IMF and the Eurozone
A Developing Country Perspective

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The International Monetary Fund has made an assessment that an additional global firewall of $1.1 trillion is required to address the fallout of the eurozone crisis. But a number of very valid reasons make it clear that the European Central Bank or some other quasi-fiscal mechanism, rather than the IMF must be empowered by the eurozone authorities to provide the liquidity required. The IMF's resources should be used primarily for developing countries that lose market access to reserve currencies and need to square their international payments.

These views are personal.

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Group of Twenty (G-20) leaders at their sixth summit at Cannes, held in November 2011 against the backdrop of a rapidly escalating crisis emanating from the eurozone, resolved to

> ensure the IMF continues to have resources to play its systemic role to the benefit of its whole membership, building on the substantial resources we have already mobilised since London in 2009. We stand ready to ensure additional resources could be mobilised in a timely manner.

The International Monetary Fund (IMF) subsequently made an assessment that an additional global firewall of $1.1 trillion was required to address the fallout of the eurozone crisis, of which it needed to raise $600 billion ($250 billion for the eurozone, $250 billion for innocent bystanders and other countries, and $100 billion as liquidity backstop for its membership), and eurozone countries $500 billion. This was over and above the $750 billion collected recently under the auspices of the G-20 in the wake of the global financial crisis. Of this, $500 billion was through new arrangements to borrow (NAB) and $250 billion through a fresh special drawing rights (SDR) issue. The IMF's proposal was endorsed by the G-20 at the seventh (Los Cabos) summit in June 2012, where its leaders committed to increase the firewall by more than $450 billion.

Stabilising the eurozone is critical for developing countries, since a meltdown there will have catastrophic effects on them. However, the eurozone problem is too big for the IMF to intervene effectively, as key resources and solutions lie within the zone. Indeed, the IMF's financial involvement can seriously cripple its capacity to firewall its traditional developing country clients. There are therefore several concerns regarding these additional resources raised for the IMF.

First, the amounts talked about are very large in comparison to the IMF's existing resources. The IMF already has an unusually large exposure and concentration of risk in Europe. As of 31 July 2012, the eurozone accounted for about half of the IMF's outstanding General Resources Account (GRA) credits, the European Union (which includes the eurozone) for about two-thirds, and Europe for almost 80%.

Second, while fiscal problems can no doubt often spill over into the balance of payments, IMF support is clearly intended to cover the unfunded liabilities arising out of balance of payments difficulties, denominated in reserve currencies included in its basket. This is envisaged in Article 1(v) of the IMF's Articles of Agreement:

> To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.

The underlying assumption is that the IMF steps in as an international lender of last resort when a country, including its central bank, has lost market access to fund its external liabilities denominated in international reserve currencies. Domestic liabilities, no matter how excessive and imprudent, can always be funded through domestic market borrowings, and/or by the central bank by printing domestic currency. No external lender of last resort is necessary.

The IMF has now been called upon to support countries in a currency union where the domestic currency is also a reserve currency. Since they are both denominated in the same – reserve – currency, the divide between fiscal and balance of payments problems of eurozone countries is blurred in terms of Article 1(v) of the IMF's Articles of Agreement, which envisages IMF liquidity provision only on balance of payments grounds.

Third, it is unclear why the IMF backstop is necessary since the eurozone collectively has the capacity and tools to address the problem. It has a balanced current account and its public debt is not out of line with the rest of the world. It is true that individual countries within the eurozone have unsustainable deficits that need to be financed. The eurozone's collective firepower, however, far exceeds anything that the IMF can hope to mobilise since the unfunded liabilities are in the currency issued by the European Central Bank (ECB). The ECB or some internal fiscal or quasi-fiscal mechanism, such as the European Financial Stability Facility (EFSF) or the European Stability Mechanism (ESM), can make the funds available to the stressed country by purchasing sovereign bonds, providing liquidity to the banking system, or printing money if empowered to do so, as the ECB has indeed been doing from time to time to calm markets.

IMF's Possible Role

It could be argued that since under Section 1 of Article IV "each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates", the IMF has a role to play if the liquidity requirements of reserve currency issuing countries are so great that money creation would materially affect the exchange rate stability that members are obligated to maintain. Section 3 of Article IV mandates that

> (a) The Fund shall oversee the international monetary system in order to ensure its effective operation, and shall oversee the compliance of each member with its obligations under Section 1 of this Article. (b) In order to fulfil its functions under (a) above, the Fund shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies.

However, whereas the IMF's intervention on balance of payments considerations under Article 1(v) envisages making its general resources temporarily available, its intervention under Article IV(3) is limited to surveillance and determination of par values (Article IV Section 4). In any case, to the extent that the eurozone crisis is largely a crisis of confidence because of the absence of sovereign backstops, clarification regarding monetary or quasi-fiscal sovereign backstops might restore market confidence without the need for large amounts of liquidity creation.

Fourth, in retrospect it appears that when some members of the IMF unilaterally entered into a reserve currency union, the articles of the IMF should have been amended, clearly demarcating the responsibilities of eurozone country central banks, the ECB and the IMF, because of the blurring between domestic and external liabilities, and because members of the currency union could no longer use one critical instrument of macroeconomic adjustment in IMF programmes – the exchange rate. Indeed, had the exchange rate instrument been available to peripheral eurozone countries, it is unlikely that the market would have allowed such large imbalances to build-up in the first place. It has been well known since the time of John Maynard Keynes that the international monetary system has an inbuilt mechanism for penalising current account deficits through the market mechanism. Such large bailouts would therefore have been unnecessary. The absence of such a clear demarcation of responsibilities has created a moral hazard in which the eurozone can shift its responsibilities to the IMF, and through it to the wider international community, by using the limitations imposed by the Maastricht Treaty as an argument. But if the ECB is barred from fiscal bailout of eurozone countries, the IMF is also barred from doing so. The limitations imposed by the Maastricht Treaty can be corrected through political negotiations within the eurozone.

Fifth, this moral hazard has created an anomalous situation where big, poor countries with large developmental needs of their own are being called upon to assist much richer countries unable or unwilling to adjust. This may be difficult to justify and defend in their parliaments. Till recently, IMF lending was mostly directed at low to middle-income developing countries facing balance of payments problems arising out of macroeconomic mismanagement or external shocks. The larger developing countries now have their own insurance mechanisms in the form of large reserves. As a result, while most of the funding sources were traditionally from developed countries, the share of emerging market economies is increasing sharply, especially after the recent NAB and quota reform. The share of Brazil, Russia, India and China (BRIC) countries in the NAB was about a fifth. On the other hand, the share of developed country borrowers, especially those in Europe, has been increasing. This has created an anomalous situation in which large emerging countries with relatively low per capita incomes are coming to the rescue of much richer developed countries.

Sixth, unlike IMF resources that are already sitting in the reserves of member countries, the eurozone component of the global firewall would be mostly in the form of commitments to be raised from the market as and when required. Only 15% of the ESM of $500 billion would actually be paid in through capital contributions over a period of time. This defeats the very purpose of a firewall, which is expected to provide an insurance against market revolt. Eurozone countries expect to raise money from the market at a time when bond markets are unstable. The ability to raise the targeted amount in such a situation is uncertain, especially since some of the major contributors have recently been downgraded by rating agencies, and further downgrades are imminent.

Seventh, it is not clear where additional resources would come from if the $1.1 trillion of fresh resources raised by the IMF and euro area prove to be insufficient. The IMF's own assessment was that its projections were not based on a worst-case scenario. The requirement could be much more if the expected policy response and application of resources are not timely, and still higher in the event of a global meltdown. The IMF's assumptions about growth rates, borrowing costs, and credit ratings could also go awry, as they have in similar cases in the past. Such as in the case of Greece. Or even in the case of the extant EFSF/ESM firewall. Such dynamic factors make it difficult to draw a fine line between illiquidity and insolvency, as the former can easily turn into the latter. Some eurozone countries in trouble, such as Spain and Italy, are too big to bail out by the ESM and IMF put together. It is therefore unsurprising that far from a "shock and awe" effect on markets, Spanish and Italian bond spreads did not even respond to the "big bazooka" commissioned by the G-20 at Los Cabos. The Los Cabos firewall was conceived as a one-off exercise. So what happens now that the big bazooka is perceived as mere field artillery by markets? Would members be willing to commit still more resources to the IMF?

Eighth, while the IMF's resources are limited and the eurozone's requirement is primarily denominated in euros, the ultimate backstop that can provide unlimited liquidity in that currency area can only be the ECB, which has a monopoly in creating euros. The conventional wisdom is that countries are constrained to turn to the IMF when their own public finance backstop is of no use in financing deficits. This backstop is the central bank. It is not possible to manage a country's public finances without the central bank backstop, even though this backstop is rarely used. Not having this backstop deprives sovereign countries of a critical policy instrument, the inflation tax, which is sometimes required to put public finances back on a sustainable track. Without this policy instrument, governments would be forever hostage to markets. The eurozone's public finances are hostage to markets precisely because its sovereigns do not have such a backstop. This is perhaps why the borrowing spreads of some sovereigns whose public finances are on a sound footing have risen to surprisingly high levels, and higher than those of European countries with worse public finances but outside the eurozone. Now that markets seem to have discovered a flaw at the heart of the Economic and Monetary Union (EMU), long known to economists, it may be difficult to permanently restore market confidence till this is fixed to their satisfaction, at least as long as there are lingering concerns over debt dynamics.

Therefore, more resources for the eurozone might kick the can further down the road, and might restore confidence for some time, as the earlier IMF package and the EFSF/ESM did, but the problem may not go away till this basic flaw is fixed to the satisfaction of markets. Plugging this weakness permanently should have been considered as part of the issue of IMF resources. Eurozone countries have taken a number of hard and courageous decisions. Markets, however, are tough and heartless taskmasters. Having seen agreements to maintain fiscal discipline in the past not work, they might be equally sceptical of tighter rules in the absence of the tried and trusted backstop that is known to work.

Responsibility of ECB

In the light of the above, the bottom line is that the ECB, or some other quasi-fiscal mechanism, must be empowered by the eurozone authorities to provide the liquidity required rather than turning to the IMF, whose resources should be used for developing countries whose currency is not a reserve currency. The IMF has adequate resources to meet their requirements. The bigger emerging markets do not need IMF cover at this stage as they are self-insured on account of their plentiful hard-currency reserves.

Ninth, the ECB or a quasi-fiscal backstop can be an effective liquidity buffer to insulate crisis-ridden governments from market revolt and buy time, but the problem of excessive domestic and external deficits within the eurozone will not go away, and additional policy action would be required. Or else, the sovereign debt of peripheral countries would simply be transferred to the balance sheets of the IMF, and to eurozone sovereigns through the ECB and ESM. The debts would still need to be restructured, and a determination made on sharing haircuts. Governments would also need to redeem the remaining debt in future through surpluses, both internal and external, generated by tough adjustments and structural reforms, including a roadmap for fiscal and banking integration. Since the inflation tax instrument is not available for stabilising domestic public deficits (as individual countries do not have monetary independence), and the exchange rate instrument is also not available for external adjustments (with all its flaws, the Bretton Woods "non-system" has a mechanism for adjusting the external deficits of countries through currency depreciation forced by markets; the euro's exchange rate, however, responds to the cumulative current account position of the zone, which is balanced, and not to the current accounts of individual countries, which are highly imbalanced), individual countries cannot force real depreciation through inflation. That leaves a downward adjustment in nominal wages as the only option for improving the productivity necessary to bridge external deficits and increase domestic savings. This carries the threat of social unrest and a downward deflationary spiral, which could make the debt even more unsustainable in real terms. It could be partly countered by propping growth by switching expenditure from consumption to investment, especially in infrastructure.

There appears to be no other solution to resolving the eurozone's problems short of some countries leaving the EMU altogether, either temporarily or permanently, the costs of which could be even higher. By remaining within the eurozone, the ECB backstop could insulate governments from the vagaries of the market, giving them more time for carrying out necessary adjustments.

Tenth, for these, or at least some of these reasons, the US, the biggest shareholder of the IMF, was unwilling to commit additional resources to the Fund at the Los Cabos G-20 summit as it was of the view that the eurozone had both the resources and instruments to resolve its internal crisis.

For the above reasons, the decision to enhance the IMF's resources yet again was deeply flawed from both the macroeconomic and developing country perspectives. The analysis here indicates that far from augmenting the resources of the IMF for eurozone bailouts, the IMF's resources need to be ring-fenced against this moral hazard, so that they are used only as a last resort, and primarily for poor developing countries that lose market access to reserve currencies and need to square their international payment commitments. While the IMF may well have a role to play in resolving the eurozone crisis, this can only be as a policy advisor and monitor, rather than a provider of resources, where it can only be a marginal player, and that too by vastly worsening its risk profile.

The question that needs to be asked is that if IMF funding for the eurozone is so patently indefensible, why did it escape stricter scrutiny by the G-20, the IMF, and both developed and developing countries? There could be a number of reasons why all the stakeholders came on board. As far as the IMF is concerned, there was a clear conflict of interest as its extant quota allocation and top leadership is dominated by European countries. The IMF no doubt has an army of well-trained economists. But as a study of the IMF's internal functioning by its own Independent Evaluation Office has observed, its culture is characterised by "group think" that does not encourage contrarian thinking.

Another major stakeholder, the fast-growing Emerging Market and Developing Economies (EMDES), including those with large net external liabilities that could ill afford large contributions, such as India, may have become willing parties to demonstrate their entry to the global stage. But, perhaps, most importantly, given the potential of the eurozone to destabilise the global economy, the G-20 may have wanted to lend moral support to its leaders, cheering them on the sidelines, with the full knowledge that the resources they were raising would not make a material difference.