Special Report 2010/01

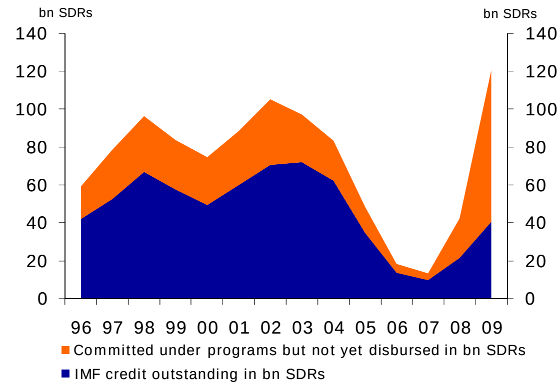
The return of IFI lending

The global financial crisis has brought the International Monetary Fund, the World Bank and other International Financial Institutions (IFI's) back to the spotlights. With several large emergency loan packages, they have helped countries to deal with the severe economic shocks. As a result, the amount of IMF credit has more than quadrupled in the past two years, while World Bank lending has also grown quickly. This contrasts starkly to the pre-crisis years, when IFI's lending operations were gradually reduced to the poorest countries only. This Special Report provides an overview of the recent trends, especially regarding IMF lending, and a brief outlook.

The return of IFI lending

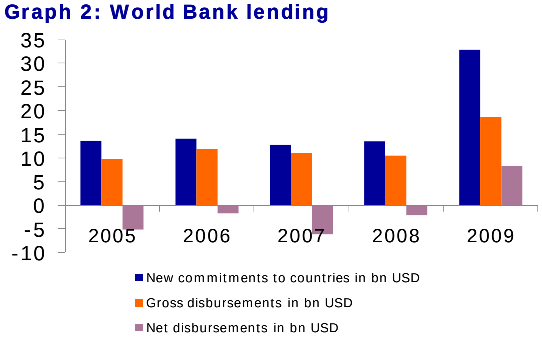
Since the onset of the global economic crisis International Financial Institutions (IFI's) are back in the lending business. Most pronounced was the return of the lending by the International Monetary Fund, which acts as a lender of last resort for central banks. Since September 2008 Ukraine, Hungary and Romania have all concluded International Monetary Fund (IMF) emergency loans programs of USD 12.9bn to USD 16bn each. Overall, the IMF more than quadrupled the amount lent to its member countries, with total credit outstanding growing from SDR 9.8bn at end-2007 to SDR 40.5bn in November 2009. The growth in commitments was even more pronounced (see graph 1). Multilateral Development Banks, such as the World Bank and the European Bank for Reconstruction and Development (EBRD), have also quickly stepped up their lending. The World Bank increased its new commitments to countries to USD 32.9bn in fiscal year 2009 (which ran from 1 July 2008 to 30 June 2009), up from USD 13.5bn in fiscal year 2008 (see chart2).

Graph 1: IMF credits and commitments



Source: IMF

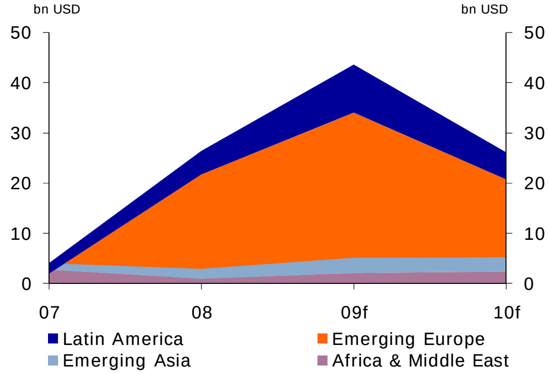
Graph 2: World Bank lending



Source: The World Bank

However, the sharp increase in lending took place in a geographically very concentrated pattern. As graph 3 shows, net IFI flows to Emerging Asia and the Middle East and Africa have stayed almost flat in recent years. In Latin America the amount of lending has increased somewhat, but this increase is relatively modest compared with the increase in net IFI flows to Eastern Europe. This is no coincidence, as many Eastern European countries ran high current account deficits and became very reliant on foreign finance in the pre-crisis years, while Asian countries in particular were building up large stocks of foreign reserves.

Graph 3: Geographical division of net lending by IFI's in USD bn



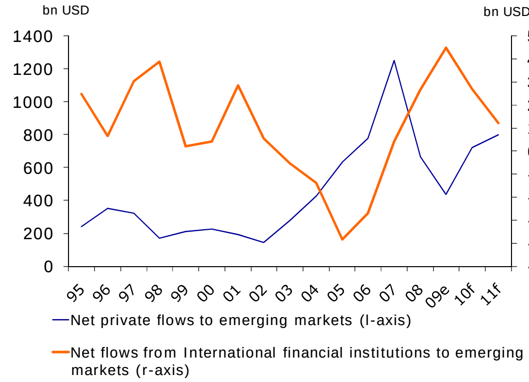
Source: IIF

The sharp increase in lending contrasts starkly to the immediate pre-crisis years. Back then the IMF more or less ran out of lending business, with the total amount of credit outstanding in 2007 at about one-sixth of the amount outstanding just five years before (see chart 1). Although the decline was less pronounced among Multilateral Development Banks, some of those institutions also saw their amount of lending decline. For instance, principal repayments to the World Bank surpassed the amount of new lending in each of the fiscal years 2005 to 2008 (see chart 2). As emerging markets enjoyed high economic growth and interest rates in the advanced economies were low, the amount of private capital flowing to emerging markets grew tremendously (see graph 4). All in all, emerging markets were able to borrow at unprecedented low rates. It is no wonder that in such circumstances demand for IFI money declined rapidly. The decline of lending led some commentators to argue for the withdrawal of Multilateral Development Bank lending to emerging markets and forced the IMF to implement sizeable budget cuts in 2007.

Rationale of IFI lending

As described above and also visible in graph 4, IFI lending has thus proved to be very countercyclical in recent years: low levels of lending in the boom years before the crisis, followed by high levels after the onset of the crisis. There is substantial evidence that private capital flows to emerging markets and developing countries are pro-cyclical. They tend to be high in boom times, but tend to disappear when the going gets tough[1].

Graph 4: Countercyclical IFI lending



Source: IIF

This pro-cyclical pattern can partially be explained by information asymmetries, which leads to herd behavior among investors. Usually, this pattern forced developing countries and emerging markets to tighten both monetary and fiscal policy in crisis times, thereby further deepening the crisis. In these circumstances, emergency IFI loans can help to mitigate the depth of a crisis, especially if a country faces liquidity problems but not insolvency problems. At the same time, (the prospect of) IFI lending may encourage both governments and lenders to take on more risk, as they expect to be bailed out if a crisis occurs. However, to ensure that macroeconomic policies of countries in need of IFI loans become less risky, conditions are usually tied to IFI lending programs. As most governments do not like this limitation of their policy freedom, conditions can also have the benefit of reducing moral hazard.

Moreover, as the conditions tied to an IFI program may commit the receiving

[1] See for example Reinhart Rogoff (2009), *This time is different*

government to more sustainable macro-economic policies, they can also help to catalyze other flows. Investor confidence may also be boosted by the IFI money itself, as this money may reduce rollover risk. Before the crisis, however, evidence of a strong catalyzing effect was rather scant.

A changed approach

The benign market sentiment for emerging market debt was not the only force behind the decline in IFI lending in the pre-crisis years. Unpopularity of the institutions because of their use of conditionality was another. In particular the IMF became very notorious among many of its borrowers after the Asian crisis. The conditions tied to its programs during that crisis were seen by many as being unnecessarily harsh, following blue print prescriptions and being too intrusive. Many governments, in particular those of Asian countries, were adamant about never having to borrow from the IMF again and accumulated large stocks of foreign reserves. In a sense they were successful, as Emerging Asia has been one of the regions which has hardly experienced any upswing in net IFI lending (see graph 3). Nevertheless, holding vast stocks of foreign exchange reserves is costly for the government holding the reserves. What is more, the current account surpluses necessary for such a build-up require current account deficits in other countries. Thus, self insurance through the build-up of large stocks of reserves instead of reliance on the IMF may have contributed to global imbalances and the global economic crisis. Of course there may be other motivations for holding large reserves, such as keeping the exchange rate competitive to boost exports. For instance, China's foreign reserves were equal to more than 24 months of imports at end-2009, which is by far more than necessary for self insurance purposes.

The IMF of today is different from the IMF of the Asian crisis. There have been two important changes: the IMF has relaxed the conditionality attached to programs and increased the amount countries can lend. To accommodate an increase in lending, the member countries of the IMF have promised to triple the total lending capacity of the IMF to USD 750bn, although the commitments given by countries to contribute are not yet very strong in some cases. Noteworthy though is the fact that many countries which were IMF borrowers not too long ago, such as Brazil and Russia, will now buy bonds (or have promised to do so) from the IMF to allow it to increase its lending operations. Furthermore, trough the allocation of new SDRs, the IMF has increased the member countries' holdings of this IMF international reserve currency from SDR 21.4bn to SDR 204.1bn.

IMF conditionality has been significantly relaxed since the Asian crisis in a number of ways. Firstly, conditionality has become more focused on specific areas, with fewer conditions in sensitive areas such as privatisation and liberalisation. Conditionality is thus more directed at solving a few core problems, instead of overhauling whole economies. Secondly, whereas the IMF prescribed very tight monetary and fiscal policies during the Asian crisis, it has been more accommodative during the current crisis. This makes sense, as many emerging markets and developing countries entered the crisis in better fiscal and monetary conditions. However, the fact that the programs of the two big IMF borrowers, Ukraine and Romania, have already been suspended, suggests that some IMF programs may have been concluded too easily.

Thirdly, the IMF has also introduced a whole new facility: the Flexible Credit Line. This new facility acts as a safety valve: countries with what the IMF considers good macroeconomic policies can draw money on this arrangement in case of an emergency, but do not have to in other circumstances. In contrast to ordinary programs, countries only have to prove that they have good macroeconomic policies before the conclusion of a program, not afterwards. This greatly reduces the level of intrusiveness. Moreover, the amount of money a member country can draw under this arrangement is much higher than under traditional arrangements. An additional benefit is that the Flexible Credit Line may reduce moral hazard, as it provides (or at least should provide) relatively easy and high access to IMF lending for countries with relatively good policies, and thus rewarding the prudent. The fact that Mexico, Peru and Poland, countries with relatively good macroeconomic policies, have all concluded such an approach and have managed to ride through the crisis in a relatively good state, suggesting that this new instrument has already had some success.

The World Bank, which had also been under fire over its use of conditions in the nineties, although less so than the IMF, has also changed its use of conditionality, mostly already before the onset of the crisis. A new element during the current crisis was the focus of its support on safety programs for the vulnerable groups, next to the more traditional support for infrastructure and medium-size enterprise and microfinance. Furthermore, the IFI's have also stepped up cooperation. The most important example is the EUR 24.5bn joint action plan for Central and Eastern Europe. Under this plan the European Investment Bank (the EU development bank), the European Bank for Reconstruction and Development and the World Bank Group are working together to support the financial systems of Eastern Europe. So far, this support has helped to avert a full meltdown of financial systems in the region.

One important issue still has to be tackled, especially at the IMF: the distribution of power. While the weight of emerging markets and developing countries has increased somewhat in recent years, upcoming economic superpower China still holds only 3.66% of the quota within the IMF, while India holds only 1.91%. Although the percentages will increase as long these countries continue their rapid growth, they may still feel underrepresented, which may reduce the effectiveness of the IMF. Conversely, relatively much smaller European countries not only hold large shares, but also are (at least partially) represented on 9 out of the 24 constituencies within the IMF.

Outlook & conclusion

How the amount of IFI lending will develop in the coming years is hard to foresee, as lending usually peaks in crisis times. Financial crisis are bound to happen again, but when exactly is notoriously hard to predict. In the near term, two important trends are worth noting. Firstly, emerging markets have proved to be remarkably resilient during the crisis. Only one region (Eastern Europe) has seen large net IFI inflows. This might indicate less future need for IFI lending, although it is yet too early to determine whether this greater resilience of emerging markets is structural. At the same time there is now an unprecedented increase in sovereign debt across the world. Although most of the increase is accounted for by advanced economies, less developed economies may find it more difficult to issue debt in the coming years as a result. Moreover, it might be possible that even advanced economies have to turn to IFI's. In fact, this has already happened in the case of Iceland, while Greece is now experiencing heavy fiscal strain as well. Even after the recent increases in lending volumes and capacity, IFI's contribution is dwarfed by the total size of international capital flows. Nevertheless, they can still make a huge difference at country or even regional level, as the joint IFI action plan for Eastern Europe has shown.

February 2010

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