

THE WAR IN IRAQ AND IMF REFORM

S. Brock Blomberg*

INTRODUCTION

On July 1 2002, I began my work for President Bush as the senior economist for international finance at the Council of Economic Advisers (CEA). "The CEA was established by the Employment Act of 1946 to provide the President with economic analysis and advice on the objective development and implementation of a wide range of domestic and international economic policy issues."¹ The name "Council" sounds as though there are a large stable of economists at the President's beck and call. In reality, there are actually only three members on the council with eight senior staff specialists like myself.² During my year of service, the CEA was given less attention by the Administration than was merited by our small size. The purpose of this essay is to explain how good intentions and good international policy are sometimes sacrificed for strategic interests. But mainly, I provide my (largely unheeded) advice on IMF reform.

Let me begin by providing some background on the good intentions of the administration prior to my arrival. On July 17, 2001, President Bush urged reform of the International Financial Institutions (IFI) including the International Monetary Fund (IMF), the World Bank, and other development banks, by calling for "compassionate conservatism at an international level."³ One way to make the world more stable and just, he said, was "to work in true partnership with developing countries to help them overcome obstacles to their development, such as illiteracy, disease, and unsustainable debt."⁴

The backbone of this call to reform came from a Congressional commission headed by Allan H. Meltzer, of Carnegie Mellon University, which provided a long list of recommendations early in 2000.⁵ The Meltzer Commission showed that, among other things, the

* Professor of Economics, Claremont McKenna College.

1. White House, Council of Economic Advisors, *available at* <http://www.whitehouse.gov/cea> (last visited May 26, 2004).

2. *Id.*

3. U.S. Dept. of State, Radio Address to the Nation (July 21, 2001) *available at* <http://www.state.gov/e/eb/rls/rm/2001/4188.htm> (last visited May 26, 2004).

4. *Id.*

5. Statement of Allan H. Meltzer on the Report of the International Financial Institution Advisory Commission (mar. 9, 2000), *available at*

IMF is largely failing in its mission to address economic stability.⁶ However, the Commission unanimously supported a proposal maintaining that the IMF continues to restrict short-term crises assistance.⁷ Why limit IMF assistance? Since the IMF provides funds to countries in need, the expectation of such assistance creates moral hazard or incentives that encourage reckless behavior and bad policies for countries. In other words, countries may not make necessary economic reforms because they believe that the IMF will bail them out during difficult times, especially if there is an important strategic interest in preventing a country from economic crisis.

This is not merely a theoretical consideration. Many analysts have pointed to the amount and persistence of capital flows to Russia before August 1998 as an example of why the IMF needs reform.⁸ They argue that this financial assistance went to a privileged few without making the economy more stable.⁹ On November 9, 2001, in the United States Treasury's Report on Implementation of Recommendations Made by the International Financial Institutions Advisory Commission, the Administration stated that "higher standards for qualification help mitigate potential moral hazard concerns related to the greater assurance of the ability to borrow."¹⁰

With this information in mind, I went to Washington believing that IMF reform was both beneficial and imminent. I left Washington having learned a valuable lesson – sometimes good economic policy is sacrificed when the political cost is too great. In the remainder of my essay, I lay out strategies for effective IMF reform that were largely ignored in the past and conclude with possible reasons why such reform was not made.

THE CASE FOR REFORM

The IMF is an international organization of 184 member

<http://www.gsia.cmu.edu/afs/andrew/gsia/meltzer/Statement-of-Allan-H.doc> (last visited May 26, 2004).

6. See Joseph Stiglitz, *Globalization and its Discontents*, Norton and Company, NY 2003..

7. Statement of Meltzer Commission report to Congress' Joint Economic Committee, available at <http://www.house.gov/jec/imf/meltzer.htm>.

8. See generally Michael Mussa, Alexander Suoboda, Jeromin Zettlmyer and Olivier Jeanne, "IMF Finance and Development" September 1999, Vol 36: Number 3.

9. *Id.*

10. See U.S. Treasury Office of Public Affairs, available at <http://www.ustreas.gov/press/releases/po876.htm>.

countries.¹¹ According to its articles of agreement, the purpose of the IMF is to promote international monetary cooperation, exchange stability, and orderly exchange arrangements; to foster economic growth and high levels of employment; and to provide temporary financial assistance to countries to help ease balance of payments adjustment.¹²

While the IMF is chartered to provide funds to encourage stability, the track record suggests that international moral hazard may be preventing the IMF from achieving its laudable goal. Since international risk spiked in the 1990s (see Table 1), 106 countries have been on IMF programs. Most countries have spent more time in a program than not and most countries have been in multiple programs despite increasing efforts to impose conditionality (see Figure 1).¹³

Increasing Financial Risks since Mid 1980s

Table 1

	1985	1989	1993	1997	2001
The IMF					
Total debt in arrears (bill \$)	0.14	13.93	03.03	03.03	0
# Countries in arrears:	14	11	13	27	45
Top 3/Total Exposure (%)	3036	40	60	53	53
The World Bank					
Total debt in arrears (bill \$)	0.1	3.82	52.22	22.4	22.4
# Countries in arrears	1	9	7	78	78

The Bigger the Loan, the Harder the Economic Fall

Figures 2 and 3 demonstrate that for those countries who received large IMF packages, more money did not lead to successful graduation from IMF programs. This means that they are the only two countries, Korea and Mexico, which received large packages and did not spend a

11. About the IMF at <http://www.imf.org/external/about.htm>.

12. Articles of Agreement of the International Monetary Fund, *Art. I*, available at <http://www.imf.org/external/pubs/ft/aa/index.htm> (last visited May 26, 2004).

13. This occurred even as structural conditions imposed on each program increased eight fold.

large portion of time in an IMF program.¹⁴ [Brazil, Indonesia, and Turkey are also exceptions, but are still on an IMF program (censored) and so their fate remains to be seen.] Even for Korea and Mexico, it is important to note other factors besides the IMF that helped each country. For Mexico, the U.S. intervention and loan guarantee surely had some affect on the outcome.¹⁵ For Korea, Kim Dae Jung's leadership was quintessential by moving to reform the banking sector and engage in corporate restructuring before he took power.¹⁶

IMF OPTIMISM LEADS TO OVER EXTENDED CREDIT

Since 1994, the IMF has announced 20 new large financing arrangements and has overestimated the ability to repay in practically every case.¹⁷ The IMF either over-estimated GDP growth or underestimated inflation, in every case but two. (See Table 1) On average, the IMF forecasted growth to be 3 percent higher than the actual outcome and forecasted inflation to be 19 percent lower. The bias, or degree to which the IMF over-estimated growth or under-estimated inflation, is highly related to the size of the package. Formal estimation shows that for every \$2 billion increase of IMF financing, GDP growth is over-estimated by 0.5 percent.¹⁸ Formal estimation also shows that this large increase in IMF financing has the estimated effect of a 6 percent increase on the probability that a country will return for more funds later.¹⁹

14. Figure 1 also demonstrates that Turkey, Indonesia and Brazil are outside the range. These cannot statistically be considered successes as it is still too early to determine the impact of the program given that the observations are right-censored. More to the point, one does not need statistical analysis to motivate the point that Brazil and Turkey are on sustainable trajectories.

15. For example, *see* Jeff Sachs "Do We Need an International Lender of Last Resort?" Frank Graham Memorial Lecture at Princeton University (April, 1995), *available at* <http://www.earthinstitute.columbia.edu/about/director/pubs/intllr.pdf>

16. For example, Kim Dae Jung met with Chaebols even before taking office to encourage restructuring. *See* Edward Graham, *Reforming Korea's Industrial Conglomerates*, Institute for International Economics, Washington, D.C., 2003.

17. *See* figure 3. In every case but Russia '99 and Indonesia '00, the IMF forecast was either too high for growth, or too low for inflation.

18. Admittedly, these regressions may suffer from few degrees of freedom (33) and omitted variable bias. Still, it is instructive that the impact of the IMF Loan/Quota on Bias is statistically significant at all conventional levels with a t-stat of 4.10.

19. Author's calculation using a simple probit model allowing financing to influence the probability of default.

IMF OVER-PREDICTS THE ABILITY TO REPAY FUNDS

The Potential Risks to the U.S. Taxpayer

In the previous section, I argued that reforming the IMF is beneficial for the developing world. In this section, I explain that reforming the IMF would be beneficial to the United States as well. To better illustrate this point, I provide a primer on IMF accounting and then relate the IMF balance sheet to the U.S. balance sheet to demonstrate that international moral hazard has an impact on the United States. I prove this by showing that the last transfer of wealth from the United States to the IMF did not improve the financial well-being of the IMF, but may have been a waste of US assets. Finally, I provide a menu of options for IMF reform.

IMF financing works as follows: countries maintain their quota of reserves and during balance of payment (BOP) crises, draw on resources through purchase-repurchase agreements called “reserve tranche positions.” The procedure is self-financed because each country borrows at a given interest rate and must repay the foreign currency.²⁰ Usable IMF assets are roughly \$230 billion with outstanding credit of \$75 billion and precautionary balances, which act as a cushion, of about \$7 billion.²¹ Yet, these transactions have little direct impact on the U.S. budget. After the initial stock of gold was given to establish the U.S. quota, the annual cost to maintaining the quota is actually quite small. Therefore, in 2001, the U.S. earned \$153 million in interest, but paid \$201 million in financing and currency adjustments leading to a net payment of \$47 million.²²

However, this does not mean that U.S. citizens are not liable. Previously, the United States made large transfers to the IMF without being scored on the budget.²³ For example, when the United States allocated an additional \$17.9 billion to the IMF in 1999, there was also

20. Administrative costs (\$450 million) are shared between creditors and debtors. The relative burden of these costs in the early 1980's was 25% to 30% for debtors, whereas creditors bore a 70% to 75% burden. These statistics are essentially counter-cyclical, so during the heavy growth years of the late 1990's it switched, with a 70% to 75% burden on debtors and a 25% to 30% burden on creditors.

21. IMF balance sheet *available at* <http://www.imf.org/external/fin.htm>.

22. *See* Quarterly Report to Congress on Financial Implications of U.S. Participation in the International Monetary Fund, *available at* <http://www.ustreas.gov/press/reports/feb2002/pdf>.

23. *See* Congress' Joint Economic Committee Statement, chaired by Jim Saxton, March, 1998, *available at* <http://www.house.gov/jec/imf.htm>.

no direct budget cost.²⁴ U.S. quota subscriptions involve an exchange of monetary assets between the Treasury and IMF and are not counted as budgetary outlays. There is also an obvious opportunity cost of transferring assets to the IMF. However, one might argue that such a transfer improved the financial health of the IMF and therefore had no net financial impact on United States.

One way to measure the health of the IMF is to compare its financial commitments (liquid liabilities) with available resources (net uncommitted resources), termed the liquidity ratio. Figure 4 (see Appendix) shows that the current liquidity ratio has fallen from its year 2000 peak and appears to be headed back to the point when the last quota increase occurred.

Figure 5 also depicts two counterfactuals - one in which there was no quota increase and another with a quota increase proportional to 3 percent per year.²⁵ If quotas had not been increased, the liquidity ratio would be practically zero, meaning that the IMF has drained all its 1998 resources. Under a more reasonable assumption of increasing quotas with the general trend of the economy (i.e., 3 percent per year), stabilization appears following the Asian and Russian crises, but took a turn for the worse in the last two years. It therefore does not appear that the quota increase made the IMF more financially sound.

On the contrary, the IMF employed the quota increase to over-extend itself to just a few countries, putting it in a precarious position if any of these countries default. Figure 5 depicts the results from an analogous exercise by looking at liquidity ratio of top indebted countries (e.g. Argentina, Brazil, and Turkey) ignoring all other loans and assuming the full amount is drawn. This shows again that quota increases have not been used to improve the liquidity of the IMF.

So, what would happen if a country defaulted on a large loan? Credit outstanding, as of February 6, 2003, is roughly \$75 billion of which Argentina, Brazil and Turkey owe \$68 billion.²⁶ The remaining

24. See S. Res. 2334, 105th Cong. (1999) (enacted). The \$17.9 billion consisted of \$14.5 billion for the United States' quota increase and \$3.4 billion for a backup line of credit for the fund. One quarter of that \$14.5 billion quota increase, or about \$3.6 billion, was actually transferred to the IMF and the rest was put in a letter of credit, which the IMF could draw on as needed.

25. For each case, I assume size does not matter and therefore the amount borrowed is unaffected by the size of the quotas. This may be a restrictive assumption, but deriving the demand for loans would require similar heroic assumptions.

26. These three countries have similar loans, with Moody's giving Argentina the lowest possible rating of a "Ca" and rating Brazil and Turkey as "B1," each below what is considered "investment grade." Moody's Sovereign Debt Rating, various issues. Researchers at Moody's show that a company rated in the C range over five years has a 50%

countries have much smaller loans, so precautionary balances are sufficient to compensate losses. However, if any of the three larger loans went into default, the situation is more troubling as there are no sufficient precautionary balances to offset such a default. This is a very important area in which the IMF and the United States need reform.

I believe there are three options to finance a large default.

The first of these options is to employ the interest-burden sharing mechanism. In this scenario, those countries with larger shares would have larger burdens.²⁷ A default of \$20 billion (i.e., \$4 billion less than Turkey's profile) would cost the U.S. \$2.5 billion over the next five years (unless more burden is shifted towards the debtor). The challenges are: A) the spread between what a country may receive and what a country may charge is limited [tranche rate can be a maximum of 80% of lending rate]; B) the agreement requires a 70 percent majority vote; and C) the burden-sharing mechanism is too severe for debtor countries. Hence, there is not enough interest-sharing available to cover such a default.

The second option is to pay for this one-time loss with unused capital such as gold. The challenges associated with this option include: A) valuing gold as \$8 billion on the books when its actual worth is \$31 billion at current market prices, which of course might decline on the news of a large sale by IMF. Moreover, drawing down gold reserves is a one-time solution unless there is a policy to replenish the gold;²⁸ and B) it requires a 70 percent majority agreement. While there is no direct cost to the United States, such a large scale sale of gold is unlikely to be an acceptable option.

The third and final option is to tap into the portion of assets that are usable, and then require countries to replenish their quotas accordingly. The burden would then be directly proportional to their quota share. Therefore, the direct cost to the United States would be \$5 billion over five years. Such action would demonstrate that the \$17.9 billion quota increase in 1999 should have been scored on the U.S. budget and should change the manner in which IMF is funded. If the United States moved to an on-budget facility, accounting for a large loan would depend on

probability of default and companies in the B1 range have a 25% probability. Both Brazil and Argentina have had "B1" ratings for five years, and Argentina has had "C" range ratings for two years. *Id.*

27. For example, the US is responsible for about 25% of the creditor cost with the G-7 totaling about 60%.

28. This has been done in the past when a trust fund was established for Poverty Reduction and Growth Facility (PRGF) [36 countries totaling \$7 billion], and Heavily Indebted Poor Countries Initiative (HIPC) [27 countries totaling \$1 billion].

the terms, conditions, and credit rating of the country. Hypothetically, an analogously large 10-year loan to a country like Turkey at treasury interest rates +200 basis points for first five years, then graduated to treasuries +500 basis points with a 4-year grace period would cost the United States by slightly over \$1 billion using the U.S. government's credit-rating methodology. This is the best option, and one that has never been considered.

CONCLUSION

The purpose of this essay has been two-fold. First, I intended to demonstrate that IMF reform is necessary and even provided a menu of options on how the United States might encourage such reform when financing a large scale default. Second, I intended to provide an explanation of why such reform has not occurred and is unlikely to occur in the near future.

Much of economics is about maximizing objectives subject to constraints. In the case I have described, the constraint is largely political. It is very difficult to mobilize interest in reforming the IMF during times of crisis such as the War in Iraq. I believe IMF reform requires moving to a system where the cost to the U.S. taxpayer from IMF assistance is made transparent. This means that the U.S. taxpayer would be made directly responsible for loans made to our allies or loans made during war to prevent additional financial crises. If such reform were to occur, the U.S. taxpayer would likely discourage lending that works at cross-purposes to the strategic goal. Once the War in Iraq occurred, any chance at true reform was pre-empted as focus was shifted away from such reform, especially because it would make these economic costs more transparent to the U.S. taxpayer. To this end, the War in Iraq has cast a long shadow on international economic policy.

So, what has occurred in the place of reform? Countries like Argentina continue to suffer as the IMF continues to send mixed messages about its seriousness for structural reform. The United States taxpayer continues to be liable for non-performing loans by countries such as Argentina, but due to the fiction of current U.S. accounting, the U.S. is unaware of the risk. Finally, the IMF continues to be in denial about its portfolio which is not without risk.

Figure 1:

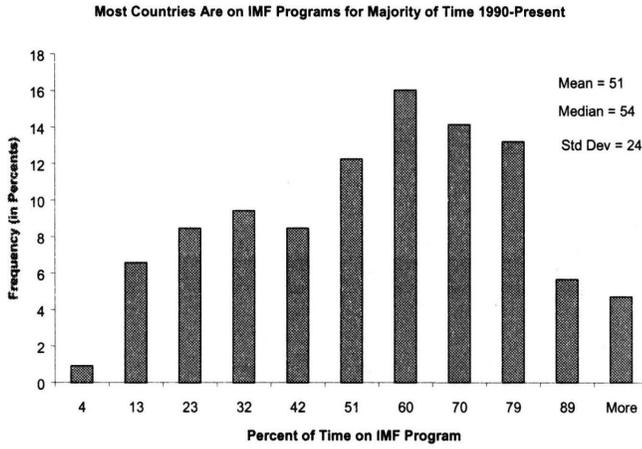


Figure 2:

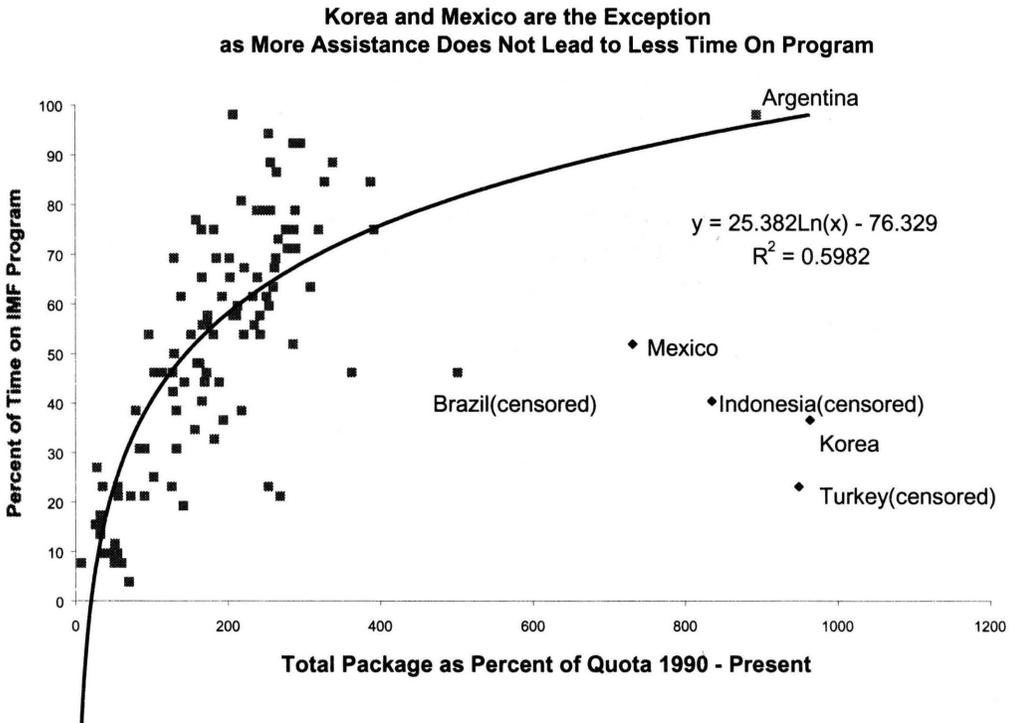


Figure 3:

Country	Date Announced	\$ Billions	% of IMF Quota	Forecast - Actual Growth	Forecast- Actual Inflation
Mexico	Feb-95	17.80	689	7.1	-33.0
Russia	Apr-95	5.61	94	-5.0	-47.0
Thailand	Aug-97	3.90	505	3.9	1.9
Indonesia	Nov-97	10.10	490	0.5	-0.3
Korea	Dec-97	21.00	1938	9.1	1.2
Russia	Jul-98	17.10	306	4.0	-77.7
Indonesia	Aug-98	7.00	337	17.2	-55.7
Ukraine	Sep-98	2.50	182	1.0	0.0
Brazil	Dec-98	18.30	600	-1.8	-17.8
Mexico	Jul-99	2.52	98	-0.7	-11.1
Russia	Jul-99	4.29	72	-5.2	6.6
Indonesia	Feb-00	4.73	225	-1.3	0.5
Argentina	Dec-00	13.70	500	-0.7	-14.0
Turkey	Dec-00	7.50	602	7.1	-53.0
Turkey	May-01	19.00	1556	6.4	-16.0
Argentina	Aug-01	21.70	797	3.2	-1.8
Brazil	Aug-01	15.60	400	0.7	-1.7
Turkey	Feb-02	16.00	1328	1.1 ^P	-12 ^P
Uruguay	Jun-02	2.30	571	8.4 ^P	.7 ^P
Brazil	Aug-02	30.00	750		
Average		12.03	602	2.7	-19
For 22 Recidivist Countries		B Credit Rating			
For 14 Non-Recidivist Countries		BB- Credit Rating			

Figure 4

Figure 1: Factual vs. Counterfactual Liquidity Ratios of IMF

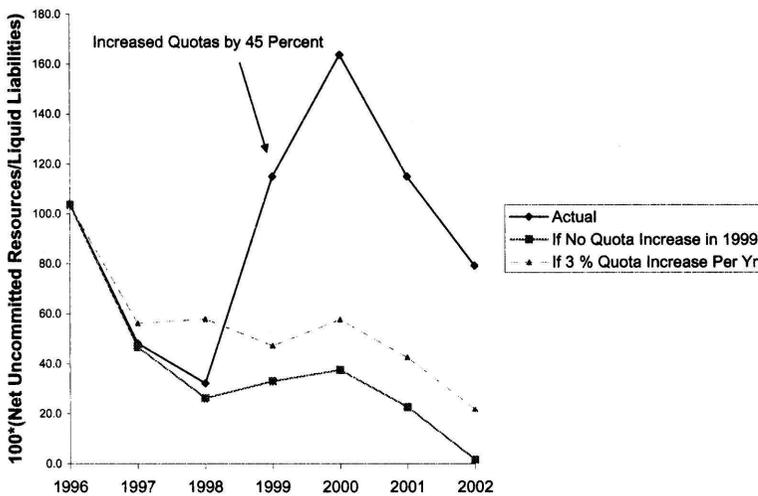


Figure 5:

Figure 2: Factual vs. Counterfactual Possible Liquidity Ratios of Top 3 Debtors in IMF

