The IMF and the Lender-of-Last-Resort Function

An External View

Recent financial crises have led to renewed interest in having an international lender of last resort. Would this make sense and, if so, would it be appropriate for the IMF to play such a role?

Curzio Giannini

THE STRING of foreign exchange crises of the last few years has brought the lender-of-last-resort function once again to the fore. This time, what is at issue is whether and how this function can be adapted to the international environment. Making the relevant decisions is no easy task, however, because of all the functions a central bank may carry out, serving as the lender of last resort is by far the most difficult to pin down. For one thing, the desirability and appropriate contours of the function cannot be identified independently of the monetary policy framework. Suppose bank deposits were not defined in nominal terms, much like mutual fund shares, or that monetary policy could be run in a purely discretionary manner without raising credibility problems. Would a lender of last resort still be needed? Many would doubt it, to say the least. But there is more. Intervention by a lender of last resort amounts to a suspension of market discipline, since it means lending in situations where other lenders are not. Hence, the very existence of a lender of last resort raises a potential moral hazard problem, which can be kept within acceptable limits only by relying on the broader legal and institutional setup—on regulation in the broadest sense of the word. In short, what the Tao Teh Ching says of the wheel could equally well be said of the lender-of-last-resort function: for all its complexity, what makes it work lies outside of it. Therefore, if we are to understand how a lender of last resort can address financial instability at the national level, as well as whether the notion of an international lender of last resort makes any sense, we must first look beyond the function's boundaries.

Evolution of concept

When Walter Bagehot, the nineteenth-century economist whose *Lombard Street* is still the classic in this field, was writing, the monetary framework was pretty rigid. It was based on the gold standard and on severe restrictions on the supply of currency, while the world's main financial center, the City of London, was run by a handful of financial institutions in a clublike fashion. This helps explain the Bagehot doctrine: when things turn bad, first expel the rotten apple from the club (that is, let it go broke), then come to the rescue of the club as a whole by lending freely to all who can supply good collateral and can afford to pay a penalty rate.

The present situation at the national level is very different from the one Bagehot had before his eyes. For instance, in the industrial world, rigid monetary frameworks have been replaced with "illuminated discretion," namely, stability-oriented monetary policy devised and implemented by an independent central bank. Moreover, in most financial systems, clublike behavior is but a vague memory, having long since been swept away by financial liberalization and heightened competition.

As a consequence, the function of a lender of last resort has also undergone momentous changes. The market-support operations to which Bagehot referred have become extremely rare. In countries where they are still carried out, such as the United States, they take the form of open market operations, which by their very nature cannot embody a penalty rate. By contrast, lender-of-last-resort operations directed at individual institutions—often even at those verging on insolvency—have become much more common. Under these circumstances, constructive ambiguity has become the main check on moral hazard. Since ambiguity means discretion, however, this way of containing moral hazard is subject, like all other forms of discretionary policymaking, to the risk of inconsistency over time. Its credibility rests on the availability of resources and high-quality information, as well as on sufficient technical autonomy and effective sanctioning powers. The latter are really key: if institutions prove incapable of exercising self-restraint, then the lender of last resort must be in a position to inflict losses upon their managements and shareholders. If it did not have, or never availed itself of, such powers, constructive ambiguity would be a rhetorical fiction. Total forbearance would then be an apter name. Bagehot did not need to spell all this out, because the informal threat of expulsion from the City club was sufficient, on average, to deter imprudent behavior. In our time, formal powers of punishment, as embodied in central banks' statutes and in banking laws, have largely come to replace peer pressure.

Limitations on international organizations

Under the Bretton Woods regime, extensive reliance on capital controls, the fragmentation of the regulatory setup, and the room for flexibility implicit in the adjustable multilateral currency peg all contributed to keep the lender-of-last-resort function within national borders. Indeed, the text of Article VI of the IMF's Articles of Agreement, which has never been amended, clearly indicates that the architects of the postwar international monetary order consciously tried to avoid having the IMF take upon itself such a responsibility. But now, with nearly free capital mobility, an intensely competitive climate in the international financial system, and many emerging market countries still relying on exchange rate pegs or even currency boards to "anchor" their economic policies, the need to decide what can be done to carry out a lender-of-last-resort function for countries has become inescapable. When addressing this issue, however, one should not forget that the international environment differs from national environments in at least three respects.

First, international organizations typically enjoy less technical autonomy than comparable national institutions. National governments, especially the stronger ones, do not wish to surrender the power to handle emergencies—since the payoffs and costs of alternative remedies are difficult to predict—but prefer to respond in ways they believe will further their national interests. If the IMF has enjoyed considerable autonomy during its first fifty years, this is due, in no small degree, to the wisdom of its founders, who appropriately scaled down its tasks and ambitions, leaving the lender-of-last-resort function, in particular, out of the edifice. Second, international organizations deal with national authorities, which are subject to domestic political constraints and agendas and, moreover, are largely responsible for the information on which any "objective" assessment of the need for, and desirability of, intervention by a lender of last resort has to be founded. In such conditions, it is sensible for any lending to be rationed, even in crisis times, and for conditionality to continue to play its very important role in IMF programs. Finally, and perhaps most important, international organizations seeking to deter moral hazard on the part of creditors can directly count neither on adherence to informal, clublike norms of behavior nor—lacking an international bankruptcy regime—on formal sanctioning powers. As a result, the grip of both the IMF and the World Bank on international investors depends largely on the cooperation of national authorities, which, however, may find it hard to coordinate their actions because of diverging national interests. Hence, in apportioning the costs of their emergency lending, international organizations tend to lean more heavily on debtor countries than on their creditors.

Changes at the margins

Things being as they are, any grand design to set up an international lender-of-last-resort function should be regarded with suspicion. If we are to improve the international setup for handling crises, we must work at the margins. The good news, however, is that such margins do exist.

A first marginal improvement would be meeting emerging market countries' demand for an external anchor with as little reliance as possible on exchange rate pegs. What these countries need most is not money, since some enjoy high saving rates, and a larger number can, under appropriate circumstances, tap international financial markets if they wish to sustain growth. What they need, first of all, is credibility. For a while, exchange rate pegs of one kind or another appeared to do the trick, but we now know that the costs of a peg may easily outweigh the benefits if a country's economy, financial system, and domestic institutions do not adjust fast enough. So, why should a country rely on a peg if other means to discipline policymaking are available? One should hasten to add that, in this area, the IMF is already doing its part. Although few outside the IMF have noticed, in recent years exchange rate pegs have become a less and less frequent

component of IMF programs. Furthermore, although the proportion of member countries with IMF programs has never been so large, program countries' actual reliance on IMF resources remains historically very low, even after the crisis packages of the last few years. Overall, the IMF appears to be transforming itself from a lender to countries that have no easy access to world financial markets into a credibility-enhancing device for countries that wish to rely on private foreign finance—in short, into the role of catalyzer of other people's money. In the process, fixing the exchange rate is becoming less important and for a very simple reason: the better the credibility-enhancing services of the IMF are, the less member countries need to rely on highly visible but sometimes problematic tools, such as exchange rate pegs, to discipline domestic policymaking.

So, no revolution is really needed in this area. One has only to appreciate more fully the scope and implications of trends that are already under way. The recent decision by the IMF to establish Contingent Credit Lines within the framework of the Supplemental Reserve Facility could prove to be a step in the right direction, to the extent that it strengthens the attractiveness of IMF programs as precautionary arrangements—arrangements undertaken to prevent, rather than ameliorate, economic and financial crises. A further improvement upon current practices would be the explicit adoption within IMF-supported programs, where feasible, of monetary frameworks based on inflation targeting rather than on rigid net domestic asset regimes.

The IMF's staff has long resisted this shift of emphasis, fearing, on the one hand, that it would entail losing sight of the "balance of payments need" principle enshrined in the Articles of Agreement and, on the other hand, that it could prove too demanding, from an institutional standpoint, for many emerging market countries. But the notion of balance of payments need, as traditionally defined, has long since become obsolete, for the very same reasons Article VI is now outdated, and there is little we can do about it. At the same time, though, we must be aware that adopting inflation targeting means much more than setting a low target for the consumer price index. Pervasive institutional changes are needed to make it both effective and credible as a monetary framework. This is why we should not expect the approach to be applicable to all emerging market countries. But the bigger and more institutionally robust among them seem ready to meet the challenge. In this regard, the experiment under way in Brazil—where, after the recent crisis, inflation targeting has replaced, with the endorsement of the IMF, the crawling peg previously in place—should be followed with great attention. The less rigid the monetary framework becomes in emerging market countries, the less we shall hear—provided the authorities' credibility is satisfactorily maintained by other means—of jumbo rescue packages like those prominently mentioned in the press over the last couple of years. The international lender-of-last-resort function, as a consequence, will return once more to the wings, where it arguably belongs.

A second marginal improvement would be making creditors more sensitive to the risks they take. This is the area where confusion looms largest. In recent years, a big fuss has been made about involving the private sector, achieving a more equitable burden sharing, and the like. But reality is much simpler. Because of the characteristics of the international environment, rescue packages orchestrated to stem capital outflows tend to overprotect creditors. This would not be a problem if debtors could be made to pay the right premium for the insurance they receive against the risk of a foreign exchange crisis and if this premium were fully factored into domestic policymakers' calculations. Unfortunately, things do not work that way. Since institutions in developing countries are frequently less than robust, domestic policymaking often tends to be myopic. Moreover, when a crisis erupts, the international community has a vested interest in avoiding social unrest, because countries, like big financial intermediaries, often have a going-concern value that is positive even when their "market" value is nil. Moral hazard, therefore, cannot effectively be checked by acting on debtors alone. Hence, the lack of grip on international creditors amounts to a significant institutional defect; until this problem is addressed, the whole international financial architecture will rest on shaky foundations.

Here, too, we are not starting from scratch, however. Informal ways to deal with the problem have already been experimented with in the course of the Asian crisis, especially in Korea. At the same time, without much publicity, the IMF has developed over the years an important tool, in the form of lending into arrears (making conditional loans to member countries that are in arrears to private sector creditors), to encourage recalcitrant creditors to negotiate debt restructurings. In recent months, the IMF has extended and perfected this practice by including reserve targets in the programs it supports, effectively implying a partial default on a country's outstanding external obligations. But moral suasion of the kind used in Korea cannot be expected to work in all possible circumstances, as recent experience with Brazil has reminded us. As for lending into arrears and related practices, they have so far been relied upon only under rather favorable conditions—namely, in situations where bank lending accounted for the bulk of a country's foreign debt or where bondholders were relatively cooperative and not too numerous. Clearly, more needs to be done in this area.

Moving forward

I think that, as experience with lenders of last resort in particular countries has shown, what is needed is a blend of carrot and stick—that is, of incentives and coercion. In this context, providing a carrot essentially means including among the conditions for granting access to IMF resources the existence of contingent credit lines with the private sector, like those in place in Argentina and Mexico, as well as adherence to internationally agreed transparency and supervisory standards. By itself, however, this is not going to solve the problem; foreign

investors may hedge their exposures during crises, leaving the overall finance made available to the debtor country unaffected. Nor can good supervision entirely eliminate the risk of instability. Here is where the stick comes in. Investors must be confronted with a credible threat that they will be made to pay for their allocative choices in foreign markets when those prove to have been ill considered. Since a coherent international bankruptcy regime is out of the question for the foreseeable future, this can in principle be done in either of two ways—ex ante, through improved regulation worldwide, so as to foster better risk assessment by lenders; or ex post, by introducing collective-action clauses in bond contracts, as has been suggested by several official reports, and expanding lending into arrears and the reach of Article VIII of the IMF's Articles of Agreement to make it more palatable for governments in emerging market countries (and less damaging to the IMF) to declare moratoriums on foreign debts and, possibly, proceed to negotiated restructurings.

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Both options have found their way into the authorities' agenda, as illustrated, for example, by their inclusion in the Group of Seven's declaration issued at the end of the June 1999 Cologne summit. With the establishment of the Financial Stability Forum last March, however, the international community has sent the market a strong signal that the regulatory option will be given top priority in the overall strategy. Concern that making moratoriums easier to declare would push the balance of power too much in the direction of debtors—and, possibly, give too much leeway to international organizations—probably played an important part in this decision. But whatever its motivation, the creation of the forum is a far-reaching move. Internalizing through regulation the consequences of a bad allocation of capital worldwide entails extending the reach of regulatory authorities to emerging countries' banking systems, to all nonbank financial institutions, and to offshore financial centers. Ultimately, this means reducing the degree of competition in financial markets—the more so if creditors are to be "involved" in crisis management. It also means coordinating safety-net practices across countries to avoid competitive distortions.

This is a daunting task, indeed. Will the world's authorities live up to the standard they have set themselves? Let us all hope they will, for historical experience shows that financial instability, if protracted and unchecked, tends to nurture protectionist pressures and inward-looking policies, neither of which is wealth-creating in the long run. Meanwhile, the IMF would be well advised to further refine its role as provider of credibility services; insist on the need for smoother workout procedures; and avoid thinking of itself as an emerging world central bank, since—as the experience of the last few years has shown—the world is definitely not yet ready to move in that direction. F&D

Suggestion for further reading:

Curzio Giannini, 1999, "Enemy of None but a Common Friend of All? An International Perspective on the Lender-of-Last Resort Function," IMF Working Paper 99/10 (Washington).

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