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THE IMF'S LENDING FRAMEWORK AND SOVEREIGN DEBT RESTRUCTURING

The euro area crisis precipitated large IMF loans, co-financed by euro area governments. The Greek program in May 2010 required a change in the IMF's framework for exceptional access arrangements, which was put into place following the 2001 Argentine crisis. The framework was meant to safeguard the resources of the IMF by setting out clear criteria that should be met before the Fund agreed to provide exceptionally large loans relative to a member country's IMF quota. Four criteria were agreed to address capital account crises, including a requirement that the country's debt would remain sustainable with high probability, with a good prospect for market re-access by the end of the program. However, in the case of Greece — whose request for an IMF loan in May 2010 amounted to an unprecedented €30 billion (3,212 percent of Greece's quota) — the high-probability debt sustainability criterion was waived, based on the systemic concerns arising from spillover risks if the program were not approved. The IMF's Debt Sustainability Analysis accompanying every program review since May 2010 has concluded that public debt sustainability risks remain significant; the IMF thus continued to invoke the "systemic exemption" to fund the program, even after the 2012 Greek debt restructuring.

Schadler (2013) criticized the systemic exemption on grounds that systemic spillover risks do not justify exceptional access to IMF resources regardless of prospects for debt sustainability. Indeed, the framework constraining the discretion of the IMF in severe debt crises failed its first serious test. This was partly the result of acute contagion risks within a currency union, but it also reflected the IMF's insufficient resistance to regional political pressures to delay crisis resolution. Along the same lines, Boughton, Brooks and Lombardi (2014) argued that the primary goal should be to restore credibility and consistency to IMF policies underpinning its major crisis-driven lending. If a debt restructuring is needed, it should be incorporated into the program design from the outset; if the IMF cannot resist political pressures to deny this reality, it would risk losing its hard-earned credibility.

In a new paper, the IMF is now proposing ditching the systemic risk exemption in favour of a new approach to addressing spillover risks in exceptional access programs (IMF 2014). The IMF proposal tries to strike a difficult balance between a framework that provides sufficient discretion to deal with severe debt crises on a case-by-case basis, and one that is sufficiently rules-based to prevent undue political influence in IMF decisions.

The systemic exemption lowers the bar concerning debt sustainability when there are serious spillover risks. The case *against* such an exemption is twofold:

- The systemic exemption carries the risk of weakening the "exceptional access" framework that was intended to constrain the Fund's discretion in resolving debt crises. As Schadler has argued, all severe debt crises carry risks of systemic spillovers (recall the "tequila effect" of the 1994 Mexican crisis) and the European precedent would make it difficult to rule against invoking the waiver in the future.
- The economic rationale for the systemic exemption is questionable. As the IMF paper recognizes, the exemption is not an efficient way to address contagion concerns, because the key to addressing contagion is to have a credible solution to sovereign debt distress. Bailouts that do not address sustainability concerns will fail to limit contagion. The 2012 Greek debt restructuring demonstrated that an orderly default involving a pre-emptive debt restructuring is possible in a monetary union, provided appropriate firewalls and crisis management institutions are in place. Uncertainty about the endgame of the crisis turned out to be the key source of contagion (Xafa 2014).



The IMF now proposes eliminating the systemic exemption and replacing it with a new framework that would make IMF support conditional on a debt “re-profiling” operation in exceptional access arrangements, in cases where the country has lost market access and there is uncertainty regarding debt sustainability, in order to avoid using Fund resources to bail out private creditors in such cases. Specifically, when these conditions are met, the IMF proposes maturity extensions of privately held debt for around three years through a voluntary debt operation, as a condition for providing exceptional access to IMF resources. This policy would give rise to three possible scenarios: if there is a high probability that debt is sustainable, Fund lending would play its normal catalytic role; if there is a high probability that debt is unsustainable, an upfront debt reduction would be required; and if there is uncertainty about debt sustainability and the member country has lost market access, Fund lending would be conditional on re-profiling.

The argument in favour of the new policy is that a re-profiling will generally be less costly to both the debtor and creditors in exceptional access cases where debt sustainability is uncertain: Creditors would avoid a worse outcome, i.e., either an upfront debt reduction or a bail-out that is followed by debt reduction. Debtors would benefit from the financing that will be released through the re-profiling, which would allow for more gradual adjustment path that would be less detrimental to growth.

The proposed framework is a clear improvement over the systemic exemption. However, we think the framework could be improved by further restricting the Fund’s discretion in two respects:

- First, the paper leaves open the possibility of making continued Fund support conditional upon the implementation of a re-profiling in cases where a member’s debt outlook becomes considerably more uncertain *during* an existing exceptional access arrangement. However, this possibility opens the door to debtor moral hazard: the paper argues that the prospect of a possible re-profiling if the program is not successfully implemented is likely to provide additional incentives for the member to effectively implement the program. But it is also possible that it would provide perverse incentives to the debtor to slow program implementation in order to reap the benefit of a re-profiling that would release resources for a more gradual adjustment path. The conclusion is that the re-profiling decision should be made up front, rather than be conditional on program implementation.
- Second, any uncertainty regarding sustainability is likely to be removed within 12 to 18 months from the start of the program — as was the case in Greece. Extending the re-profiling beyond this horizon is kicking the can down the road and should thus be avoided.

Works Cited

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