies through the GAB. Moreover, GAB

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<sup>51</sup> Other recent Fund interventions through the GAB were in 1977 when the Fund borrowed reserve currencies from GAB participants and lent them to the United Kingdom and Italy respectively under stand-by arrangements to provide temporary financing to these countries which were suffering substantial current and capital account imbalances, and in 1978 when the Fund obtained surplus US dollars to lend to the United States in order to finance its reserve tranche purchase.

<sup>52</sup> The Fund cancelled the lending arrangement for Russia in 1999 after the Fund repaid the outstanding amount owed to GAB creditors following the Fund's receipt of increased quota payments by IMF members as required under the Eleventh General Review of Quotas. See IMF 'IMF Borrowing Arrangements: GAB and NAB' Factsheet, (Aug. 2006)(Washington DC: IMF).

<sup>53</sup> The GAB has been renewed nine times beginning in December 1962 for approximately five year intervals and was most recently renewed for a period beginning December 2003 for five years.

<sup>54</sup> GAB participants include the G10 countries plus Saudi Arabia as an associate member.

participants even proved reluctant to make their funds available to other GAB members, as the special majority requirement to approve calls for funds by the IMF Managing Director was often a difficult threshold to reach.

In addition, the requirements for non-GAB countries to qualify for GAB loans proved in practice difficult to meet. Although paragraph 21 (a) allowed the Fund to make calls for foreign exchange for non-GAB members in one of four circumstances which most members could meet based on their usual drawings from Fund accounts, the approval of a proposal for calls depended on acceptance by a special majority of GAB participants and approval by the IMF Executive Board. Even if the special majority and Board approval were obtained, an individual GAB participant could still unilaterally decide, based on its balance of payments and reserve position, that 'calls should not be made on it, or that calls should be made for a smaller amount than that proposed'.<sup>55</sup> These obstacles explain in part why no country outside the GAB membership was approved for a GAB loan until 1998 when Russia obtained a loan because of the consensus view of GAB countries that the Russian financial crisis was a serious threat to international financial stability and to the financial institutions in their countries. In addition, the absence of legal obligation for an individual GAB participant to make a loan according to an approved call raises serious issues regarding the stability of expectations and legal certainty in the operation of an emergency lender of last resort function.

#### *New Arrangements to Borrow (NABs) and Supplemental Reserve Facility*

The New Arrangements to Borrow (NABs) emerged as a result of the Mexican financial crisis of 1994-95 and the conviction by IMF members that more resources should be made available to the Fund to stabilize financial crises for developing and emerging market economies.<sup>56</sup> The NAB contains a set of bilateral credit arrangements between the Fund and twenty six IMF members and institutions that enable the Fund to borrow their currencies in order to forestall or prevent an

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<sup>55</sup> Baumgartner Letter, above note 33, para. C. Gold also interpreted the GAB paragraph 7 (b) and paragraph C of the Baumgartner Letter to mean that the GAB '[does] not bind the participants to lend, and do not require the Fund to borrow'. Gold, above note 27, p. 457.

<sup>56</sup> The NAB was adopted by decision of the Executive Board in 1997 and entered into force in 1998, when it was immediately used to finance an extended arrangement for Brazil. See IMF Press Release No. 98/57 (Nov. 19, 1998), 'IMF's New Arrangements to Borrow Enter into Force'.

impairment of the international monetary system or to deal with a threat to financial stability. The larger membership of the NAB also includes a number of developing countries, such as Korea, Malaysia, and Thailand, but its membership is primarily composed of wealthy developed countries and jurisdictions.<sup>57</sup>

The NAB contains total credit arrangements of SDRs 17,000 millions equal to the GAB arrangements and resulting in a combined total of SDRs 34,000 millions for both programs. NAB is not intended to replace the GAB, but rather to enhance the amount of resources available to the Fund from which it can borrow to forestall a financial crisis. The NAB was designed to allow the Fund to have access to substantially more resources than what was available under the GAB so that it could address systemic problems in the global financial system. Like the GAB, NAB participants are eligible to draw on Fund resources through GAB and NAB financing, and non-NAB states who are Fund members are eligible for NAB financing subject to the same terms and repayment conditions as NAB participants, whereas non-GAB states are subject to less favourable repayment terms than GAB participants.<sup>58</sup> Therefore, under NAB financing, there is no discrimination between NAB and non-NAB members in the financing conditions for an approved NAB credit, whereas under the GAB, GAB participants receive more favourable treatment than non-GAB members.

Any IMF member which wants to draw on resources in the NAB must apply and conclude a stand-by arrangement with the Fund, and to present a Letter of Intent agreed with the Fund before it can draw on resources. As with other standby facilities, such as the Poverty Reduction Strategy Programs (PRSPs) or Supplemental Reserve Facility (SRF), a failure to meet the objectives of the program does not lead to sanctions or punishment, but only to a suspension of the right to draw or the denial of a renewal under the stand-by arrangement.<sup>59</sup> Fund conditionality, therefore, plays an important role in the member having continued access to NAB financing.

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<sup>57</sup> All GAB participants are also participants in NAB plus the following countries/institutions: Australia, Austria, Banco Central de Chile, Denmark, Finland, Hong Kong Monetary Authority, Korea, Kuwait, Luxembourg, Malaysia, Norway, Singapore, Spain, and Thailand.

<sup>58</sup> NAB, para. 6. Initiation of Procedure

(b) ‘The Managing Director may initiate the procedure set out in paragraph 7A for exchange transactions requested by members that are not participants if’ [the conditions are fulfilled]

<sup>59</sup> This means a failure to follow through with the program or plan laid out in the arrangement does not therefore amount to a failure to perform a legal obligation, and,

As mentioned above, the GAB has only been invoked on ten occasions and in each instance financial support was provided to a G10 or G8 country which was either in deficit or needed assistance to purchase part of its reserve holdings. In contrast, the NAB has been activated only once when it was used to provide a stand-by arrangement for Brazil in December 1998 when the country experienced a temporary loss of confidence by foreign investors which led to a collapse in its currency. Acting through the NAB, the Fund made a call for SDRs 9,100 millions, of which SDRs 2,900 millions were used to support the Brazilian currency and its government bond market.

The actual drawing from the Fund by the borrowing member under the NAB (or GAB) is considered a legal act. For example, it is considered a purchase, which is given in exchange for the obligation to repurchase special drawing rights or “freely usable currencies”.<sup>60</sup> Moreover, as with the GAB, the Fund, when borrowing from NAB participants, assumes a legal obligation to repay the NAB lenders within five years.<sup>61</sup> The NAB does not replace the GAB, but the NAB is the facility of first and principal recourse for non-GAB members, with the exception that if a country is a member of both the NAB and the GAB, it may request funding under either facility.

Another short-term financing facility approved by the Fund in the late 1990s was the Supplemental Reserve Facility (SRF) that was established in 1997 during the Asian financial crisis. The SRF facility provided the Fund with another lending mechanism for it to make short-term loans at market rates to members suffering from a financial crisis. Member borrowers would have to comply with a Fund restructuring program in order to maintain eligibility to draw on the facility.

The NAB and SRF provided needed additional facilities for IMF members to access reserve currencies in a crisis. However, the available credit under these programs is inadequate, even when supplemented by existing Fund programs, to stem

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consequently, there are no legal sanctions or enforcement mechanisms for not fulfilling conditions in the standby.

<sup>60</sup> Ibid. Freely usable currencies are the currencies generally acceptable for settlement of international accounts, such as G10 reserve currencies and other floating currencies traded in the foreign exchange markets.

<sup>61</sup> Para. 11. Repayment by the Fund

States in relevant part (a) ‘[t]he Fund, five years after a transfer by a participant, shall repay the participant an amount equivalent to the transfer calculated in accordance with paragraph 12. If the drawer for whose purchase participants make transfers is committed to repurchase at a fixed date earlier than five years after its purchase, the Fund shall repay the participants at that date.’

a major financial crisis. Although these lending programmes may provide adequate resources for countries experiencing temporary economic and financial imbalances, the amount that the Fund could borrow under the GAB, NAB and SRF would likely be inadequate to stabilize a contagion-like crisis similar to the crisis that affected the East Asian countries in 1997-98. This undermines the Fund's ability to play a credible lender of last resort role.

Based on the inadequacies of the GAB, NAB and other emergency lending facilities in serving a LOLR role, high level debates have occurred involving former senior officials of the Fund regarding what role the Fund should play in providing emergency lending in a financial crisis with systemic proportions. Should the Fund have an enhanced role with an added institutional dimension or are the existing borrowing arrangements adequate? One view holds that the emergence of a globalized financial system requires an international lender of last resort and the IMF is in the best position to play this role because of its experience in dealing with a number of financial crises.<sup>62</sup> Former IMF Managing Director Michel Camdessus has argued that the Fund has been performing and adapting to this role for the last fifty years and it would be important for promoting financial stability to reaffirm its role in this area so that it can more effectively fulfil this vital function. Furthermore, the Fund's experience and expertise provide it with enough judgment to avoid any influence of moral hazard either from governments or market participants. Similarly, Krugman and Fischer assert that the Fund has become a *de facto* international LOLR because of its many interventions on behalf of countries in financial distress. They argue that because of the general acceptance of a domestic lender of last resort that by analogy there needs to be an international LOLR to stem a bank-run-like scenario when foreign investors lose confidence in a country and began to liquidate their exposures.<sup>63</sup>

On the other hand, Kohler recognizes that the Fund is not a LOLR in the traditional sense, and that its inability to act quickly with substantial resources precludes it from preventing most crises or stabilizing a country undergoing one. Moreover, the

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<sup>62</sup> Michel Camdessus, 'International Financial Institutions: Dealing with New Global Challenges' (2005/06)(Washington DC: Per Jacobssen Institute) available at [http://www.i20.org/publications/22\\_vP\\_IR\\_Narrative.pdf](http://www.i20.org/publications/22_vP_IR_Narrative.pdf) accessed 17 July 2007

<sup>63</sup> See V. V. Chari and P.J. Kehoe 'Asking the Right Questions About the IMF' p. 2 (1998)(citing Krugman and Fischer)available at: <http://www.minneapolisfed.org/pubs/ar/1998/ar1998.cfm> accessed 17 July 2007

political constraints on providing financial support in the GAB or NAB and the lack of legal certainty once a special majority has approved financial support undermines the Fund's credibility to be able to act decisively and obtain adequate resources to through the GAB and NAB to stem a major crisis. The absence of legal certainty regarding the Fund's powers obtain the necessary supplementary resources from the pre-existing credit arrangements of GAB participants means that its effectiveness in exercising the LOLR function is undermined. Although it is important on moral hazard grounds for the market not to know at what point the Fund might intervene to provide liquidity support, it is also equally important that investors believe that the Fund has the capacity and willingness to stabilize a crisis if necessary. Otherwise, it will be more difficult to incentivize foreign investors to play their part by not exiting the market so quickly when there is an apparent loss of confidence in the market.<sup>64</sup>

### **Crisis Management and the Lender of Last Resort**

The financial crises of the 1990s triggered vigorous discussions amongst economic policymakers and academics regarding how to reform the International Financial Institutions (ie., the IMF and World Bank) so that they could more effectively address financial disruptions in international markets and how to avoid financial crises. Following the Asian crisis, the debate focused on achieving greater financial stability through a two-pronged approach, namely crisis prevention and crisis management. A vast literature has arisen on crisis prevention,<sup>65</sup> which addresses how to improve the predictability of a financial crisis and how to minimize the social costs once it occurs. By contrast, crisis management focuses on what measures should be adopted *ex post* once a crisis has occurred or is imminent, and how to manage the contagion effect across countries and their potential spill-overs on the rest of economic activity.<sup>66</sup> This section examines existing approaches of crisis management and highlights the main gaps and suggests a reformed international LOLR framework that would address some of the *ex ante* problems of sovereign debt finance including moral hazard and the need to provide more legal certainty in the *ex post* crisis lending mechanism for

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<sup>64</sup> Michel Camdessus, Jacques de Larosiere and Horst Kohler 'How should the IMF be Reshaped: Three Points of View on the IMF in the Twenty First Century', *Finance and Development* 41 (3) (Sept. 2004) pp. 27-29

<sup>65</sup> See Eatwell and Taylor above note 7, pp. 25-26.

<sup>66</sup> Mardi Dungey and Demosthenes Tambakis (2005) 'International Financial Contagion: What Should We Be Looking For?' in *Identifying International Financial Contagion* pp. 3-34.

GAB and NAB participants to lend reserve currencies to non-G10 countries who are experiencing a financial crisis. The GAB and NAB credit arrangements would be consolidated and substantially increased to SDRs 100,000 millions. The Fund would play the role of intermediary by certifying when a financial crisis is occurring and assessing the amount and composition of reserve currencies needed to stem the crisis. In doing so, the Fund's Managing Director, after consultation with the Executive Board, would consult with GAB participants and consider any objections to the use or composition of GAB currencies and then make a call for loans. Once the special majority requirement is reached, the Managing Director would have the legal authority to obtain the respective currencies in their prescribed allocations and disburse them through Fund drawing operations for the borrowing sovereign debtor. The legal certainty added to the process would be that, once the special majority requirement was reached, all GAB and NAB participants for whom the proposal for calls applied would be obliged to lend according to the call.

#### *Managing a financial crisis*

Following the occurrence of a financial crisis, the management of the crisis is usually an essential function of a central bank. Remedial action in managing a crisis must target the source of the crisis, and there must be adequate resources at hand and sufficient legal discretion for the central bank to take the necessary measures. If these conditions are in place, the impact and potential contagion of the crisis to other sectors of the economy or financial system as a whole may be minimized or even prevented.

In so far as crisis prevention is not sufficient or proves inadequate for avoiding the occurrence of a crisis, the role of crisis management becomes all the more important for the soundness of the financial system. Eichengreen notes, however, that the achievements with regard to crisis management have been particularly small in comparison with prevention efforts.<sup>67</sup> The lack of progress in the field not only lies in the intrinsic challenge of crisis management, such as moral hazard, distinguishing between insolvency and illiquidity, and determining adequate levels of assistance; it is

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<sup>67</sup> Barry Eichengreen, *Financial Crises and What to do About Them*, Chapter 3 addresses crisis management.

also due to the prevailing rigidity of the institutionalized approach and the need for reform of institutions and their mandates.

Inevitably, most of the debate over reform has focused on the institutions and tools which so far have been responsible for crisis management. Financial crises have traditionally been addressed and managed with financial assistance by the Fund, other IFIs, and the G10 countries. The subsequent sections present the actors and tools outside the GAB framework involved and also discuss an array of alternatives, comparing their benefits and shortcomings with existing crisis management techniques. In the next section, a suggested approach for a lender of last resort will be suggested with a discussion of the policy implications.

### *Financial Assistance*

Lack of sufficient, adequate and speedy emergency financing is often considered as one of the main threats to financial stability. This poses a considerable strain on crisis management, particularly when countries with sound macroeconomic fundamentals are victims of capital volatility.<sup>68</sup> A general consensus has emerged among commentators that improved access to financial assistance in a crisis is necessary to provide liquidity for countries experiencing a shock to their financial systems.<sup>69</sup> This has led to the design and discussion of various proposals and recommendations concentrating on other components of crisis management beyond mere financial assistance, such as institutional reform, participation and cooperation, and new instruments and tools.

Furthermore, the lack of clarity and consensus on how to proceed partly explains why only limited progress has been made. For instance, IMF emergency lending to a country in crisis may be accompanied by a temporary suspension of international debt service payments. Although IMF emergency measures in recent years have provided a needed respite for countries in arrears and suffering from liquidity problems, the real detriment of the IMF programs has been the stringent conditionality arrangements imposed on sovereign debtors as a result of the country accepting emergency financing support. These Fund programs have led to substantial economic and financial sector restructuring in the debtor country's economy that has

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<sup>68</sup> Ariel Buira, "the Governance of the IMF in a Global Economy" in A. Buira *Challenges to the World Bank and IMF* (London: Anthem Press) pp. 13-36.

<sup>69</sup> Barry Eichengreen *Toward a New International Financial Architecture* (Institute for International Economics: Washington DC ) pp. 65-69

proved to be socially costly to implement and in most cases failing to achieve economic recovery and financial stability objectives.

Official assistance has come in the form of bail-ins and a restructuring of debt servicing, often at a high cost for the country in question. Until the financial crises of the 1990's, however, lending by institutions like the IMF and other institutional and international creditors often did not consider the fundamental reason of why a country should receive temporary assistance in a crisis. Rather, the main objective of the official international lending community was whether further lending to the country in crisis would enable it to resume making payments on its debt and eventually whether it could cure its arrears. Very little emphasis was placed on the systemic impact of the country's inability to continue making payments on its debts.

During the financial crises of the late 1990s, there was a growing awareness that the decision to provide emergency lending should depend on factors other than the ability of a country to resume servicing its debts to private and official sector creditors. Instead, the focus was placed on the systemic effects of providing a country or financial sector with financial support, and when to offer assistance by distinguishing between illiquidity and insolvency as a source of financial crises. In essence, this new approach raised efficiency considerations of financial assistance. As Eichengreen observed: “[t]he bottom line is that the IMF must make a judgement of whether limited assistance will help a country to surmount its financial difficulties and resume business as usual, in which case it should lend, or whether lending is unlikely to have its effect, in which case the fund should stand aside...”<sup>70</sup>

Crisis management, as envisaged today by the IFIs, was initially conceptualized and tailored during the financial crises of the 1990s. In particular, many proposals materialized as part of a broader approach to the design of an international financial architecture. In particular, the G-7 Köln summit laid the groundwork by recognizing the Fund's efforts in the Asian crisis and proposing a series of recommendations. For debt restructuring and reduction of Fund programs, a series of “operational guidelines” were laid down, such as medium-term financial sustainability, the need for broad comparability and fairness of treatment where both private and institutional creditors were involved, clarity in official financing terms, and public disclosure of policy approaches adopted by the IMF, among others.

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<sup>70</sup> Eichengreen, see above note 67, p. 61.

Further, the G-7 urged the Fund to continue reforming its specific lending facilities according to a set of principles, such as offering institutional support to prevention of crises and sound macroeconomic policy design and the observance of standards, among others.<sup>71</sup>

### *Sovereign Debt Restructuring*

Sovereign debt restructuring is often an alternative for countries with an unsustainable debt burden. This may be the only way out of an insolvency crisis, where the borrowing country is unable to meet its long term repayment obligations. Under such circumstances, creditors will call in their loans and subsequent efforts such as standstills and creditor committees will be enacted to try and deal with the debt overhang of the insolvent country.<sup>72</sup>

Private creditors, however, may resist engaging in orderly debt renegotiations, especially if individual creditors believe they will obtain improved conditions if they “hold out” after a debt restructuring process. As such, cooperation to achieve a balanced distribution of responsibility and losses is often undermined by the pursuit of individual interests, which may harm the indebted country, cooperative creditors and international financial markets.<sup>73</sup> To address this, a leading private sector association, the Institute of International Finance (IIF) has been the leading private sector institution in developing a set of principles for stable debt restructuring.<sup>74</sup>

The IIF principles are organized under four pillars offering an approach to debt restructuring that seeks to ensure stability of capital flows and minimize the likelihood of unmanageable market disruptions. The four pillars are: (i) transparency and timely flow of information; (ii) close debtor-creditor dialogue and cooperation in order to avoid restructuring; (iii) good faith actions in debt restructuring situations, and (iv) fair treatment of all parties. They are accompanied by a set of principles and

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<sup>71</sup> Group of Seven, “Strengthening the International Financial Architecture: Report from the G7 Finance Ministers to the Heads of State and Government”, Fukuoka, Japan, 8 July, 2000.

<sup>72</sup> David Vines and Gilbert, “The IMF and International Financial Architecture”, in Vines and Gilbert (Eds.), *The IMF and its Critics* pp. 24-25.

<sup>73</sup> See IMF, “Progress Report to the International Monetary and Financial Committee on Crisis Resolution”, April 12, 2005. Debt restructuring is perhaps one of the topics of crisis management which has been intensively discussed by diverse institutions, private sector participants and academics, given the numerous and repeated country experiences of unsustainable debt payment and servicing in recent years.

<sup>74</sup> IIF, “Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets”, March 11, 2005.

brief description of each in the form of recommendations. The development of the principles and their market oriented approach has been the result of consultations between borrowing countries and international private creditors, and are seen as a non-binding and flexible blueprint in the event of a debt crisis.

The IMF has commented positively on the IIF principles, but it has also stressed that it holds a different view from the IIF in relation to measures that the IIF recommends for a sovereign having difficulties in making its debt payments. The IMF notes that the IIF Principles recommend: "... that the creditor community should consider appropriate requests for voluntary and temporary maintenance of trade lines and inter-bank lines to support a borrowing country's efforts to avoid a broad debt restructuring"<sup>75</sup> and considers this recommendation as problematic if linked to continued debt servicing. The IMF argues that creditors could decide in favor of the country's request for an emergency loan if interest and inter-bank payments and other debts are serviced, but that such a condition may place the sovereign debtor in a riskier position, since the creditors' option of withdrawing trade and inter-bank lines could pose the threat of a greater default.

Other considerations which are relevant in sovereign debt management are linked with the conditions of IMF financing. Such financing could alleviate a sovereign debt liquidity crisis if the interest rate on IMF loans was sufficiently subsidized so as to cover the debt overhang of the borrowing country. The cost of subsidizing the insolvent country would then have to be borne by either the creditors or the borrowers.<sup>76</sup> An alternative to financing would be for the firms in the indebted country to negotiate and sign write-downs, depending on the share of debt of private versus public debt and also the willingness of the indebted country to take over the private debt. Such a write-down would avoid a default and the suspension of credit from private banks, thereby ensuring the uninterrupted flow of capital. However, both of these alternatives may not be effective if the IMF lending is limited in terms of the amount and speed of the bailout. The expectation of IMF subsidized funds might generate the incentive among private creditors to withdraw funds available in the form of equity investment and channel these to IMF lending, since these resources will be

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<sup>75</sup> For a summary of previous efforts and relevant literature of the different efforts see IMF "Progress Report to the International Monetary and Financial Committee on Crisis Resolution", April 12, 2005, 12.

<sup>76</sup> Vines and Gilbert, see above note 72, pp. 24-25.

bailed out if there is a crisis. Further, such positioning will in turn raise the return on investment given that the expected value of the subsidy will be greater, and thus pose a moral hazard.<sup>77</sup>

In light of the debate over these issues, the Fund staff developed and proposed a Sovereign Debt Restructure Mechanism (SDRM).<sup>78</sup> The SDRM was proposed as a restructuring tool for equitable sovereign debt restructuring, having the objective of avoiding the risk of default while restoring sustainability and growth in the affected economies.<sup>79</sup> It consists of a standstill mechanism which allows for a temporary deviation from the obligations of an indebted country vis-à-vis its creditors, and is based on four principal features: 1) the debt restructuring process is initiated and maintained on the basis of consent by a qualified majority of creditors in each creditor class whose claims are being restructured and is binding on all creditors of the class; 2) it eliminates the incentive for individual creditors to start litigation by deducting whatever they may have recovered in the litigation from the residual claim submitted in the restructuring agreement; 3) it offers protection of creditor interests by including safeguards; and 4) it allows for the exclusion of new financing for restructuring unless there is qualified majority consent by each creditor class.

The Fund Executive Board, however, rejected the SDRM proposal. This was partly due to US opposition, as well as to the fears of many developing countries of how it may have affected their ability to raise capital in financial markets and in particular how it may have affected the cost of sovereign debt issuance.<sup>80</sup> Further, it was also argued that SDRM would create moral hazard,<sup>81</sup> since the availability of an

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<sup>77</sup> Ibid, pp. 25-26.

<sup>78</sup> See IMF, “Proposed Features of a Sovereign Debt Restructuring Mechanism”, January 2003(providing a detailed study of the SDRM proposal).

<sup>79</sup> The SDRM, also known as the “Krueger Proposal”, was developed by the First Deputy Managing Director of the IMF, Anne Krueger. See Anne Krueger, “International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring,” address by Anne Krueger, First Deputy Managing Director, IMF, November 26, 2001, and also Krueger, A, “A New Approach to Sovereign Debt Restructuring”, IMF., April 2001.

<sup>80</sup> See Barry Herman ‘Mechanisms for Dialogue and Debt-Crisis Workout That Can Strengthen Sovereign Lending to Developing Countries’ in A. Buiru, “Challenges to the World Bank and IMF’ pp. 203-226.

<sup>81</sup> The moral hazard created because of a perception of a bailout can lead to an under-pricing of the financial risk to which the investors and depositors may be exposed and potentially increase systemic risk.

IMF imposed creditor standstill could reduce the incentives for sovereign debtors to fulfil their contractual obligations.<sup>82</sup>

For the present, the IMF continues to offer large-scale lending packages in crisis situations based on the acceptance by the borrowing country of strict conditionality.<sup>83</sup> These packages are constructed on the basis of instruments intended to offer bridge financing, such as the General Arrangements to Borrow (GAB), the New Arrangements to Borrow (NAB), the Supplementary Reserve Facility (SRF) or the Lending-into-Arrears policy (LIA). None of these instruments, however, necessarily distinguishes between illiquidity and insolvency, nor addresses the specific questions regarding the unintended incentives and social costs they may impose on the debtor country or on creditor-debtor relations. Indeed, former Managing Director Rato has recognized that a wide range of views exists regarding what the extent and scope should be of the Fund's financial assistance programs. As a result, there is a need for a review of the existing instruments for crisis resolution, in terms of their efficiency, the limits of the Fund's resources, and the moral hazard they may create in international capital markets.<sup>84</sup>

#### *Lender of Last Resort (LOLR)*

The Lender of Last Resort (LOLR) concept originated from the theoretical contributions of Thornton and Bagehot.<sup>85</sup> The term later became commonly used in the late nineteenth century, after an observation made by Sir Francis Baring in 1879 on the Bank of England who described the institution as a *dernier resort* for banks in need of liquidity during crises. The LOLR function has become the essential role for central banks. The growing importance of a LOLR function may also be considered a symptom of the increase in banking and currency crises in recent years, as these types of crises originate from a sudden loss of confidence by private investors and lenders

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<sup>82</sup> International Law Association, "International Monetary Law Committee Report", *Report of the Seventy-First Conference*, Berlin, 2004, pp. 122-124.

<sup>83</sup> Haldane, A. and M. Kruger, "The Resolution of International Financial Crises: An Alternative Framework", in Vines and Gilbert (Eds.), *The IMF and its Critics*, pp. 207-224.

<sup>84</sup> IMF, "Report of the Managing Director to International Monetary and Financial Committee on the IMF's Policy Agenda", September 22, 2005, p. 10.

<sup>85</sup> Henry Thornton discussed the role of a lender of last resort in "An Enquiry into the Nature and Effects of the Paper Credit of Great Britain" published in 1802. Bagehot later developed the concept in his renowned work titled "Lombard Street: A Description of the Money Markets" in 1873. See Capie and Wood, above note 1.

in a country's banking sector and in the ability of the state or sovereign agency to manage its finances.

In addition, central banks are also confronted with yet another major challenge that involves the collapse of a certain financial institution or group of financial institutions as a result of a sudden loss of confidence by depositors or lenders when these institutions are 'too big to fail'. This can have serious implications for systemic risk. The resulting speculative attacks can threaten to infect the whole financial system, as well as other sectors of the economy. In this sense, in so far as financial crises prevail and international financial markets remain exposed to systemic risk and contagion, the need for a LOLR is justified, since it goes beyond traditional financial assistance activities targeting a particular country.

#### Functional challenges of the International LOLR

Although an international LOLR function is attractive in theory, its feasibility has been questioned on the grounds that there is no political consensus regarding what type of powers such an institution would exercise or who would provide it with adequate resources. Since the early 1990s, the IMF has played an increasing role as a *de facto* lender of last resort (LOLR), especially in the Mexican and Asian crises. The Fund's performance in resolving these crises, however, was strongly criticised.<sup>86</sup> There are several explanations for this. First, the criticism relates to the difficulty of identifying whether a financial crisis stems from a liquidity or solvency problem.<sup>87</sup> The absence of a clear divide between the two types of crisis resulted in the IMF following a policy that had the effect of providing indiscriminate assistance to any member state in crisis. This created a moral hazard among private lenders who perceived the private costs they had incurred in making investments in these countries as having been shifted to, and subsequently shared with, official sector agencies.

Ideally, the LOLR function should be exercised on behalf of countries that are encountering liquidity problems, rather than countries with solvency problems. In offering the same type of assistance, the IMF does not discriminate between countries which are in crisis because of irresponsible financial management and overexposure to risk provoked by speculators and private sector participants, and those which have

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<sup>86</sup> See Rosa M. Lastra, "The International Monetary Fund in Historical Perspective", *Journal of International Economic Law* (2000), 507-537.

<sup>87</sup> See Eatwell and Taylor above note, pp. 43, 46-7.

fundamental shortcomings underlying their macroeconomic and financial management. The former generally are illiquid because of speculative moves, which dry out reserves and other assets in speedy capital exits. The latter reflect weak government performance in macroeconomic management, which can eventually result in an inability to pay or even service debts acquired with foreign creditors.<sup>88</sup>

Indiscriminate lending disrupts market order since private lenders which under normal circumstances would not lend to a particular country have the incentive to take the risk since they know they will be eventually paid with Fund resources. Evidently, private creditors taking this approach increase their risk exposure beyond adequate levels, thereby transferring part of their costs to the country acquiring the debt. A second reason for the inadequacy of the IMF as a LOLR may be seen in the peculiarities of Fund lending policies. According to Griffith-Jones and Kimmis, serious problems arise from the timing, scale and conditionalities of lending.<sup>89</sup> Excessive focus on satisfying lending conditionalities has disregarded the importance of timely assistance. This has resulted in burdensome and lengthy consultation process with the countries in crisis, resulting in an increased need for more funds once the actual assistance comes through. In addition, the way in which Fund lending has been based on periodic arrears poses considerable strain on financial recovery expectations. The inability to assess whether the next arrear will come through or be suspended tends to trigger speculative reaction in financial markets. This behaviour became evident in the Russian and Argentinean crises, contributing to an even deeper downfall of those economies.

Though the IMF tried to solve the problem of timely assistance through the creation of Contingent Credit Lines in 1999, and with Emergency Finance Mechanism and the Supplementary Reserve Facility, its efforts have been inadequate. It has been observed that the actual amount needed for liquidity assistance by most countries in distress exceeds the Fund's capacities and that greater funds are necessary.<sup>90</sup> Furthermore, current IMF lending has a negative effect on market discipline. As Eichengreen states: "Repeated rescues create moral hazard... weakening market discipline. IMF support allows governments to cling to unsustainable policies even

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<sup>88</sup> Eichengreen, see above note 67, Chap. 3 (discussing crisis management).

<sup>89</sup> See Stephanie Griffith-Jones and Kimmis, "Stabilizing Capital Flows", in Michie and Grieve Smith (Eds.), *Global Instability*, pp. 87-96.

<sup>90</sup> See Rosa M Lastra, "Member of Last Resort, An International Perspective", *International and Comparative Law Quarterly* (April 1999), Vol. 48, 340-361.

longer than they would otherwise do, which allows financial vulnerabilities to build up, leading to more severe fallout when the collapse finally comes.”<sup>91</sup>

A third consideration as to why the Fund is an inadequate LORL relates to surveillance. Lastra notes that, together with a LORL role, enhanced surveillance and transparency is required, in order to monitor supervisory and regulatory policies. In this sense, the IMF would need to strengthen its mandate on surveillance, contained in Article IV of the Agreement. In addition, the organization would need to develop a ratings system based on a set of parameters to monitor the financial systems of its member countries.<sup>92</sup> The Fund, however, began to address the surveillance concern by establishing a Capital Markets Department in 2002 which has a remit for reviewing the financial sector policies of members and the impact of member financial policies on global and regional financial stability.

A fourth critique is in relation to the role of a LOLR as an undisputed function of central banks. At the national level, this may be a lesser problem, as most nations have a central bank or an institution vested with central bank functions. At the international level, however, this creates a considerable array of problems concerning which institution should exercise this function and how much sovereignty countries may be willing to cede to such an international organization.<sup>93</sup> Indeed, Goodhart has addressed the organisational dilemmas of central bank activity at the domestic level by observing that the different challenges posed by prudential regulation and financial crisis management today go beyond the scope of sole institutional actors<sup>94</sup> The main challenge therefore lies in the political will in devising an effective institutional mechanism of central bank or LOLR intervention.

A fifth and perhaps main reason for contesting the IMF as a LOLR lies in how it departs from the approach of central banks. Lastra notes that the LORL role of central banks has three distinguishing features, namely: “(1) The discount rate at which the central bank lends, acting in its capacity as a lender of last resort, in an

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<sup>91</sup> Eichengreen, *Financial Crises and What to do About Them*, p. 52.

<sup>92</sup> See Rosa M. Lastra, “The International Monetary Fund in Historical Perspective”, *Journal of International Economic Law* (2000), 507-537.

<sup>93</sup> Ibid.

<sup>94</sup> He states “... crisis management already involves joint co-operation, assessment and agreement between Central Banks and Ministries of Finance. Does it then matter so much if the Committee becomes tri-partite, involving the specialist supervisor, Central Bank and Ministry of Finance?” Charles A. E. Goodhart, “The Organisational Structure of Banking Supervision”, *FSI Occasional Papers* 1 (Basel: BIS)(Nov., 2002).

instrument of *monetary policy*... (2) The lender of last resort in an instrument of *banking supervision* in a “crisis situation” stage. As part of its micro prudential functions, the central bank acting as a lender of last resort provides assistance to a bank (or banks) suffering from a liquidity crisis. (3) The lender of last resort is a service provided by the central bank in its capacity as *banker’s bank*.”<sup>95</sup> Clearly, this approach departs from the de facto LOLR activities the IMF has undertaken.

#### *Private Sector Involvement*

Critiques on the current state of crisis management also voice concerns about private sector involvement. The IMF’s financial assistance, as well as that of other IFIs does not apply to the private sector.<sup>96</sup> As such, a private sector crisis such as a banking crisis will only receive assistance once the country’s authorities decide to assume part of the private sector obligations, and apply for financial assistance in order to cancel the private sector debt. Further, the Fund has abstained from involving the private sector by directly lending to it to resolve a crisis, though proposals for extending financial assistance to the private sector already exist.<sup>97</sup>

Proposals to assist the private sector directly were made at the Köln Summit in 1999, where government and central bank representatives envisaged a framework for involving the private sector in crisis resolution. The focus was on cooperative solutions to manage crises based on communication and dialogue. It was intended for creditors and debtors in the financial sector, as well as for countries and other market participants in the broader financial system. Several principles were suggested addressing risk and responsibility sharing, adequate risk assessment, debt financing and payment and equal treatment of private creditors and claims, seeking effective dialogue, cooperation and market-based solutions.<sup>98</sup>

In 2000, at the G7 summit in Fukuoka, Japan, Heads of State further clarified the particularities of private sector involvement (PSI) in crisis prevention and resolution. The proposals called for operational guidelines to enhance IMF lending programmes and a facilitative role in mediating negotiations between private creditors and sovereign debtors. Specifically, the proposals make a distinction between the

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<sup>95</sup> Lastra, above note 90, pp. 340-361, fn. 2.

<sup>96</sup> See Eatwell and Taylor, above note 7, chapter 3.

<sup>97</sup> See Eichengreen, above note 67, pp. 52-53.

<sup>98</sup> Group of Seven, “Report of G7 Finance Ministers to the Köln Economic Summit”, Cologne, 18-20 June, 1999, para. 45.

functions of the IMF and the Paris Club by stating: “In cases where a contribution from official bilateral creditors (primarily the Paris Club) is needed, the IMF financing plan would need to provide for a broad comparability desired and achieved between the contributions of official bilateral and private creditors. The Paris Club, if involved, should of course continue to assess the comparability desired and achieved between its agreement and those to be reached with other creditors.”<sup>99</sup> Since then, the IMF has recognized the efforts of the Paris Club to foster support toward consultation and coordination procedures between official and private bilateral creditors.<sup>100</sup> However, the way that the Fund can respond to a financial crisis distinguishes it from that of private creditors, in terms of speed, form, process and comparability of restructuring.<sup>101</sup> Further, joint consultations between the Paris Club and the IMF in seeking to improve the process of restructuring have led to the proposition of alternative solutions in cases where both official and private claims are significant.<sup>102</sup>

The involvement of the private sector in supporting a country in a financial crisis should be encouraged on efficiency grounds because private sector foreign investors often do not calculate the full social costs of their risky investments and therefore they have an incentive to invest too much speculative short-term capital in countries with inadequate regulatory institutions and fragile financial systems. To address this, academics and policymakers have advocated various mechanisms of private sector involvement crisis prevention and resolution that takes the form of ‘bailing in’ the private sector or ‘burden sharing’.<sup>103</sup> The best approaches for involving the private sector should be determined on a case-by-case basis and take into account such factors as the severity of the crisis, the type of debt instruments issued and their term structure, the extent of foreign exchange exposure, and whether the state appears to be suffering a liquidity or solvency crisis. Indeed, Goodhart has noted that because financial crises have gone beyond the scope and abilities of central

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<sup>99</sup> Group of Seven, “Report from the G7 Finance Ministers to the Heads of State and Government.” Fukuoka, 8 July 2000., Para. 21 (b).

<sup>100</sup> In parallel to the official creditor’s Paris Club, there is another like forum for private creditors, known as the London Club. Its origins were inspired in the Paris Club and serves as a venue for private commercial banks.

<sup>101</sup> IMF, “Reviewing the Process for Sovereign Debt Restructuring within the Existing Legal Framework”, August 1, 2003.

<sup>102</sup> IMF, “Involving the Private Sector in the Resolution of Financial Crises – The Treatment of the Claims of Private Sector and Paris Club Creditors – Preliminary Considerations”, June 27, 2001.

<sup>103</sup> Rosa M Lastra, “The International Monetary Fund in Historical Perspective”, *Journal of International Economic Law* (2000), 507-537.

banks, their management cannot solely depend on these institutions. He also notes, however, that private sector participation in the form of assistance is by far more challenging than before, given the incentive structure against financial assistance in the private sector. He argues that: "... multinational banks will claim that the home country forces, whether shareholders, regulators, or their own domestic law, prevent them from risking their own capital in any co-ordinated rescue exercise in another country. If the multinationals will not play, then competition will prevent the domestically headquartered banks from doing so either."<sup>104</sup>

Previous efforts to involve the private sector in crisis prevention and resolution have been inadequate and the absence of an effective framework that involves creditors in negotiations on debt relief schemes and crisis management undermines financial stability. Not only is the allocation of responsibilities and risk burdens absent, the needed dialogue for fostering accountability and benefiting from private sector expertise in crisis management so far remains a foregone opportunity. Perhaps, the Fund could play a more active role in this area in coordinating the involvement of private sector actors to assume more of the responsibility of managing the risks of financial crises.

#### *Alternatives to Current and Future Financial Assistance*

Various alternatives proposals to Fund lending programs have been suggested that include: a) presumptive lending limits on IMF lending; b) standstills to protect a country and lend into arrears (i.e. bridge financing); c) approved debt roll-overs with a penalty for liquidity shortages; d) enforce collective action clauses; e) create an international bankruptcy court, and f) adopt a voluntary approach.<sup>105</sup>

Presumptive lending limits are viewed to be more efficient alternatives to Fund lending programs because they address the moral hazard problem which became apparent in the Mexican and Asian crises in the 1990s, where Fund rescue packages were much greater than the actual quotas maintained by these countries with the Fund. Generally, Fund bailouts programs would total at the maximum one hundred percent of a country's quota, but in the Mexican and Asian crises, rescues packages amount to

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<sup>104</sup> Goodhart, "The Organisational Structure of Banking Supervision", *FSI Occasional Papers* 1, November, 2002, 26.

<sup>105</sup> For a complete description and discussion of alternatives to current IMF lending see Eichengreen, above note 67.

between five hundred and seven hundred percent for Mexico and approximately nineteen hundred percent of the actual quotas of Asia members. Eichengreen has suggested that the Fund should apply lending limits that aim to maintain the one hundred percent rule in the first year of the bailout while committing a maximum of three hundred percent for a whole lending program. The goal would be to restore the belief among foreign investors that the Fund would not continuously offer financing for a debtor country after it exhausts its Fund quota and not to provide indefinite support in the event of a prolonged or recurring crisis.<sup>106</sup>

This approach, however, may be more difficult to implement than envisaged. Though financial assistance is determined on the basis of quotas, so are voting powers on the Fund's Executive Board. Current quotas may not reflect actual or potential country needs of a bailout. Such differentiation could pose difficulties under systemic risk and contagion, or may actually favour some countries more than others, inadequately targeting the impact of a given financial crisis. In addition, reviewing current quotas would pose an immediate conflict of interest among IMF members seeking to maintain the voting status quo.<sup>107</sup>

Finally, though setting limits on financial assistance may be the optimal solution, ultimately, the question of credibility remains an issue. There is no point in establishing such limits if the IMF waives the rule, no matter how well justified additional financing in a particular case may be.

### Standstills

Standstills, either sanctioned or endorsed by the IMF, are considered an alternative to current financial bail-outs in the event of a liquidity crisis. If a country were suffering from capital flight, a Fund-imposed standstill on debt payments could give the country enough time to seek an orderly solution, which could allow creditors adequate time to coordinate their actions and to allow the state debtor to make the necessary commitments to undertake economic reforms.<sup>108</sup> This would reduce the risk of precipitating a solvency crisis because of creditor runs, and provide for the opportunity of corrective and timely action. In addition, the IMF could provide bridge financing during the time of the standstill in order to stabilize the economic situation.

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<sup>106</sup> Ibid, pp. 76-80.

<sup>107</sup> Ibid, p. 78.

<sup>108</sup> Ibid, pp. 80-83.

An alternative could also be to shift the sanctioning power of standstills to an independent institution, other than the Fund, allowing for a clear separation of the financial assistance role of the Fund from the actual decision to impose a standstill on debt repayments. Another variant on this approach might involve the sovereign borrower declaring the standstill, subject to approval by an independent international panel. Negotiations for debt rescheduling between the sovereign borrower and the creditors would be limited in time and subject to terms imposed by the panel if no agreement were reached within a given period. Under this approach, the IMF could simply endorse the standstill, which was imposed by another institution, in order to send a message of stability and credibility to the markets, and follow its endorsement with bridge loans that could stabilize the debtor country during the standstill.

#### Debt roll-overs with a penalty for liquidity shortages

A debt roll-over envisages the incorporation of clauses in debt contracts, allowing for a one time only opportunity to defer the interest payments while rolling over the principal debt. The debtor wishing to roll over debt would pay a penalty fee and would have a deadline to pay the deferred service (i.e., ninety days).<sup>109</sup> This alternative presumes that the problems of liquidity could be solved by providing an extension of the period for servicing the debt. As with a standstill, the period during which the country is waived from its debt payments allow for corrective action and for a return to stability in the market (i.e. speculative creditor reactions). If the sovereign's payment difficulty, however, were of a solvency nature, such a mechanism would only offer a truce for initiating negotiations for major debt restructuring and a bail out.

#### Collective action clauses

Following the Fund's rejection of the SDRM, collective action clauses in sovereign bond contracts have emerged as an effective device to allow sovereign debtors and their bondholders to renegotiate the terms of their payments and possibly to restructure their debt in the event of payment difficulties. Traditionally, most sovereign bond contracts were governed by New York law and usually contained clauses that required a bond issuer to obtain unanimous consent from all bondholders of a particular class of bonds before a change in payment terms could be agreed. New

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<sup>109</sup> Ibid pp. 83-85.

York law bond contracts made it difficult for sovereign debtors to restructure repayment terms because a single (or small group) creditor could object to the proposed renegotiated terms and block any restructuring. For instance, a small group of bondholders could hold out and attempt to enforce repayment under the original terms of the contract, while at the same time a majority of bondholders were negotiating with the sovereign debtor for a restructuring that might have led to a reduction in the principal or interest rate. By contrast, English law bond contracts have contained CACs that allow the issuers of the bonds to restructure the payment terms of the principal and interest if they can persuade the bondholders who hold a super-majority of the value of the class of bonds to vote for the restructuring.<sup>110</sup>

CACs offer a flexible mechanism for debtors and bondholders to renegotiate payment terms and provide an incentive for all bondholders to participate in restructuring negotiations and not to free ride on the willingness of other bondholders to renegotiate their claims.<sup>111</sup> CACs also ensure a more orderly and coordinated action by bondholders if the servicing or payment of debts is disrupted. As mentioned above, it incentivizes bondholders to act in unison, eliminating the incentive of a few bondholders to institute litigation at the expense of the majority of bondholders. The advantage of CACs lies in their transparency, since creditors are bound to proceed in a particular manner under the event of a suspension of debt payments, as specified by the clause. By vesting the power to file suit in the hands of a trustee, and eventually also the decision to initiate buy ups and distribute the proceeds of such buy ups among the creditors, these clauses offer additional predictability and lower the levels of uncertainty for creditors, since the trustee will be expected to act for the benefit of all creditors bound by the clause.

The incentives for some bondholders, however, to abstain from participating in collective restructuring remain high, as dissident bondholders may try to enforce their claims in sympathetic jurisdictions. Further, the proliferation of bond holders in sovereign debt markets points to a greater number and diffusion of creditors, and, given the shift away from syndicated commercial bank lending to direct issuance of debt instruments, and has resulted in a sophisticated secondary market of tradable

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<sup>110</sup> The most important provision of the CAC specifies the proportion of shareholders which qualify as a majority and is entitled to initiate a debt restructuring process which will bind all parties of the clause.

<sup>111</sup> These clauses establish decision-making rules and specify how bondholders are to be represented in the event of a renegotiation of debt payments.

sovereign debt instruments. Finally, changes in the legal systems have weighed in favor of more litigation, where limitations on “sovereign immunity” allow creditors to bring civil actions to recover damages or to enforce specific performance in foreign courts. This partly explains why collective action clauses, though potentially effective, may be increasingly difficult to implement because of the ability of individual bondholders to bring their claims against debtor states in court.<sup>112</sup>

Nevertheless, CACs are being used in a growing majority of both English and New York law bond contracts and represent a flexible market-based approach to addressing the problems faced by countries experiencing liquidity crises and other types of payment difficulties. Notwithstanding the difficulties, international bodies have proposed modified CAC structures.<sup>113</sup> Also, other jurisdictions are adopting modified CACs in their international sovereign bond contracts.<sup>114</sup>

Although the above proposals have addressed many of the challenges of building a durable institutional and legal framework to govern the lender of last resort function, each proposal contains inherent flaws that range from enhancing the powers of the Fund beyond what would be acceptable in today’s international political climate to the misalignment of incentives between creditors and debtors in the proposal for a SDRM. The CAC approach creates incentives for bondholders and the sovereign to renegotiate payment terms in light of changes in the economic environment and provides an effective *ex ante* set of rules for bondholders to coordinate their actions for the benefit of a super-majority of claimants. Nevertheless, greater coordination in the provision of, and access to, liquidity on a cross-border basis is needed to support a crisis management situation, especially where a sovereign’s debt exposure is denominated in one or more of the reserve currencies of G10 countries for which it does not have central bank support. This becomes

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<sup>112</sup> International Law Association, “International Monetary Law Committee Report”, *Report of the Seventy-First Conference*, Berlin, 2004, pp. 122-156.

<sup>113</sup> See Group of Ten, “Report of the G-10 Working Group on Contractual Clauses”, September 26 2002, for the G10 proposal. The IIF together with the Emerging Markets Traders Association, the International Primary Market Association, The Bond Market Association, the Securities Industry Association, the International Securities Market Association and the Emerging Markets Creditors Association developed a “Model for Collective Action Clauses for Sovereign Bonds” and issued it as a Discussion Draft in January 31 2003. For a detailed report of advances in the field, see IMF, “Progress Report to the International Monetary and Financial Committee on Crisis Resolution”, April 12, 2005.

<sup>114</sup> International Law Association, “International Monetary Law Committee Report”, *Report of the Seventy-First Conference*, Berlin, 2004, pp. 122-156.

particularly important in a financial crisis when a sovereign debtor or a large financial institution in its jurisdiction loses the ability to make current payments on its liabilities and therefore is in need of emergency funding for a short period of time until investor and/or depositor confidence is restored. The premise for such emergency lending is that the debtor state or bank is simply illiquid and not insolvent. The following section argues for a revised General Arrangements Borrow (GAB) framework that would support the Fund in providing a more effective international lender of last resort.

### **The need for multi-lateral coordination of central bank intervention**

Recent non-G10 sovereign debt and banking crises (Mexico 1994-95, Russia 1998, and Argentina 2001) demonstrate that the Fund does not have adequate resources to act on its own in stemming a financial crisis and in particular in playing the role of lender of last resort. Fund negotiations with G10 countries such as the US to obtain reserve currency financing for non-G10 sovereigns in a crisis is *ad hoc* and often results in delayed disbursement of badly needed liquidity which has led in many cases to a deepening of the crisis. Moreover, there is a concern regarding the adequacy of the Fund's resources to deal with a full-blown financial crisis that occurs on a regional or global basis. Only with the support of one or more of the G10 central banks could the Fund pre-empt or stabilize a crisis in a large developing country (eg., Mexico) or in a country with a large financial sector. Although the Fund's authority is clear regarding how it would intervene to stem a crisis in a member state, its role is not so clear regarding how it would raise capital in a major financial crisis where its own resources were inadequate and it would be required to obtain resources from the central banks of the G10 countries. What type of institutional framework could be devised to address a financial crisis caused by a sudden loss of investor confidence in a country or region's economy and the need to provide liquidity assistance to sovereign debtors whose cost for accessing international capital markets has become prohibitively high? Specifically, how might the Fund coordinate an emergency financial rescue of an ailing sovereign debtor. It does not have the resources to act on its own; rather, it would have to coordinate with a group of central banks from reserve currency countries and agree on procedures and obligations to ensure that adequate liquidity could be made available to a sovereign borrower or state-owned or controlled bank that cannot meet its obligations? How might a group of central

banks share responsibility for providing liquidity support to a sovereign debtor whose access to foreign lending in reserve currencies has been drastically curtailed because of an external shock to its economy or imbalance in its own economy or financial system?

Since 1962, the General Arrangements to Borrow (GAB) has allowed the G10 countries to voluntarily lend to one another and to other IMF members by lending reserve currencies to the Fund which in turn the Fund would make available through exchange transactions or stand-by arrangements to a GAB participant that was experiencing a current or capital account imbalances. In 1998, the New Arrangements to Borrow was adopted that allows NAB participants of which there are twenty six (including GAB participants) to lend their currencies to the Fund if a special majority approves the Fund Managing Director's proposal for calls to lend and the Executive Board approves. As with the GAB, however, a NAB participant does not have a legal obligation to lend its currency to the Fund in proportion to its pre-existing credit arrangements for the benefit of a country in a financial crisis. This creates legal uncertainty precisely at a time when there needs to be stability of expectations on the part of foreign investors that an ailing state is able to access emergency loans to stabilize a liquidity crisis or to prevent a further deterioration of its finances.

On the few occasions when GAB participants have loaned their currencies in response to a Fund call for loans, the Fund was borrowing the currencies to support another GAB participant that was experiencing persistent current account or fiscal deficits.<sup>115</sup> Generally, non-GAB participants (non-G10 countries) have not been able to borrow assets through the GAB and have had instead to borrow from other more limited Fund lending programs. In the NAB, however, any IMF member is able to borrow from NAB countries (which includes GAB countries), but must be supported by the Managing Director and approved by the Executive Board. Moreover, even if the Managing Director proposes a call for loans from NAB countries, individual NAB members are not legally bound to lend. Despite the large number of banking and currency crises that have occurred since 1998, only one call for loans under NAB was

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<sup>115</sup> For instance, GAB loans were made to the United Kingdom on four occasions: 1964 (SDRs 405 millions), 1965 (SDRs 525 millions), 1967 (SDRs 476 millions), 1969 (SDRs 200 millions), and 1977 (1,493.5 millions). One loan has been made to Italy in 1977 for SDRs 82.5 millions. See Gold, above note 42, p. 510, Table 2, 'Borrowing by Fund Under General Arrangements to Borrow'.

approved and that was to Brazil in 1999. As with the GAB, the NAB has been under-utilized as an international LOLR.

The GAB and NAB process has suffered from a lack of legal stability regarding the absence of a legal obligation of GAB and NAB participating countries to lend their currencies once the Fund has approved a call for loans. The chapter suggests that the Fund can play an enhanced role in serving as the intermediary through which developed country central banks can lend to developing countries to prevent or stabilize a financial crisis. In doing so, the Fund can act as payment agent for disbursing funds on behalf of the G10 countries and by exercising enhancing surveillance over non-G10 countries which borrow reserve currencies in a crisis.

An important aspect of the Fund's inability to intervene decisively in a crisis are the political and legal uncertainties regarding the willingness and obligation of GAB participants to provide adequate resources to the Fund so that it can pre-empt an impending financial crisis. A major weakness in the GAB and NAB in confronting modern financial crises is that the consultations and decision-making by GAB participants and with the Fund and its Executive Board can be time-consuming and, if there is a proposal for calls, involve extensive negotiations between the Managing Director and each GAB participant in order to decide the allocation of GAB lending to individual members. Once an announcement is made that a commitment to lend is in place, an individual participant who did not vote with the special majority does not have to participate in the call. Moreover, a participant which commits itself to participate in the call can later decide to withdraw upon giving notice to the Managing Director and other GAB participants that their involvement will have an adverse impact on their currency reserves or create other significant economic imbalances. There are no specific tests to determine precisely what a participant has to prove in order to refuse, or withdraw from, participation in the call. Under both the GAB and NAB, the participants appear to exercise almost complete discretion whether to participate in a call for loans with the exception that they have an obligation to engage in consultations and to notify other participants and the Fund of any change in their circumstances regarding how they affect their decision either to be involved or not.

It is submitted that the GAB framework should be amended to enhance the legal certainty of the lending obligation of a GAB participant once the Fund makes a determination that a financial crisis or impairment of the international monetary system is occurring and that determination has been supported by a majority of the

IMF Executive Board. Once the Managing Director has consulted with the GAB participants and the Executive Board, and obtained a majority approval from the Executive Board and a special majority of the GAB, then the Fund could compel GAB members to lend in proportion to the relative amounts of their credit arrangements. For each time lending is requested, a G10 central bank would be designated to take the lead in coordinating the provision of reserve currencies from other G10 countries to meet the specific needs of the crisis. The Fund would consult with GAB participants to determine which participant should take the lead in lending to the Fund and in possibly encouraging others to lend to the Fund. An important criterium for determining which participant should take the lead in lending for a bailout would be the portion of that participant's currency which was denominated in the debt instruments that were issued by the ailing sovereign debtor and/or any related state-owned corporations. For example, if a state defaults on debt instruments of different classes that have the following value in denominated currencies: 60 million (US\$), 30 million (CH), and 10 million (UK£), then the Fund should ask the US participant to coordinate the lending effort because a majority (60%) of the debt instruments are denominated in US dollars. Moreover, there would be a presumption that the US participant would lend 60% of the amount of the loan, while the Swiss participant would lend 30%, and the British participant 10%. Only in exceptional circumstances where a designated participant could show that by lending according to the formula that it would have an adverse effect on its capital or current account would it be excused from its proportional responsibility. This would promote more transparency in the Eurocurrency markets and would create incentives for participants that issue their currencies to oversee and supervise the trading book of financial intermediaries that use their currencies in cross-border debt investment.<sup>116</sup>

In addition, an enhanced GAB framework would require some *ex ante* regulatory safeguards that members should undertake to be eligible for GAB financing. All countries seeking GAB support would be required to have their economies and financial sectors subject to enhanced surveillance and oversight by the Fund so that more market information could be made available about these countries' financial markets to foreign investors. Moreover, there would be a requirement that states seeking GAB assistance purchase credit risk protection in advance that could

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<sup>116</sup> I adopt the traditional definition of Eurocurrency that is a reserve currency, or a hard currency, that is a traded in a jurisdiction in which it is not the currency of issue.

take the form of sovereign credit default swaps or other synthetic credit derivative instruments.<sup>117</sup> The Fund could act as an agent in selling the credit risk protection on behalf of a private sector financial intermediary or by directly providing the credit protection itself. Moreover, it could approve and monitor the provision of credit risk insurance by third party intermediaries to sovereign debtors. In return for complying with these *ex ante* safeguards, a member state would be eligible to access GAB members' currencies by conducting exchange transactions or stand-by arrangements with the Fund.

Finally, the GAB and the NAB should be consolidated so that their credit arrangements can be pooled and enhanced to at least SDRs 100,000 millions. The new GAB II framework would apply the same rules regarding lending and consultations and repayment requirements for all of its participants and for all IMF members who obtain resources through GAB II lending arrangements. All participants and non-participants in the funding framework would be subject to the same requirements regarding conditionality and economic restructuring which the Fund may impose in its discretion.

Summing up

Devising an effective international institutional arrangement to cope with or forestall an impairment to the international monetary and financial system requires that the cross-border dimension and externality of financial risk be controlled. As discussed above, sovereign debt crises raise serious concerns for international economic policymakers because of the threat that financial failure of a sovereign or a large state-managed banking system could create significant spill-over effects on other economies and financial systems. Addressing these threats to financial stability in a way that promotes the treaty objectives of the Articles of Agreement while adhering to the more narrow objectives of maintaining currency stability for GAB participants requires that the Fund play the role of intermediary and monitor in the provision of emergency liquidity assistance to a member country. This would involve devising *ex ante* disclosure standards and financial practices for states to enhance their credibility with foreign investors regarding how they manage their economies and financial systems. The Fund would also take on a more robust role in monitoring the

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<sup>117</sup> *Credit derivatives are financial instruments that allow debtors to insure against losses on their debt and their use is growing rapidly for sovereign debtors.*

global financial system and members' economic and financial policies, but recognizing that the sources of market failure can vary from country to country and that a one-size fits-all approach to economic and financial policy should be set aside and replaced with a more flexible surveillance function that dispenses with strict conditionality and allows states to experiment with different economic policies and regulatory approaches.

Moreover, it is necessary to enhance legal certainty in a consolidated GAB and NAB framework – GAB II - to ensure that if a financial crisis occurs and a sovereign is suffering from a liquidity problem that the Fund can access adequate G10 or GAB/NAB participants' currencies by making calls for loans which, if approved by a special majority, would oblige all GAB II participants to make loans according to a pro-rata portion of the relative sizes of their credit arrangements.

Devising an institutional and international legal framework to address these issues would not involve a substantial reform and modification of the present international financial regulatory and legal regime. For instance, Article VII (1) of the Articles of Agreement provides the IMF with authority to negotiate agreements with its members to borrow capital to support Fund objectives. It was pursuant to this authority that the original General Arrangements to Borrow was agreed in 1962 so that the Fund could borrow the currencies that were being used increasingly for cross-border capital transactions in order to lend them to other G10 countries to cover their economic imbalances. The GAB, however, was not available to non-G10 countries, mainly because when it was adopted strict capital controls were still in force in most countries and there was little need for these countries which had not liberalised their capital and current accounts to borrow reserve currencies. In today's liberalised and globalised capital markets, however, all developed countries and many developing countries and emerging market economies have adopted some form of capital account liberalisation, which means they are exposed to potential imbalances in the capital account which can shift quickly because of a change in investor sentiments. These countries therefore are in need of an emergency financing mechanism that would allow them to borrow currencies for which they have liabilities in the capital account and to finance substantial imbalances in the current account.

Conclusion

Presently, the IMF is confronted with demands to change its focus, and substitute its policy of “replacing private capital flows” to one of “dealing with market failures in private markets.” The main challenge before the IMF is the definition of its role in managing a financial crisis. Specifically, the question has arisen whether it should lend to sovereign debtors or large systemically-important banks to help resolve an insolvency or liquidity crisis. If so, should the Fund lend into arrears in order to provide temporary liquidity to stabilize a crisis, especially in today’s globalised capital markets when it has inadequate funds at its disposal?<sup>118</sup> In the area of crisis management, the main challenges for the IMF are, on the one hand, policy coordination with the G-7, and the Financial Stability Forum, the G10 central bankers and financial regulators in order to share responsibility for bail-outs and guarantees from the IMF to central banks; and, on the other hand, playing the role of broker in assisting sovereign debtors by liaising with private creditors to find alternative sources of liquidity in order to stabilize a financial crisis (“crisis management”).<sup>119</sup> In addition to the first task of being a full actor, its second task involves that of a facilitator. Under either approach, the Fund will have to accept a more limited role in directly intervening in financial crises and in using its lending activities as a policy instrument to bring about economic and financial reform.

The IMF’s existing lending programs were adopted in the late 1990s along with other emergency liquidity assistance programs. But most of these programs have been under-utilized by non-G10 sovereign debtors in need of emergency lending because of strict conditionality requirements that have often resulted in poorly designed economic policies and financial sector reform. The chapter thus makes the following proposals for a more proactive role for the Fund in promoting financial stability by enhancing its facilitative role as a lender of last resort. First, the *ex ante* role would involve the Fund requiring that sovereign debtors comply with the disclosure requirements of Fund programs such as the General Data Dissemination standard. Also, to be eligible for emergency lending under the GAB framework, members must purchase credit risk protection on their bonds or other debt instruments and loans. Second, the Fund’s crisis resolution role would involve the Fund in coordinating access to reserve currency assets by consolidating the GAB and NAB into one credit arrangement and increase the aggregate credit amount available to

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<sup>118</sup> See Vines and Gilbert above note 42, p. 33.

<sup>119</sup> See Knight et al., above note 10, pp. 144-148.

borrow from to SDRs 100,000 millions. Once the requirements for making a call for loans are fulfilled, each participating country (or regional organisation, ECB) would have an obligation to lend an amount in proportion of the call that reflected the proportion that its currency constituted of the defaulted sovereign debt instruments. The country or participating central bank with the largest percentage would take the leading in coordinating the other lending participants. The Fund would play a facilitative role in providing technical advice regarding how the loans should be disbursed to the sovereign debtor. Although these proposals do not significantly enhance the Fund's role in overseeing and maintaining financial stability, its key role as an intermediary in the provision of credit risk insurance and in accessing emergency reserves from G10 countries keeps it at the heart of the international monetary system.

These proposals set forth a meaningful and realistic role for the Fund to contribute to financial stability and to assist countries in borrowing reserve currencies in a financial crisis. Moreover, the proposals would require an amendment of the General Arrangements to Borrow to create an obligation for G10 countries to lend their currencies up to the amount of their available facilities upon a recommendation by the Fund Managing Director supported by a majority on the Executive Board. This would not require an amendment of the Articles of Agreement, but rather would only require an amendment of the GAB. Under this approach, the Fund would facilitate the provision of emergency financing and there would be a principled framework for allocating financial responsibility among G10 countries and institutions so as to coordinate the disbursement of reserve currencies to an ailing sovereign debtor through the Fund. Finally, these suggested reforms are based on economic and legal theories that support the role of international economic law to be that of regulating the negative externalities (or social costs) of international economic activity. In this regard, creating a more effective international lender of last resort to control the social costs of sovereign debt failure that can arise because of the 'bank-run' sentiments of foreign investors necessitates a Bagehot-like institution to issue its notes on good collateral. The GAB framework potentially allows the leading developed countries acting together to play the role of ILOLR by acting through the Fund to minimize the social costs of sovereign debt failure.