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IMF LENDING: THE ANALYTICAL ISSUES

Graham Bird

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Preface and Acknowledgements

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This paper is one of a series of drafts for a study currently under preparation at ODI by Graham Bird and Tony Killick with the provisional title of *The IMF and Developing Countries: Its Role in the 1990s*. The completed report will review developments in the 1980s; examine the Fund as a source of finance and issues in its lending policies; review the theory and practice of IMF policy conditionality and of heterodox alternatives to it; and explore the future role of the Fund. The following titles are already available as *Working Papers*, and others will appear later:

46 The IMF in the 1990s: Forward to the Past or Back to the Future?
Graham Bird

47 What Can We Know about the Effects of IMF Programmes?
Tony Killick, Moazzam Malik and Marcus Manuel

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CONTENTS

INTRODUCTION

The IMF may be viewed as both a financing and an adjustment-oriented institution. Through the prolonged debate there has been about Fund conditionality it is the adjustment role that has received the greater scrutiny, but it is important not to lose sight of the financing role. Indeed, an optimal strategy for dealing with balance-of-payments (BoP) deficits is always likely to involve a combination of adjustment and financing[1]; and the role of the Fund may be perceived as trying to ensure that this optimal blend is achieved both globally and at the level of individual countries.

However, while the basic rationale of Fund conditionality is rarely challenged nowadays, it has been suggested forcefully by some observers that the Fund should not make loans of its own. Not only is Fund lending viewed as being of no benefit, but it is also seen as being harmful.

This *Working Paper* assesses the issues raised in this context, examining first of all the general moral hazard case against Fund lending. It then goes on to examine a series of more specific analytical issues associated with Fund lending. Most of the paper focuses on Fund lending through the General Resources Account and through various additional accounts designed especially for poorer countries, but, towards the end, there is some discussion of the Special Drawing Rights (SDR) account.

Historically developing countries have argued that there is substantial scope for enhancing inward resource flows through modifications to the SDR facility. The fact that SDRs have not been created since 1981 has made such proposals appear largely irrelevant. But a rekindling of interest in the SDR could transform the situation and raise again the question of using SDRs as a means of facilitating international resource transfers.

This paper also briefly discusses alternative ways in which the Fund's lending operations may be financed, examining the alternatives of quota-based subscriptions, borrowing from members, borrowing from private capital markets, and the use of SDRs and gold.

This *Working Paper* should to be read in conjunction with a forthcoming paper in this series, provisionally titled 'IMF Lending: The Empirical Issues', which provides an empirical analysis of Fund lending building on many of the issues raised here, not only analysing the size and pattern of Fund lending inter-temporally and cross-sectionally but also investigating the cost of Fund finance, its composition across the range of Fund facilities, and its significance in relation both to the problems with which it is attempting to deal and other sources of international finance.

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1 For an analysis of the optimal blend of financing and adjustment see Bird (1978), where it is concluded that this occurs where the community's marginal rate of substitution between current and future expenditure equals the marginal rate of transformation between the sacrifice of current expenditure (adjustment) and future expenditure (financing).

The discussion of the analytical issues underlying Fund lending points to the conclusion that it would be inappropriate to rely exclusively on private markets as a mechanism for bringing about international resource transfers; the involvement of international financial institutions is justified. Indeed the need for the international provision of public funds has received a new urgency in the context of the payments and development problems being faced by the emerging economies of Eastern Europe. A more difficult question relates to the precise mechanism through which international financial transfers should take place and the role of the IMF as against other institutions. If the Fund is to retain a significant lending function there is a strong case for reassessing the means through which Fund lending occurs and to redress the proliferation of lending windows that has occurred over the last twenty years.

1. FUND LENDING: GENERAL ANALYTICAL ISSUES

1.1 'Hard' and 'Soft' Critiques of Fund Lending

Should the Fund be putting any of its own resources into BoP financing? Why not leave such financial provision to private international capital markets? Those approaching these questions from a neo-liberalist angle argue that Fund lending is both inefficient and, to the extent that international equity is relevant to the Fund's operations, also inequitable. The principal source of inefficiency arises from the supposed 'moral hazard' of Fund lending. The suggestion is that, by offering BoP finance at subsidised and concessionary rates, governments of potential borrowing countries are enticed to pursue policies which create the BoP deficits without which they would be ineligible for Fund support. Fund lending thereby contributes to causing the very problems that it is supposed to help solve. Moreover, it is claimed that the availability of Fund resources makes indebted countries less willing to pursue the adjustment programmes that are necessary to enable them to meet their outstanding debt service obligations. Fund lending is again portrayed as creating a moral hazard by rewarding those countries that threaten default and demand debt rescheduling or debt relief. Lending by the Fund is seen as undermining its adjustment role.

But why does the IMF continue to lend if the moral hazard argument is legitimate? Two answers are offered. The first is that continuing, and even expanded lending is what the economic theory of bureaucracy would predict. Here the Fund's implicit organisational utility function is seen as comprising its own size, power and influence. According to this line of argument the Fund will try to expand its portfolio of loans as well as progressively increase the spread and strictness of conditionality. To better achieve its own organisational objectives the Fund will also favour the subsidisation of its loans in an attempt to increase the demand for them.[2]

The second answer is that the Fund believes, mistakenly according to liberalist critics, that the benefits associated with its lending outweigh the costs expressed in terms of moral hazard. Vaubel (1983), for example, presents and then attempts to dismiss various arguments for Fund lending. First, the defence of exchange rates is argued to be inappropriate in the context of a generalised flexible exchange rate regime; and, in any case, IMF lending as a means of financing the intervention required to defend exchange rates is argued to be unnecessary even with fixed exchange rates, since such intervention may be substituted by sufficiently restrictive domestic monetary policy. Second, the selection of more gradualist adjustment programmes permitted by Fund lending presupposes their superiority over the alternative shock treatment. Shock measures may, however, be the ones that are required. Where gradual adjustment is appropriate, neo-liberalist critics of Fund lending argue that this will be supported by loans from private international capital markets. Again, according to this

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2 Vaubel (1986) provides an interesting discussion of the public choice aspects of international agencies which develops many of these ideas more fully.

view, the market should be left to determine the international distribution of capital and the Fund should not become involved.[3]

Third, the insurance argument, namely that the Fund is needed as a lender of last resort, is rejected on the grounds that the international banking system is much less susceptible to collapse than is often supposed; that banks making unwise loans should not be protected; that the insurance role may be played by the monetary authorities of the developed countries; and that, in practice, the Fund is frequently used as a first rather than as a final line of credit; a use that the Fund itself encourages by offering concessionary loans.[4]

A fourth argument, that Fund lending discourages recipients from pursuing undesirable beggar-my-neighbour policies, and therefore confers positive externalities, is rejected on the grounds that the Fund should not attempt to buy 'social peace' by giving into 'blackmail'. Such a policy is presented as myopic on the grounds that it encourages further threats and ultimately aggravates international discord. The more benign 'mutuality of interests' motivation for financial assistance is rejected as being an inefficient means of correcting deficiencies of aggregate demand in donor countries.[5] A higher multiplier applies to domestic government expenditure.

Fifth, critics argue that Fund lending is not needed in order to encourage countries to pursue economic adjustment, since creditworthiness in the international capital market will provide quite sufficient incentive. Vaubel claims that, 'in the market, conditionality is automatic, perfect and unavoidable' (p.298). Although the pursuit of an appropriate adjustment programme will justify a reduction in the rate of interest that a borrowing country has to pay, it is not seen as justifying a relatively lower rate on Fund-lending.

The so called 'enforcement', 'bogeyman' and 'coherence arguments' which claim that the Fund is better placed to enforce conditions through the imposition of sanctions; that governments need someone to blame for unpopular policies; and that a co-ordinating agency representing creditors is needed in order to design coherent policies, are interpreted as potential reasons for the Fund's existence as an adjustment institution but not as justification for a lending role. Similarly the argument that the Fund possesses superior information is, if accepted, seen as an argument for more freedom of information rather than as an argument for Fund lending. Information, it is claimed, is a public good.

A rather softer critique of Fund lending does not go so far as to suggest that it should be discontinued altogether. However, the implicit notion here is of an optimum quantity of Fund lending that can in principle, and has in practice, been exceeded. Fund lending will be

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3 The economics of shock versus gradualist policies is still poorly developed, but see, for example, Edwards and Montiel (1989). One difficulty is that much depends on behaviourial and expectational changes which are difficult to model.

4 A strong counter-claim, namely that the system needs a lender of the last resort in order to ensure stability can of course be made. On this specific issue see Griffith-Jones and Lipton (1984).

5 The 'mutuality of interests' argument formed a central element in the Brandt Commission's justification for enhanced international resource transfers (Brandt, 1980).

excessive to the extent that it is linked to inadequate adjustment programmes. The costs of excessive lending by the Fund will be a loss of its reputation and credibility which will eventually undermine it as an international financial institution. The loss of reputation will erode the catalytic effect that Fund-supported programmes and Fund-lending are claimed to have on other financial flows.[6] The result will be that excessive Fund-lending will, in the long run, have a net negative impact on the total flow of international finance to those countries that currently receive loans from the Fund.

We return to assess this softer critique of Fund-lending a little later. The more extreme criticism essentially comes down to the view that private international capital markets are more efficient in allocating resources than is the IMF. Fund-lending is claimed to provide an illustration of government failure.

1.2 Justifying Fund Lending: Moral Hazard or Market Failure?

Unsurprisingly, the justification for Fund lending rests heavily on claiming that moral hazard is not associated with Fund lending and that any government failure is dwarfed by the size of the market failure associated with relying on private flows. Although a defence of Fund lending may therefore be mounted in fairly conventional terms, they are in fact terms that have remained rather resilient to the resurgence of the neo-classical paradigm.[7]

For a number of reasons it is illegitimate to criticise Fund-lending on grounds of moral hazard. Evidence to be examined in a future paper in this series suggests that many countries prefer to borrow from private capital markets, albeit at higher interest rates, at times when they would be able to draw from the Fund. This has certainly been the case for all industrial countries over recent years, but it has also been true for a large number of developing countries. Members of the Fund are disinclined to borrow from it because of the conditionality that is attached to loans. It was, for example, the desire to avoid IMF conditionality that led Latin American countries to borrow from the commercial banks during the 1970s and early 1980s in preference to the Fund. If IMF conditionality and is not perceived as a soft option; it may reasonably be presumed that conditionality more than offsets any moral hazard associated with the provision of relatively cheap finance by the Fund. By the same token, of course, any relaxation in conditionality may enhance the moral hazard criticism. In any case data to be presented in a future paper calls into question the assumption that Fund finance is highly and universally concessionary. For those Fund resources that are financed by borrowing the rate of interest may not be significantly below the market rate; although it has to be noted that potential borrowing countries may face an availability constraint and be unable to borrow at market rates.

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6 This argument is not infrequently presented in oral discussions with Fund staff. However, it has been expressed in writing by a former senior member of the Fund's staff, see Finch (1989). Also relevant to this debate is a series of papers by Guitian (1991a; 1991b; 1991c).

7 Killick (1989) provides a comprehensive review of the re-emergence of the neo-classical paradigm with its implication of a reduced role for the State, and illustrates how proponents of the market mechanism have been unable to counter the concern over market failure.

In the past not all Fund credit has been subject to strict conditionality. Is the moral hazard problem more relevant in the case of low conditionality lending by the IMF? In fact even here it turns out to be largely illusory. The Fund's most significant source of low conditionality finance has been the Compensatory Financing Facility (CFF). Yet members of the Fund have only been eligible for support under this facility where their payments problems have been caused by export shortfalls (or import excesses on purchases of cereals) that are assessed as being beyond their control. The external causation element has therefore neutralised any potential moral hazard. After 1983 the CFF became, and since 1988 the remodelled Compensatory and Contingency Financing Facility (CCFF) has been, a high conditionality facility. The CCFF therefore circumvents the moral hazard criticism via the conditionality route. It would therefore seem that at worst the moral hazard criticism of Fund lending applies only to drawings under the first credit tranche and is therefore of minimal quantitative significance.

Besides, there is an accumulating body of evidence to suggest that BoP deficits are caused not only by domestic economic mismanagement, but also, and importantly, by adverse terms of trade movements and increasing real interest rates.[8] Again the moral hazard critique of Fund lending is undermined.

When it comes to international lending, the claim that the private capital markets know better than the Fund has been exposed to considerable criticism over the last ten years; particularly in the context of private bank lending to developing countries. In response to the question, 'why not leave international financial provision exclusively to the market' the short conventional answer is that the market mechanism is deficient on grounds of both efficiency and equity. Commercial lending has been characterised by instability and uncertainty, by contagion and bandwagon effects, and by a revealed inability accurately to assess creditworthiness. If private creditors had the perfect foresight that they are sometimes claimed to possess the developing country debt crisis would not have happened. Indeed a reasonable case may be argued that if greater reliance had been placed on the IMF as a source of BoP financing during the 1970s and early 1980s, the debt crisis would have been avoided.

Lending by the commercial banks will be inefficient if it is unstable; if it is unrelated to the underlying productivity of resources throughout the world; and if it brings external costs with it.

It is certainly unstable. The banks moved rapidly into balance-of-payments financing following the rise in the price of oil in 1973-4 and then endeavoured to extricate themselves in the 1980s. In general terms they were quick to lend to developing countries following the (temporary) upsurge in commodity prices, and anxious to reduce their lending as borrowers encountered declining terms of trade and debt difficulties. Such instability is enhanced by the tendency towards 'herd behaviour' that characterises the banking community. Withdrawal by one bank can quickly encourage other banks to follow suit rather than to offset the withdrawal by lending more themselves, or at least maintaining the level of their involvement. Indeed there is a problem in the sense that all banks will have an incentive to reduce exposure

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8 This argument was strongly made in Dell and Lawrence (1980) but also finds support from empirical studies undertaken within the Fund itself, Khan and Knight (1983).

at the first suggestion of repayment problems, yet not all of them will be able to do so, since such behaviour would certainly induce default. As a result of these characteristics bank lending is pro-cyclical rather than counter-cyclical.

As the above discussion implies, lending may be only loosely related to the underlying strength of an economy or the marginal productivity of resources. Banks may have imperfect information and may misinterpret what information they do have; they may be unduly influenced by transient and often largely cosmetic factors or, in syndicated loans, by the views and prestige of the 'lead' bank. This can of course work both ways. On some occasions banks may overlend, yet on others they may underlend. Either way, they are unlikely to allocate capital efficiently.

Furthermore, factors which alter the credit-worthiness of one borrower can have an influence on the willingness of banks to lend to other countries, which is quite unrelated to their economic performance and prospects. For example, a fall in the price of oil will create debt problems for oil producers such as Mexico and Venezuela and will damage their credit rating with the banks. But as a result of debt problems in these countries the banks may become more risk-averse and less prepared to lend to other countries whose economic prospects actually improve as oil prices fall, because the price of a major import has fallen and because a falling oil price tends to increase world aggregate demand and therefore the demand of their exports. The lack of simultaneity in the debt-servicing capacity of borrowers suggests that such a response is irrational, though to the extent that the withdrawal of funds itself creates a liquidity and perhaps, with rising interest rates, even a solvency problem in the affected countries, it may seem rational after the event.

Another externality associated with bank lending relates to its global consequences. Where banks pull out from providing balance-of-payments finance and nobody else steps in to take their place, the result is that borrowers have to correct their deficits more rapidly. Rapid correction can be brought about by deflating domestic aggregate demand, and thus the demand for imports, or by introducing import controls. Either way, the countries that provide the imports will experience a reduction in their exports and a deterioration in their balance of payments, which they, in turn, may have to correct. A vicious circle of deflation, recession, protectionism and falling world trade can become entrenched, from which most countries stand to lose. Furthermore the mere uncertainty of bank lending may give rise to external costs.

But at the same time, is it really the banks' responsibility to ensure that things do not go wrong in this way? They will undoubtedly see their principal responsibility as being to their shareholders, and they are likely to take the view that these interests are best served in an uncertain world environment by trying to maximise short-run private profits; it may be unreasonable to expect them to assume the global role of maximising world economic welfare.

The concept of welfare also raises the question of the distribution of bank lending. In aggregate terms this has been heavily skewed; being concentrated in industrial countries and a narrow range of middle-income developing countries. The banks have usually deemed low-income countries uncreditworthy.

Again, however, it is unreasonable to criticise the banks for the inequitable distribution of their lending. After all, they are not charitable institutions. Indeed, on the contrary, they would be more open to criticism were they to lend to countries that seemed to have little chance of repaying the loans. But at the same time, the elements of market failure remain, not only with respect to equity but also in terms of efficiency. If bank lending fails to meet the requirements of an efficient and equitable market solution, should the recycling of world capital be left in their hands or should international agencies such as the Fund not become involved? The Fund is also better positioned than the banks to take a global view of economic welfare.

Further doubts about the wisdom of relying too heavily on private bank lending are raised in a measured assessment of the international capital transfer process by Llewellyn (1990) which draws heavily on earlier work by Lessard and Williamson (1985). He identifies the main requirements of an ideal process as follows (p.35):

(1) *The mechanisms should facilitate (or at least not impede) an efficient selection of projects such as to maximise the risk-adjusted rate of return on world capital.*

(2) *Institutions and markets would offer a wide range of instruments and financing facilities with respect to maturity, risk, rate of return, contract formulae, etc., so that a balanced portfolio of liabilities is available to borrowing countries. A balanced portfolio is required to avoid concentration on particular types of servicing contract, and a dependence on a single source of finance whose supply could be interrupted.*

(3) *The supply of finance should be reasonably stable and not subject to large discontinuities.*

(4) *The nature of the contracts would offer a reasonable match between debt-servicing obligations and the borrower's ability to pay, both with respect to maturity and cash flow. Lessard and Williamson (1985) identify 'cash flow matching' via, for instance, risk-sharing equity contracts, hedging instruments, etc, as a major part of their proposals for improving upon the quality of finance in future arrangements for financing the net absorption of real resources by developing countries.*

(5) *The mechanisms should allow for the diversification, transfer and sharing of risk to where they can be most effectively absorbed because of the holder's capacity to reduce risk via diversification.*

(6) *There would be an efficient system for identifying and pricing risks on a continuous basis.*

(7) *Lessard and Williamson also identify the issue of performance incentives whereby the intermediation mechanisms would create the correct incentives for the performance of the borrower.*

(8) *A displacement of domestic savings and local financial markets should be avoided. Lessard and Williamson suggest that this did happen in*

the case of some heavily indebted countries through the route of 'capital flight' due to inappropriate policies by governments. They suggest that general balance of payments financing from the international banking sector enabled governments to bypass local markets (international intermediation displaced domestic mechanisms).

(9) *International financial intermediation mechanisms would limit systemic hazards for financial systems supplying financial intermediation services.*

(10) *There should be no incentive to repudiate debt.*

Llewellyn goes on to claim that on the basis of almost every one of these criteria banks were an inappropriate conduit for international resource flows during the 1970s and early 1980s; and remain so in the 1990s.

There are, of course, ways in which private bank lending may be made more efficient. If methods of country-risk analysis have been inadequate in the past, they can be improved.[9] The results of such improvements would be to make bank lending firstly more stable and predictable, secondly more closely related to significant economic factors determining the future ability to service debt, and thirdly less subject to the regionalisation phenomenon. In practice, however, banks have tended to respond to the developing country debt crisis not by putting their resources and efforts into making risk analysis more sophisticated but rather by simply taking decisions not to lend to developing countries. Refining the techniques of risk analysis has therefore been seen as decreasingly rather than increasingly important.

Moreover the observation that the banks possess less information than the Fund and therefore will always tend to reach inferior decisions cannot legitimately be dismissed by arguing, as some have attempted to argue, that this only reflects a prejudicial unwillingness to accept the judgement of the market. The Fund does possess superior information.

Although the Institute for International Finance collects and processes information on behalf of the banks, the Fund remains in a uniquely strong position to collect and interpret information and to act on the basis of it. From the viewpoint of political economy it would be exceedingly difficult to make all this information openly available to banks. If countries were to lose the confidentiality that they enjoy with the Fund, the flow of accurate information would be reduced, and this would make the capital transfer mechanism yet more imperfect.

Some of the deficiencies of bank lending may be overcome, in principle, by shifting to other forms of private lending such as bonds, or indeed foreign direct investment as is implied in points 2, 4 and 5 in Llewellyn's list quoted above. There can be little doubt that short-term bank credits are likely to be an inappropriate means of financing economic development or long-term BoP problems. But although there is scope for improving the financial instruments through which private capital is internationally made available, it remains unlikely that the

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9 Bird (1989), for example, provides various suggestions concerning the variables that should be consulted by the banks in assessing risk.

ultimate lending decisions will be efficient. Private capital markets are not well equipped to evaluate risk where lending is programme-based.

But to what extent is there an unwillingness to accept the judgement of private capital markets because it fails to coincide with some predetermined preferred result? Is this an important factor in the market failure debate?

Of course it is quite possible that a particular view of international equity will underpin someone's attitude to the market solution. But surely this is perfectly legitimate. The fact that the distribution of private lending fails to coincide with a targeted distribution of financial flows is after all a central justification for foreign aid.

But the issue is more complex than this. Without international lending agencies, countries deemed uncreditworthy by international capital markets will be forced to pursue adjustment policies that seek to rapidly correct BoP deficits. If it may be shown that such policies impose higher welfare costs than alternative adjustment strategies then it is not unreasonable to suggest that the international capital transfer mechanism should seek to support these alternative strategies. If, for example, rapid adjustment based on compressing domestic aggregate demand implies shifting an economy inside its production possibility frontier, whereas slower adjustment implies shifting the frontier outwards and raising the supply capacity of the economy, it is reasonable to claim that the second adjustment path is more efficient. Where reliance on private markets would exclude this path, it follows that a market imperfection has been identified. It is correct, of course, that the specification of a welfare function will always be a normative issue. But economists should not shrink from commenting on mechanisms for internationally allocating capital because of this.

It may be noted in this context that the IMF's involvement in low income countries does not arise from any specific desire to redistribute world income, but rather from the BoP problems which these countries encounter. Given the size and nature of these problems some degree of financing is appropriate on grounds quite apart from equity. One has to have a very narrow definition of efficiency to argue that the unwillingness of private international capital markets to lend to these countries implies that they should concentrate exclusively on short-run payments correction.

A different, although also normatively charged approach to justifying Fund lending proceeds by endeavouring to identify financing gaps. To the extent that the gaps are not filled by private markets, a lending role for the Fund - or some other IFI - is defined. The difficulty here is again that the gaps only exist to the extent that the actual or predicted state of affairs differs from a desired state. *Ex ante* financing gaps may, in principle, be closed by movements either on the demand side or the supply side. An excess demand for foreign exchange may be eliminated by compressing imports as well as by raising the supply of foreign exchange by international borrowing. If one is indifferent as between the alternative ways of closing *ex ante* financing gaps then little sympathy for the entire concept of financing gaps will be shown. If, on the other hand, it is felt that the welfare consequences of the two alternatives are significantly different, and that the welfare consequences of reducing the demand for foreign exchange are high, there will be a greater desire to spell out more precisely what the financing gaps are.[10]

Starting from a specific target of (say) preventing a fall in living standards, it will be possible to project the likely demand for foreign exchange. Projections of the supply of foreign exchange through export earnings and private borrowing will then identify the size of any resultant foreign exchange gap. The rationale of Fund lending might then be to contribute towards closing this gap. However the need for Fund lending could easily be removed by abandoning the original specified target. In many ways it is one's normative judgement concerning the desirability of these alternative responses that will affect one's willingness to rely exclusively on private markets as a means of allocating international capital.

The question of what is the 'correct' balance between adjustment and financing is difficult if not impossible to answer with any scientific precision. Where, however, an argument is made for endeavouring to make adjustment the independent variable and financing the dependent one, rather than have adjustment adapt to the availability of finance from private capital markets, an argument is also effectively being made for agencies such as the Fund to be involved in the allocation of capital as lending institutions.

Another way of saying approximately the same thing would be that, if there is little discrepancy between the private costs and benefits of international lending and the social costs and benefits then it is quite efficient to leave it in the hands of the private markets. However where the discrepancy is large, the existence of an international agency which takes such externalities into account may be justified.

Let us now return to the softer critique of Fund lending that was raised earlier and that concentrates on the dangers of excessive lending by the IMF. Two observations may be made about this. First, the criticism is more one that relates to the design of IMF-supported adjustment programmes than to IMF lending; although making conditionality stricter would indeed consequentially tend to lead to reduced lending by the Fund. Second, to the extent that the major concern of critics is that the Fund will lose its catalytic effect, this is a concern which, at least to some degree, is empirically testable. How significant has the catalytic effect been?

Indeed many of the issues raised so far may be further assessed in the light of the empirical information that is to be presented in a future paper in this series. But the general discussion already conducted has itself raised a number of additional analytical issues which warrant further investigation.

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10 There is a potentially important inter-temporal dimension that also needs to be borne in mind. Closing a financing gap by means of compressing imports may mean that the financing gap is made wider in the long run since today's imports may be significant inputs with tomorrow's exports. Khan and Knight (1988) provide empirical support for such concern.

2. FUND LENDING: SPECIFIC ANALYTICAL ISSUES

If, as a result of the above discussion, it is believed to be inadequate to rely completely on private international capital markets as a means of organising international resource transfers, a series of additional questions arise. Should it be the Fund or some other international financial institution that makes loans? How large should the Fund's lending role be? Should the Fund's lending role be different in different countries? Through what sort of facilities should loans be organised and how heavily should lending be associated with conditionality?

2.1 The Fund versus other IFIs

The answer to the first of these questions was a good deal clearer ten or fifteen years ago than it is now. If the Fund is characterised as a balance-of-payments institution and the World Bank as a development one, and if the Fund lends on a programme basis whereas the Bank lends on a project basis, then it would be appropriate for the Fund to be the lending institution where BoP difficulties exist and where a programme of macroeconomic policies is required, and inappropriate in other circumstances. But, as described in *Working Paper 46*, a feature of the 1980s and 1990s has been the increasing difficulty in distinguishing between the need for BoP finance and the need for development finance. Where does one end and the other begin? To a large extent capital inflows, and particularly those associated with programme loans, are fungible, and it may be unhelpful to try and distinguish between BoP and development finance.

Where development finance implies support for specific projects, and BoP finance implies support for an adjustment programme designed around reducing aggregate demand, the distinction retains some meaning. But where BoP difficulties spring from supply side weaknesses that will take a number of years to rectify, BoP adjustment forms an integral part of economic development. Financial support for a programme which is designed to raise the efficiency of domestic industry, for example, is simultaneously both BoP finance and development finance. This begs a fundamental organisational question. For, if the distinction between BoP finance and development finance is fairly meaningless in the context of the 1990s, is it equally meaningless to retain a distinction between the Fund and the Bank?

The justification for lending by the Fund, as it is currently constituted, is stronger where a need for short-term credit may be identified. The IMF was, after all, originally designed to provide a revolving pool of credit to member countries rather than a permanent source of long-term finance. But in many cases, as the data to be presented later will show, the Fund is not doing this. Rather than lending to a wide range of members for short periods of time it often lends to a relatively small group of countries (given its total membership) over a relatively long period of time. A series of short-term credits effectively becomes long-term financial support. Indeed longer-term lending by the Fund has been formulated to some extent in the Enhanced Structural Adjustment Facility (ESAF); a facility which also formalises cooperation between the Fund and the Bank.

An initially more clear cut justification for Fund lending builds on the notion that some Fund members have inadequate international reserves. Reserves and reserve changes are conventionally seen as an indicator of the balance-of-payments position; although they will clearly also be affected by a country's development strategy. The theory of the demand for international reserves and the related theory of reserve adequacy is well established; although it is far from easy to apply the theory in a suitable empirical fashion.[11] Most studies reveal considerable inter-temporal and cross-sectional variation in reserve adequacy. The simple examination of reserve-import ratios in *Working Paper 46* suggested that some developing countries hold adequate reserves while others have inadequate reserves.

The theory of reserve adequacy implies, however, that where the BoP is unstable, adjustment costs are high, and the supply of commercial credit is low, countries will have a relatively high demand for official reserves. Although only Reserve Positions in the Fund count as part of a country's owned reserves, other forms of Fund credit represent conditional international liquidity. Should the Fund be meeting the need for international liquidity?

Further thought reveals that even this approach towards analytically justifying Fund lending is far from straightforward. International reserves are basically an inventory. While they may be decumulated at one stage they should be replenished at another. The purpose of reserves is to cushion the impact of short-run instability in the balance of payments. They are an inappropriate means of financing a secular BoP deterioration or quasi-permanent BoP deficit; they will eventually run out. Again, therefore, even where IMF lending is perceived as a way of providing conditional reserves to countries experiencing reserve inadequacy, it would be an inappropriate way of permanently financing deficits, unless part of the Fund's role is seen as facilitating such permanent resource transfers; traditionally this has not been the case. Indeed it has been the belief that the Fund has increasingly been doing precisely this that has led some critics to express concern that Fund lending actually reflects it as a development agency rather than a BoP one.

The general answer to the question of whether the Fund or the Bank should be lending is therefore that it all depends on whether one superimposes a narrow or broad constraint on the purpose of Fund loans. A narrow definition of BoP stabilisation and a strict delineation of what constitutes a monetary institution implies that a much smaller proportion of any financing gap should be met by Fund lending. A broader definition of BoP adjustment implies a much enhanced lending role for the Fund. It really comes down to a matter of what is the best organisational structure for meeting international financing needs.

2.2 The Optimum Size of Fund Lending

The above discussion has also implicitly answered the second question raised at the beginning of this section. The appropriate size of Fund lending depends crucially on the role that the

[11] Bird (1978) provides a review of the theory of reserve adequacy. This has not altered very much in recent years as the issue of reserve adequacy has generally appeared less relevant in a world of flexible exchange rates and private international liquidity. Recent contributions to the empirical literature include Edwards (1983), Chrystal (1990) and Frenkel (1984).

Fund is given to do, as well as upon the nature of the international financial regime. Within a regime that emphasises short-term BoP adjustment as opposed to financing, and within which a significant proportion of BoP financing is provided by the private sector, the lending role of the Fund will be relatively small. A modification in regime type towards one which incorporates longer-term adjustment and a smaller financing role for the private sector brings with it an increase in the implied size of Fund lending.

The practical difficulties in translating these general ideas into precise numbers are immense, and are aptly illustrated by the persistent debates there have been over the appropriate size of Fund quotas.

What the Fund can lend depends on the resources it has at its disposal, and in large measure these depend on the value of quotas. Thus:

> *It is generally agreed that the resources available to the Fund should be sufficient for the Fund to play its important role in adjustment and the financing of balance of payments deficits ... While the Fund has had to supplement the resources obtained through quota subscriptions by borrowing from members ... it is generally accepted that its activities should be financed primarily from quota resources.* (IMF Annual Report, 1982, p.73).

Yet it has often proved difficult to quantify the Fund's 'important role in adjustment and the financing of balance of payments deficits' in terms of the value of resources it needs to carry through these functions. Bird (1987), for example, presents an analytical framework within which the adequacy of the Fund's 'global quota' may be assessed. The need for Fund resources is thus related to:

(i) the size and location of current account balance-of-payments deficits;

(ii) the size and distribution of actual and desirable private financial and other financial flows;

(iii) the size and distribution of non-IMF reserves; and

(iv) the efficiency and cost of BoP adjustment.

However the model based on these criteria cannot be estimated precisely since many elements of it cannot be objectively measured. The results of the analysis do confirm however just how sensitive the Fund's need for resources is to judgements concerning the factors listed above. The resources made available to the Fund by its principal shareholders therefore implicitly reveal their preferences in terms of the role that it should be performing.[12]

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12 Williamson (1983) also provides an, albeit loose, analytical framework for considering the quantity of Fund lending and its related need for resources based on estimating financing gaps within the international financial regime.

2.3 Cross-country Differences

Some of the above discussion also helps us to answer the question of whether the Fund's lending role should be different in different countries. The theory of the demand for international reserves suggests that demand will be negatively related to the availability of other forms of international liquidity. If loans from the IMF are conceptualised as a form of conditional reserves then it follows that these will be demanded more heavily by countries which have less access to commercial credit. There is an apparent logic at work here since, if Fund resources are relatively scarce, it will be more efficient to allocate them to countries where the need for them is relatively great. The implication of this logic is that the membership of the Fund may be broken down into various (say three) categories. First, there are the industrial countries where creditworthiness is well established. These countries are unlikely to demand loans from the Fund. Second, there are the low income countries with persistently poor creditworthiness; these countries are likely to possess an equally persistent demand for resources from the Fund. Third, there are the middle income countries where creditworthiness varies between countries and over time. Countries in this category will demand resources from the Fund at some times but not at others. This is indeed the pattern of Fund lending that was noted in *Working Paper 46*. Developed countries have not used Fund credit for the last fifteen years or so. Low income countries have, on the other hand, fairly widely drawn on the Fund throughout the period since the mid-1970s. Middle income countries tended to avoid the Fund during the 1970s and early 1980s when their creditworthiness enabled them to meet their demand for international liquidity from the private international capital markets, but, as this access evaporated in the wake of the developing country debt crisis, they began to demand loans from the Fund.

Even this simple typology suggests that the basic rationale of Fund lending may be different in the latter two groups. In formerly creditworthy countries, and in those on the margins of creditworthiness, the rationale may be to restore creditworthiness. For a transitional period Fund lending and commercial lending may be complementary. However, for low income countries that are a significant distance away from the margin of creditworthiness, Fund lending is more appropriately seen as a substitute for commercial BoP financing.

To the three categories identified above it would be appropriate to add a fourth to cover countries in Eastern and Central Europe. There can be little doubt that these countries will put heavy claims on Fund resources as they struggle to bring about required economic adjustment, and as private markets are reluctant to lend until some signs of achievement are forthcoming.

This typology can of course be used by critics of Fund lending, who would no doubt argue that the Fund should not be lending to countries that the market assesses as being uncreditworthy. But even putting this argument to one side, since it sees no lending role for the Fund in any member country, the simple typology of lending does raise some important issues.

If the Fund possesses superior information to the market and can therefore more accurately foresee a loss of creditworthiness, should it not be seeking to become involved in countries that at present remain creditworthy in the eyes of the market. Should it not be seeking to prevent a loss of creditworthiness rather than seeking to restore creditworthiness once it has been lost. But then how can countries that are deemed creditworthy by the markets be forced to borrow from the Fund and expose themselves to Fund conditionality?

Moreover the classification offered above implies that the Fund is a lender of last, and sometimes only, resort. This may be an appropriate systemic role for the Fund, but it does carry with it an important external cost. Countries will only turn to the Fund at a time when no other creditor will lend; or at least will not lend independently of the Fund. At this point BoP problems are likely to be deeply entrenched and the required policies will therefore be fundamental rather than superficial. IMF conditionality will be strict. Yet a reputation for strict and far-reaching conditionality may disincline countries from turning to the Fund at an earlier stage in the evolution of their BoP problems. The question is how to break out of this vicious and self perpetuating circle? Success in doing so would of course again imply that the Fund would (and should) be lending to countries that may concurrently retain some access to commercial credit.

An interesting empirical issue that emerges from this is whether Fund lending is used as a complement to or a substitute for private lending. The above analysis suggests somewhat ambiguous conclusions, since the relationship will be different in different countries. On top of this, the credit rating of certain groups of countries will change over time. At certain times the Fund may be used as a substitute for private capital markets but at other times as a complement. Yet ambiguity is consistent with the role of the Fund as an institution designed to compensate for the deficiencies of private markets. In the case where the Fund is acting as a substitute, the deficiency may be expressed in equity terms or in terms of the myopic vision of markets. In the case of complementarity the deficiency may be of a short-term informational type. It is in this case that a government is attempting to enhance its own credibility by importing the reputation of the Fund in the design of macroeconomic policy. Of course credibility will be lost where countries are expected to renege on the commitments they have made to the Fund. Maximising the catalytic effect therefore relies on minimising the extent to which countries renege upon or fail to implement programmes negotiated with the Fund. It is in this area of credibility and reputation that precommitments to turn to the Fund, and contingency elements in Fund- supported programmes become analytically important. Contingency clauses, for example, which enable Fund-supported programmes to be salvaged in circumstances where they would otherwise have failed will improve the reputation of IMF conditionality and will strengthen the catalytic effect. A precommitment to turn to the Fund where circumstances deteriorate will enhance the confidence of private markets and will improve current creditworthiness.[13]

2.4 <u>Fund Lending: Low or High Conditionality?</u>

We can now turn to our final question. If there is a case for the IMF to lend should this lending be of a high or low conditionality type. Two key concepts have been used in trying to answer this question.

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[13] Edwards (1989) provides a brief insight into what contribution might be made by recent advances in macroeconomic theory towards analysing the role of the Fund.

That emphasised by the Fund has been the distinction between temporary and permanent deficits.[14] Given the non-transitory nature of most deficits, adjustment is needed. The Fund argues that it is best able to encourage this through the conditions it attaches to its financial support. Left to their own devices many governments lack political commitment to payments adjustment, and the provision of low conditionality finance by the Fund would therefore merely postpone adjustment with the result that payments performance would deteriorate further, leading to an even more critical need for adjustment.

The second key concept, although seen as being largely irrelevant by the Fund, is the cause or causes of deficits. One view is that the causes of deficits have a vital bearing on the correct balance between low and high conditionality.[15] Where deficits are caused by exogenously generated adverse movements in a country's terms of trade the argument is made that strict conditionality is inappropriate. Countries should not be penalised through high conditionality for problems for which they are not responsible.

An intermediate attitude is that while the causes of deficits cannot legitimately be regarded as insignificant to the conditionality debate, external causation is insufficient reason to attach low conditionality to Fund finance. This view stresses three things. First, that while temporary deficits should be financed rather than corrected, in order to impose minimum cost on economic and social welfare, non-transitory deficits do require correction. Second, that IMF conditionality does have a role to play in encouraging such correction. But third, that conditionality should be appropriate to the economic characteristics of the countries concerned, with an important determinant of appropriateness being the causes of deficits. A central issue here is whether the Fund should become involved with the policies of a country whose payments problems have been externally caused? There is in principle a case for allowing more rather than less discretion to governments that have a good track record of payments management but which have been adversely affected by exogenous factors, and the suggestion has been made that conditionality could be tapered to accommodate various degrees of responsibility (Williamson, 1983).

However, the main problem is to convert these rather vague concepts into measurable and operationally useful ones. There are immense definitional difficulties. How can one distinguish *ex ante* between deficits that are temporary and those that are permanent and therefore between the need for finance and for adjustment? Furthermore, given the problems, on which side is to better to err?

Is it possible to state categorically the extent to which any specific payments deficit has been caused by external factors? And, in any case, for what economic phenomena can a government be held responsible? Is it, for example, responsible for a country having a particular level and pattern of production and trade, or merely for controlling the level of aggregate demand? The answer is that it is impossible to be precise about the concepts which are relevant to the discussion about the balance between low and high conditionality. Some degree of subjective judgement is therefore unavoidable.

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14 A clear statement of this view may be found in Nowzad (1981).

15 See, for example, Dell (1982).

On top of this there is again the whole question of the role of the Fund, the role of conditionality, and the correct balance between global adjustment and financing. If the Fund is regarded as an exclusively adjustment orientated institution then there is little purpose in having low conditionality facilities if these are simply envisaged as helping to deal with temporary imbalances which do not require adjustment. The private markets might be expected to provide such finance. However, if it is further argued that private markets will be of little use to the least developed countries then there may be a financing function for the Fund to perform and a related role for low conditionality facilities. Generally speaking the more the emphasis is placed on adjustment the less will be the relevance of low conditionality facilities. It was indeed different perceptions of the need for adjustment which led to different responses to the first and second oil price increases in the 1970s, with the first being met by an expansion in low conditionality finance and the second by a relative contraction in such finance.

What emerges from this discussion is that there can be a role for low conditionality Fund finance. How important this role is depends on the nature of deficits in terms of their duration and causes, the amount of discretion to be allowed to governments in circumstances where their policies have not been a prime cause of the deficits, and the location of deficits in relation to the creditworthiness of the countries involved.[16]

Although in this *Working Paper* we are attempting to retain some distinction between the Fund as a lending and as an adjustment institution, it is a distinction which is difficult to make at all precisely. The point is that the central feature which differentiates Fund loans from private loans is the conditionality which is associated with them. Most observers accept that the Fund is in a strong, if not unique, position to design conditionality and to encourage its implementation. Unless there is compelling evidence of a pronounced catalytic effect, countries will almost certainly need to be offered finance by the Fund as a way of encouraging them to accept IMF conditionality. Evidence on the use of Fund credit certainly suggests, however, that, even with such finance, countries are often very reluctant to turn to the Fund and subject themselves to conditionality, and, as noted above, the catalytic effect is only likely to be present in the case of countries which are already on the margin of creditworthiness. This is not the situation in low income countries. One argument for offering subsidies on Fund lending is to provide an additional incentive for countries to turn to the Fund and import an input from the Fund in the design of macroeconomic policy. If the programmes of policies turn out to be successful, the reputation of IMF conditionality will improve and the catalytic impact of IMF conditionality will strengthen. In these circumstances the need for Fund lending will be reduced in the long run.

However, all this hinges on the appropriateness and effectiveness of Fund-supported programmes. Where IMF conditionality is not effective in encouraging BoP adjustment, the demand for BoP financing will remain high, the catalytic effect will weaken and the availability of private credit will diminish; the demand for finance from the Fund will

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16 A slightly different defence of low conditionality lending to low income countries has been made on the grounds that such countries have not enjoyed the growth in international reserves associated with the appreciation in the price of gold, since their holdings of gold are low. Richer countries with more substantial gold holdings have, on the other hand, experienced an increase in unconditional international liquidity. Brodsky and Sampson (1981).

therefore increase. Certainly for countries on the margin of creditworthiness Fund lending linked to effective conditionality may be necessary in the short run in order to reduce the need for it in the long run; Fund lending will induce economic adjustment and restore access to private capital markets.

Where adjustment programmes can achieve their objectives quite rapidly, the involvement of the Fund as a lending institution within particular countries will only need to be short-term. Hence we have the original vision of the Fund as a provider of temporary finance to deal with short-term BoP problems. However, where the size and nature of adjustment difficulties is more substantial, and where the catalytic effect is weaker, the Fund may be expected to be drawn into a longer-term lending role which unavoidably begins to overlap with that of development financing.

Central to the entire debate over the Fund as a lending institution is its effectiveness as an adjustment one. Within any one country the more effective is IMF conditionality the less will be the long-run need for Fund lending. Assuming a constant flow of BoP shocks throughout the world, the aggregate level of Fund lending should not be expected to change, although the identity of the countries that draw on the Fund at any one time will change. In essence what one has here is the conventional trade-off between the speed of adjustment and the demand for international liquidity.[17] But superimposed on this trade-off is the additional element that where adjustment becomes slower and more difficult, the demand for loans from the IMF will become higher; not only because the overall demand for liquidity will rise but also because the supply of private loans will fall.

2.5 General Assessment

We have now answered the questions that were raised at the beginning of this section, even though on occasions the answer has been to explain why it is impossible to give a precise answer. What has emerged is the following. If it is accepted that private markets fail, then there is a lending role for an international financial institution to play. Where the nature of the BoP problems facing countries is short-run, this lending function may be performed by the Fund within its existing Articles of Agreement. Where, however, BoP problems are of a longer-term and more structurally related type, the lending function of the Fund becomes less clear cut since such problems may also be seen as developmental ones which require longer-term development finance; provision of this type of finance has conventionally been seen as lying beyond the Fund's legitimate role. The options are clearly either to channel such lending through a different IFI, or to legitimise this lending activity as part of the Fund's accepted role.

How large Fund lending should be depends clearly upon how the Fund's role is defined and upon how effective Fund conditionality is. However, once a role is defined it is possible to quantify, at least approximately, the resources that will be needed to carry it through. Such an approach has the attraction of focusing attention on the basic factors that determine the specific answer.

17 Clark (1970) provides what remains one of the clearest statements of this trade-off.

It is also difficult to reach a 'positive' answer to the question of whether the Fund's lending role should be different in different countries. The short answer is simply that it *is* different. Broadly speaking there appears to be a graduation of countries. As countries become richer they appear to draw less from the Fund (although again this is something that is tested empirically in a future paper in this series). At one extreme the developed countries do not borrow at all from the Fund. At the other extreme low income countries seem often to be left with no option other than to draw from the Fund. And in between some countries at some times borrow from the Fund. As they become more fully developed, however, and make the transition from developing to developed status they may be expected to cease borrowing. Although the basic purpose of Fund lending is the same in all the countries that draw from it, the means by which this objective is realised may be expected to differ sharply, not least in terms of the duration of Fund involvement.

A logical case may be made for low conditionality Fund finance in circumstances where there is confidence that the government will design an appropriate adjustment strategy. On the other hand, to the extent that there is broad consensus about what this strategy should be, high conditionality should perhaps not be regarded as a significant cost, except perhaps in a political sense. The costs of high conditionality will clearly depend crucially on the nature and effectiveness of the conditions. Moreover, if it is accepted that it is the conditionality attached to Fund loans that makes them unique and which is needed to generate a catalytic effect then the case for low conditionality finance weakens. It is only where the potential catalytic effect is unimportant that this argument against low conditionality will disappear. The difficulty is that this state of affairs will be most pronounced in low income countries. Such countries may well require technical assistance with the design of macroeconomic policy and in this respect Fund conditionality may have a significant role to play. But low income countries are also likely to encounter severe supply side problems, and this again creates difficulties for the Fund both in the design of adjustment policy and in terms of a longer-term lending commitment.

The political economy of conditionality is also likely to be very important. Unless it is simply the announcement of an agreement with the Fund which generates an impact by altering expectations and behaviour, the success of conditionality will depend on the extent to which programmes are implemented. Indeed even where it is at present the announcement which is important, this will not remain the case since problems of time inconsistency will arise. The incentive to renege, itself created by the announcement effect, will eventually undermine it. But if conditionality will only work where it is implemented the issue becomes one of the optimum level of conditionality in terms of maximising implementation. Even where low or no conditionality may be inappropriate it may be unwise to aim for conditionality that is perceived as being so strict that it disinclines countries from implementing it, or even from turning to the Fund for financial support in the first place. There is a real problem of conditionality optimisation. The political economy of conditionality suggests that it should certainly be no stricter than it absolutely needs to be.

The discussion of Fund lending conducted so far raises two further questions to which we now turn. The first is whether lending is more appropriately carried out through the General Resources Account, through various specific facilities, or through the Special Drawing Rights Account. The second is how the Fund should itself be financed, if indeed it is to perform a lending function.

3. SDRs AND OTHER FORMS OF FUND LENDING

SDRs have had a somewhat chequered history. In the mid-1970s the Fund envisaged that they might become the principal reserve asset in the international monetary system, and there were proposals for establishing substitution accounts to facilitate the transition away from the use of currencies as international reserves. At the same time a good deal of attention was paid to making the SDR a more attractive asset in terms of its capital value, the interest it carried, and its usefulness and liquidity. It was against this background that considerable debate took place over the appropriate way of distributing SDRs, with developing countries favouring the establishment of a 'link' between SDR allocation and the provision of foreign aid.[18]

However with the changes that occurred after the collapse of the Bretton Woods system in 1973, the problem of reserve adequacy, which had led to the introduction of SDRs in the first place, became systemically less important. Reserve adequacy was apparently no longer relevant in a world of flexible exchange rates and BoP financing by private capital markets. After 1981 no further SDR allocations were made and the world moved to a multiple currency system.[19]

A reversal of these systemic trends - the movement towards greater exchange rate management and the failure of private markets to provide a satisfactory means of BoP financing - is, however, creating new interest in SDRs. World economic recession is seen by some, not least the Fund's Managing Director, as reflecting a shortage of international liquidity and as justifying an additional allocation of SDRs. Indeed throughout the 1980s some commentators have sought to defend SDR allocation not only in broad systemic terms but also in terms of helping to deal with specific problems such as developing country debt (Williamson, 1984) and the global environment (Bird, 1992).

Without replicating the full reviews of the SDR, the 'link', substitution accounts, and the targeted use of SDRs that exist elsewhere, there are certain aspects of the SDR which are directly relevant to our discussion of IMF lending.

First, drawings under the SDR account differ significantly from those under the General Resources Account and other Fund accounts. Strategically they are essentially unconditional

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18 Bird (1985) provides a brief introduction to the SDR, discussing its advantages and disadvantages as compared with other reserve assets. For an analysis of the link proposal see, for example, Bird (1978). For more recent discussion of the SDR which concentrates on enhancing its attractiveness see Coats (1990), and for an analysis of international resource transfers associated with the SDR, see Coats *et al.* (1990). Further useful analysis of the SDR can be found in von Furstenberg (1984).

19 Chrystal (1978) and Lal (1980) give an outspoken critique of the SDR. See also Chrystal (1990) for the argument that reserve adequacy was never the problem it was assumed to be during the 1960s and that the SDR facility was not needed.

and are not subject to any strict repayment schedule.[20] Second, as originally envisaged they were not intended to be a means of facilitating permanent real resource transfers, but were distributed on the basis of IMF quotas which were seen as standing as a proxy for the long-run demand to hold international reserves. Third, the potential for resource transfers under the SDR facility has been reduced by raising the interest rate on the net use of SDRs to a market related level; but this has failed to eliminate the benefits from SDRs to recipients. In many cases developing countries cannot borrow at market rates. Their lack of creditworthiness means that they face an availability constraint which the receipt and use of SDRs would help them overcome.[21] Broadly speaking the less creditworthy a country is, the more important SDRs will be. Considerations of political economy clearly reveal why in a world where creditworthiness appears to be strongly and positively correlated with the level of development little interest tends to have been shown in the SDR.

Where certain countries are identified as holding inadequate international reserves, the allocation of additional SDRs to them represents one way in which reserves may be raised to adequate levels. But beyond this simple statement lurk all the problems discussed earlier in this paper.

If SDRs are only of use to countries that are not creditworthy, should the Fund be making resources available to them? Should such countries not instead be seeking to raise their creditworthiness by pursuing policies of economic adjustment? But then again will the receipt of SDRs help or hinder them in this endeavour? Where SDRs are spent and not held by recipients should the Fund become a source of quasi-permanent financial assistance? And in any case can one distinguish between BoP and development finance and what is the appropriate time frame to adopt?

Basically where the Fund is viewed as an agency for providing strictly temporary BoP finance, and where the unique attraction of Fund lending is the conditionality attached to it, the SDR facility will be seen as an inappropriate means of providing financial support. To those who see little distinction between BoP and development finance, who favour a longer-term perspective on the balance of payments, who see it as legitimate for the Fund to have a quasi-permanent financing function in low income countries, and who favour low over high conditionality, the SDR - particularly where subsidised for some users - will represent an attractive means of Fund financing.

Compromises are in principle quite possible. SDR allocations could be made subject to strict reconstitution provisions; they could be allocated on a discretionary and not a universal basis and could be tied to conditionality.

However a danger with the gradual and evolutionary reform of the SDR, and in particular a danger with channelling SDRs through the Fund's existing lending windows is that the SDR will lose its basic simplicity of operation. A feature of the reform of the IMF has been the

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20 There have been reconstitution requirements associated with SDRs which limit the extent that they can be used in the long run (Bird, 1982; Williamson, 1984).

21 Bird (1978) discusses the 'informal' link and the benefits that LDCs have derived from the SDR facility in terms of resource transfers. On the latter issue see also Bird (1979; 1981b; 1983).

proliferation of facilities under which countries may borrow. Starting from the general principle that all circumstances were covered by conventional credit tranche drawings, the situation has changed radically with more and more facilities being introduced to deal with specific difficulties. In the early 1960s the change seemed relatively undramatic and was represented by the introduction of the CFF, but this was followed by the Buffer Stock Financing Facility, the Extended Fund Facility, the Trust Fund, the Oil Facility, the Structural Adjustment Facility, the Enhanced Structural Adjustment Facility, the Compensatory and Contingency Financing Facility, not to mention various subsidy accounts.

What starts off as a sensible course of action to deal specifically with particular difficulties can be carried too far. The argument that there has been an excessive proliferation of lending facilities would be strengthened by empirical evidence that the facilities are not working well and by analysis which suggests that there are deficiencies in their design.

Evidence to be presented in the future papers in this series raises serious questions about specific facilities. The ESAF and the remodelled CCFF have been little used since their introduction. The BSFF has never been greatly used during its life. The EFF was decreasingly used up towards the end of the 1980s and seems to have had a particularly poor record of performance. The CCFF has lost the low conditionality features that used to be associated with the CFF before 1983, and yet has not operationally captured a uniqueness in terms of its contingency components.

In many instances researchers have found that while the facilities may be differentiated in terms of the rubric that describes them, it is much more difficult to distinguish between them in the way in which they are used. If this is true, two options present themselves. The first is for the Fund to establish a clearer operational identity for each of its separate lending facilities. The second is to rationalise; to decide which distinctions are operationally significant and design a more limited number of facilities around these distinctions.

Legitimate distinctions could, for example, be drawn between the appropriate level of conditionality, and the appropriate type of conditions where high conditionality is deemed appropriate. But even these distinctions, which according to some interpretations are not at present significant in terms of the Fund's lending operations, could be accommodated within a less complex structure of lending facilities.

4. FINANCING THE FUND: QUOTA-BASED SUBSCRIPTIONS AND THE ALTERNATIVES

If the Fund were to play only an adjustment role it would be a relatively inexpensive organisation to run, but if it is to make loans then it clearly requires the resources to lend. There are various ways in which these resources may be raised. The options are: subscriptions from member countries; borrowing from member countries; borrowing from private capital markets; the use of SDRs; and the sale of gold.

4.1 Subscriptions from Members

At present approaching 70% of the Fund's resources comes from members' subscriptions which are determined by their quotas. Additional resources come from borrowing from members. Other Fund lending, such as that conducted through the Trust Fund has been financed by sales of gold. Up to now the Fund has not borrowed directly from private capital markets.

A detailed analysis of the quota system has been made elsewhere by the author (Bird, 1987). A fundamental problem with IMF quotas is that they are used for many different purposes; they effect voting rights; the size of ordinary drawing rights and access to special facilities; the size of SDR allocations to individual members; and the size of subscriptions to the Fund. Such multi-purpose quotas would not be a problem if the purposes were (perfectly) positively correlated, but in fact the purposes may be in direct conflict. Raising quotas not only increases the supply of Fund resources but is also likely to increase the demand for them as well. Countries in the strongest position to provide the resources necessary to run the Fund are, almost by definition, unlikely to be the ones in greatest need of the Fund's financial support. Similarly, as noted earlier, the criteria for evaluating a country's need for support from the General Resources Account may not be exactly the same as those relevant for assessing its need for SDRs, since GRA resources are largely conditional liquidity whereas SDRs are essentially owned reserves.

Moreover the apparently objective process by which quotas were initially set was in fact largely spurious, and the process through which they are increased is ill-defined and increasingly unsatisfactory in a world where global economic variables change rapidly. There is some empirical support for the claim that the outcome of quota reviews depends heavily on political factors and bargaining strength within the Executive Board of the Fund since variations in the size of the quota increases cannot be explained simply in terms of key international economic variables (Bird, 1987). A lack of flexibility in altering quotas means either that the Fund's contribution to dealing with global economic problems will be constrained, or that other methods for increasing resources will have to be found. When faced with shortages of resources, and although subject to certain guidelines, the Fund has frequently resorted to direct borrowing from specific members as a means of increasing its capacity to lend. This has taken place under the General Arrangements to Borrow (GAB), the supplementary financing facility, bilateral borrowing arrangements with Saudi Arabia and Japan, and the policy on enlarged access.

In certain respects borrowing is a significant step away from the rigidity imposed by quotas. While still seeking to equate the aggregate demand for and supply of Fund resources, borrowing serves to alter the distribution of demand and supply. As a result some countries have become eligible to draw more resources from the Fund while subscribing no more resources to it; at the same time other countries have lent more resources to the Fund without an increase in their access to resources from it. In this way the Fund has acted as an intermediary in the process of international financial recycling, and the connection between quotas and both the demand for and supply of Fund resources has been relaxed. Some commentators have criticised borrowing from members as changing the basic nature of the Fund as a credit union, and altering the distribution of rights and obligations of members. (Kenen, 1985)

There are further arguments to suggest that the mechanisms used by the Fund for escaping from the rigidity of the quota system are unsatisfactory and that greater reliance on suitably reformed quotas would be preferable. On the *demand* side these arguments relate both to the *cost* of those purchases from the Fund which are financed by borrowing, as well as to their *nature*. As regards cost, the charges on resources drawn under the Oil Facility or under the SFF or the enlarged access policy (EAP) are higher than those applying to purchases under the Fund's other facilities; though Subsidy Accounts have been used in the case of the Oil Facility and the SFF in an attempt to assist the Fund's poorer members meet the higher charges.

With regard to their nature, because the SFF and EAP have been used to 'top up' credit tranche stand-bys and EFF loans, they have meant that a higher proportion of Fund lending has been of a high conditionality type than would have been the case had quota increases been used to generate an equivalent amount of additional resources. This of course need not constitute a problem if Fund conditionality is perceived as being appropriate to those countries borrowing from the Fund, but this is not universally the case. The implications of the means of financing the Fund for the balance between high and low conditionality resources should not therefore be neglected.

On the supply side the main problem is the uncertainty associated with *ad hoc* measures. Can economically strong countries, and those in substantial balance-of-payments surplus - the identity of which may well change and become more dispersed - be relied upon always to provide the resources necessary for the Fund to maintain its programme of loans? While, given the institutional constraints and the immediacy of problems, borrowing may have been the only way of dealing with the Fund's own liquidity problems in the late 1970s and 1980s, it does not represent the best long-term solution for financing the Fund.

Yet similarly, and under the existing system of negotiated infrequent reviews, can quota increases of sizes which permit the Fund to play a central role in international economic affairs be guaranteed? If not, considerable costs are likely to ensue. If the resources are not forthcoming, there will be global costs in terms of higher levels of unemployment and lower levels of output and trade as countries are forced to adjust to lower levels of financing. Even if extra resources are eventually made available, the *uncertainty* regarding the outcome of negotiated quota reviews will clearly raise a question-mark over the role that the Fund can play and this may have a destabilising effect.

One way of ensuring that the Fund has sufficient resources is to index quotas against indicators of the need for Fund resources, bearing in mind that there are arguments for basing the distribution of potential access to Fund finance on a different set of criteria than that used for determining the distribution of subscriptions. By introducing a more automatic and direct link between the need for Fund resources and their supply, many of the costs associated with infrequent reviews could be avoided.

Moreover, the effects of global inflation on the real value of quotas could be more easily neutralised. As things stand, quotas are expressed in nominal SDRs; inflation therefore means that from the very moment a new set of quotas is ratified, their real value begins to fall. Clearly the quantitative relevance of this depends on the rate of inflation; an acute problem in the mid-1970s the problem became less significant in the 1980s, even though other reasons for questioning the adequacy of quotas associated with different aspects of global economic performance became more marked. Index linking is, of course, a fairly conventional means of trying to reduce some of the costs of inflation. But if the global quota is to be linked to broader indicators of global economic performance, what should these indicators be?

One option is to use the value of world trade. The ratio of quotas to world trade has fallen significantly from 14.2 in 1950, to 11.5 in 1960, to 8.2 in 1971 and to 3.8 in 1981. In 1990 it was 3.5. Although the precise value of the ratio depends on whether the year chosen is just before or just after quotas have been raised, the downward trend is well established. However, although the quota-to-trade ratio is convenient to calculate, it is a poor proxy for the adequacy of Fund resources, since the demand for these is related to the incidence and size of payments deficits, which may not be perfectly positively correlated with the *level* of world trade. Indeed, the use of the quota-to-trade ratio may be criticized for basically the same reasons as those assembled against using the reserves-to-imports ratio as a measure of reserve adequacy, the most telling of which is that the simple use of ratios fails to provide a rigorous explanation of what constitutes the optimum value for the particular ratio chosen, or indeed what factors most significantly influence this value. This leads on to the question of whether it is possible to gain any insight into assessing the adequacy of Fund resources and therefore quotas from other approaches to the adequacy of international reserves.

In the case of Fund quotas there are in fact additional problems on top of those normally associated with judging reserve adequacy. In part these relate to the cost of producing extra Fund resources, which require countries to swap foreign exchange and SDRs for Reserve Positions in the Fund and to subscribe more of their own currency to the Fund at a potential future real resource cost. But they also relate to the benefits of Fund resources, since these are affected by the fact that a large proportion of Fund resources are conditional - the benefits therefore depend on the appropriateness of the conditions attached to Fund loans. Moreover, the benefits of extra Fund resources also depend on the global advantages of expanded Fund activity. While it is possible to talk about these in general terms, it is difficult to convert them into a satisfactory and objective specific value. In relation to this latter point only a small part of Fund resources may be counted as 'reserves'; the rest represents credit.

A conclusion from the above discussion is that Fund resources have distinctive features as compared with other forms of reserve assets and international liquidity. Their conditionality, along with the fact that Fund operations may involve positive externalities, needs to be borne in mind when assessing the adequacy of Fund resources.

Faced with the problems of quantification, analysis of the adequacy of international reserves has also drawn on a qualitative or symptomatic approach. The basic idea behind this is as follows: a shortage or excess of reserves will exert an impact on certain key economic variables either directly, through, for instance, affecting the domestic money supply, or more indirectly by encouraging the pursuit of particular policies. By observing the *policies* that are pursued and the performance of certain key *economic variables*, one may reach tentative conclusions about reserve adequacy. This approach has also been subjected to considerable criticism,[22] and again its deficiencies are multiplied if adopted as a means of assessing the adequacy of Fund resources. The question is not simply one of whether there are enough reserves or whether there is enough international liquidity but also one of whether there is the right balance *between* the various reserve assets and components of international liquidity; does the system need more Fund-based resources *relative* to the other types of international finance? Although it is possible, in principle, to derive a symptomatic guide to answering this question - for example, by examining the appropriateness of macroeconomic policies in individual countries or by looking at the implications of private bank financing - it is difficult to convert such generalities into specific values for Fund quotas.

While this brief review suggests no easy answers to the problem of determining the adequacy of the global quota, it does help to identify some of the factors that should be taken in account. It has, in other words, identified some of the arguments in the implicit demand function for Fund resources. As shown by the author elsewhere (Bird, 1987) a greater degree of objectivity could be introduced into calculating the value of resources that the Fund requires and translating this into appropriate subscriptions and quotas.

4.2 Borrowing from Private Lenders

Just as the World Bank finances some of its activities by private borrowing, could the IMF not avail itself of this source of finance? Would commercial banks, for example, lend to the Fund? Although this again would alter some of the basic features of the Fund, direct borrowing from commercial banks does, in principle, offer a way of recycling resources from surplus countries to deficit ones; there would simply be two intermediaries involved in the transaction. The incentive for banks to lend to the Fund would have to arise from the rate of return offered to them by the Fund and their own assessment of the relative risk involved in lending to the Fund, which would, of course, be influenced by the way in which the Fund planned to use the extra resources. If the banks assessed the risks associated with lending to the Fund as being less that those involved with direct lending to the eventual recipients of Fund credit, they might be prepared to accept a relatively low rate of return.

However, it might encourage them to pull out of direct payments financing. Indeed, the most common criticism of Fund borrowing from private markets is that it would crowd out other borrowers, including developing countries, and possibly the World Bank. In this context it needs to be recognized that debt crises have in a sense done this anyway, and the counter-argument can be made that in aggregate terms Fund borrowing might well crowd in additional financial flows; even so, the concern has to be taken seriously.

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22 See Bird (1985) for a review.

Another problem with direct borrowing relates to its cost. Would the Fund simply on-lend at the price and for the time period on which it borrowed or would it attempt to transform the maturity and reduce the interest rate. Where the Fund charged a lower rate on its lending than it paid on its borrowing, an additional financing problem would clearly arise. However, if it did not do so, direct borrowing from private markets would be of more limited benefit to many developing countries.

Finally, too heavy a concentration on private borrowing as a means of financing the Fund would expose its activities to the vagaries of the capital market. Moreover, resort to borrowing from the markets might persuade some governments to reduce their own financial support for the Fund, with the result that it might become even more difficult to get agreement on quota increases.

In conclusion, and bearing in mind the public-good nature of many of the Fund's activities, it seems more appropriate that these should be supported by government subscriptions.[23]

4.3 Using SDRs and Gold

A third alternative, which is in certain ways more attractive than either of the above, is for the Fund to finance its activities by the creation of SDRs which would then be transferred to the General Account.[24] The attractions are associated with increasing the significance of the SDR and of allowing the Fund to use its own asset more fully. Furthermore, quotas in their role of determining individual country subscriptions could be dispensed with. Such a move would of course mean that some SDRs would be issued to Fund members in the form of conditional and repayable credit - under the auspices of the GRA. It would also rely heavily on the SDR becoming a more useful asset. Finally, there is the implicit presupposition that it would be easier to get governments to agree to extra SDR allocations to the General Account than to quota increases. Although countries would not be asked to give up financial resources directly, they would still be a potential real resource cost. More to the point, if they oppose any expansion in the Fund's activities, they may be expected to resist this by whatever means it is to be financed. Such resistance may also be encountered against a plan to finance the Fund's lending activities through further sales of gold.[25]

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[23] As noted earlier the Fund's public good attitudes are interpreted by some as not requiring it to lend and therefore not requiring finance.

[24] Kenen (1985) describes a more involved scheme based on SDRs.

[25] Brodsky and Sampson (1981) make a strong case for the further use of Fund gold to finance a development account. Bird (1981a) has similarly shown how IMF gold sales could be used to finance the expanded use of subsidies, and how the operations of a substitution account could be tied to gold decumulation by the Fund.

5. CONCLUDING REMARKS

IMF lending raises a myriad of difficult analytical issues. It touches on questions of efficiency and equity and involves both positive and normative economics, as well as considerations of international political economy and the economics of bureaucracy and public choice. Precise and uncontentious answers should not be expected; they certainly cannot be given. Indeed the more precise the answers, the more contentious they also generally become.

If one believes that international equity is unimportant and that markets are always efficient, or at least more efficient than governments, there is reasonable justification for arguing that neither the IMF nor any international agency should be lending at all. We have argued, however, that private international capital markets have shown themselves to be inefficient on the basis of a number of criteria. Moreover, the international community should not ignore those countries that are ignored by private markets. International distributional issues are important. In any case uncreditworthy countries still have BoP problems. In these circumstances there is a role for lending by international financial institutions. But should it be the IMF?

The paper shows how the original blueprint for Fund lending, designed as it was for the purpose of short-term BoP financing, encounters difficulties where payments correction becomes a longer-term process relying heavily on supply-side change. This means that Fund lending conducted, as conventionally envisaged, will often be inappropriate. The increasing overlap between BoP and development finance has made the purpose of Fund lending increasingly unclear and has been reflected in the proliferation of Fund lending facilities. Operationally, however, the success of this institutional response must be seriously challenged. Rhetoric has differed from practice.

The distinguishing features of Fund loans, in principle, are their cost and their conditionality. Indeed Fund loans may need to be concessionary in order to encourage borrowers to accept the conditionality that is attached to them and to be appropriate to the debt servicing capacity of poorer ones. Where Fund-supported programmes are successful a rather strong case for Fund lending may be made. Where they are unsuccessful it becomes more difficult to support Fund lending except as a form of aid, and then the question is whether loans from the Fund are the best way of providing aid. Certainly what emerges is that the Fund as a lending institution cannot be divorced from the Fund as an adjustment institution. The more efficient it becomes in this latter role, the less will be the need for it in its former role; although, at the same time, the stronger will be the justification for using the availability of loans from the IMF as a way of encouraging countries to pursue Fund-supported adjustment programmes.

The lack of a clear cut analytical case for Fund lending is also found in comments from some Fund staff, where the view is expressed that many existing forms of Fund lending are inappropriate for the institution as they define its purpose. According to this view the Fund should not be lending where there is little or no chance of reasonably rapid BoP correction.

The strongest case against Fund lending does indeed seem to be that the nature of international financing gaps has changed in a way that reduces the relevance of conventional forms of Fund lending.

Two policy responses suggest themselves. The first calls for significant adaptation on the part of the Fund to modify the ethos of its lending policies. The second calls for existing and future financing needs to be met in ways that do not require the Fund to alter its basic orientation. These options will be discussed further in future papers in this series.

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