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Statement of the Shadow Financial Regulatory Committee

On

The G7's New Precautionary Credit Line Facility for the IMF and Its Use in Brazil

December 7, 1998

The centerpiece of the G7 Declaration of Finance Ministers and Central Bank Governors of October 30, 1998 is a proposal for a new International Monetary Fund facility to provide contingent short-term credit on a pre-approved basis. The intent is to enable countries to avoid falling victim to currency crises sparked by events in other countries (i.e., "contagion"). In principle, the pre-approved credit line would provide rapid liquidity protection to innocent victims of global or regional capital market turmoil and would be made available to countries pursuing IMF-approved policies. It would be accompanied by "appropriate private sector involvement." Lending under this facility would be for shorter maturities and at higher interest rates than previous IMF assistance programs.

Implementation of such a facility faces four difficult challenges that are not addressed in the G7 Declaration. First, the IMF must have an effective and credible means of distinguishing countries that are potential "innocent victims" of global turmoil from countries that are pursuing unsustainable macroeconomic policies. Failing to do so would waste IMF resources and amplify moral hazard problems.

Second, any credible approval process must specify conditions and circumstances under which approval later could be revoked. Revoking approval could exacerbate a loss of confidence and worsen a country's financial plight. Failure to address that prospect raises doubts about whether the IMF would enforce conditions.

Third, even if the first two challenges could be met, there remains an awkward moral hazard problem vis-à-vis borrowing countries: how to prevent abuse of the facility. This is a standard problem confronting all lenders of last resort, for which as early as 1873 Bagehot prescribed the remedy of lending on good collateral at a penalty rate. Although the staff memorandum accompanying the Declaration contemplates charging higher interest rates onthis facility, the rate would still be below what many countries must pay on their sovereign debt in private capital markets. Moreover, no provisions for collateral are specified.

Fourth, there is an additional moral hazard problem vis-à-vis the private sector: how to avoid the use of IMF resources to bail out private sector investors. The Declaration mentions "appropriate private sector involvement" without describing the objectives of such involvement or how those objectives would be achieved. As the Shadow Committee noted in Statements No. 145 (May 1998) and No. 148 (September 1998), the design of private sector involvement should preclude the shifting of losses or risks to taxpayers.

Subsequent to the G7 Declaration the IMF approved a new $41 billion, three-year, standby credit for Brazil. In some respects this package is like traditional IMF programs that are disbursed in tranches contingent on the borrowing country's meeting specified macroeconomic targets. The press has viewed this program as the first implementation of the G7's new contingent short-term line of credit facility. If this program represents the way the G7 proposal will be implemented, then our concerns about the new facility are intensified along each of the four dimensions discussed above.

First, Brazil does not appear to be an innocent victim. A large part of its difficulties are a result of an unsustainable combination of a persistent fiscal deficit and a pegged exchange rate. That is presumably why the IMF has imposed conditions on Brazil's fiscal and monetary policy.

Second, from past experience it is doubtful that the IMF will withdraw credit if Brazil fails to meet the specified conditions. The Fund's past record suggests that it will at most delay disbursement of some tranches.

Third, because capital markets continue to doubt Brazil's commitment to fiscal reform, Brazil is very likely to use this assistance irrespective of external financial turmoil. The interest charge – even with the new premium of 300 basis points above the usual low IMF rate – is cheaper than Brazil's current cost of borrowing in world capital markets. Moreover, unlike large bilateral credits to Mexico in 1995, Brazil has offered no collateral.

Fourth, there is no private sector involvement accompanying the new facility. Existing private claims have not been rescheduled, nor have new rules been established to insure that private investors will share the risk of any future defaults with taxpayers. This was a conscious decision of the Brazilian government, which did not wish to trigger private market withdrawals by suggesting that private market claims might be in jeopardy.

If this is a new beginning, it is an inauspicious one.