

Master PPD M1

2008 / 2009

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# Lecture16 – Bretton Wood institutions

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# Outline of the lecture

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- **Why do we need BW institutions (IMF and WB)?**
  - What kind of?
  - How should they work?
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# Institutions and markets

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- ❑ Market failures?
  - ❑ International financial markets (asymmetry of information): financial crises (not after 2001), credit rationing
  - ❑ Prisoner's dilemma: the competitive devaluations of the 30s led to a collapse of the international trade
  - ❑ Capital does not flow from rich to poor countries (Lucas Paradox)
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# IMF 1944

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- Stability of the international financial system (= fixed exchange rates, \$-gold based)
  - “With the collapse of BW in 1971, the original function for which IMF was established simply disappeared. But instead of closing down, the IMF turned itself into a junior WB” Milton Friedman, (in Killick 1995).
  - Unclear if IMF may be described as a lender-of-last-resort (LLR) (monitoring, supervision power, resources)
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# Is an international LLR needed?

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- Emerging countries: problems with lender-of-last-resort (LLR) operations:
    - Credibility of the Central Bank as an inflation fighter may be in doubt
    - Debt contracts are typically short term and denominated in foreign currencies
  - LLR operations:
    - may exacerbate the crisis (by fears of inflation spiralling out of control, causing currency depreciation and greater deterioration of balance sheets).
    - as well as alleviate it
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# International LLR

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- ❑ An international LLR helps stabilizing the domestic currency, strengthening the balances sheets and preventing contagion
  - ❑ Strong case for an international LLR
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# Problems with international LLR

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- Ready to bail out irresponsible financial institutions lay result in excessive risk taking, making financial crises more likely (moral hazard problem)
  - Example: Alan Meltzer, head of Congressional Commission: the IMF lending during the 94 Mexican crisis led to Asian 97 crisis) (creditors expecting bail out)
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# LLR and Bankruptcy at the international level

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- ❑ Governments are more and more financed by markets (bonds) not banks
  - ❑ Governments don't go bust.
  - ❑ The IMF tried to create a framework for an equitable debt restructuring that restores sustainability and growth, without including incentives that increase the risk of default : the Sovereign Debt Restructuring Mechanism (SDRM)(A.Krueger 2003)
  - ❑ No success (US Treasury opposed)
  - ❑ Instead: Collective Action Clause allows a supermajority of bondholders to agree a debt restructuring that is legally binding on all holders of the bond, including those who vote against the restructuring
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# Bailing out or preventing crises

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- Preventing is better, (much) less expensive
  - Problems:
    - Crises are different: three generations + a new one (the current financial crisis)(More on next slide)
    - Can we rely on early warning indicators?
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# Different types of crises

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- First generation (Krugman 79): Before exhaustion of reserves, misalignment of Xrate (fixed) according to fundamentals
  - Second generation (Obstfeld 94, 96): Speculation as a Self-fulfilling prophecy (namely in case of contagion), even if fundamentals are right. Anti-contagion instruments are needed.
  - Third generation (Asia 97) financial/Xrate crises. Change in Xrate result in illiquidity of the financial system (bankruptcies and credit crunch)
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# Development Finance

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- Original objective (standstill of capital flows after WWII):
    - 1944: Credit (projects financing) at market rate for reconstruction and development (IBRD)
    - 1960: Concessional lending for LICs
  - Problems we face today:
    - Emerging countries: volatility of private flows, contagion
    - LICs: Credit rationing
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# Outline of the lecture

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- Why do we need BW institutions?
  - **What kind of?**
    - Legitimacy vs Power
    - Accountability
  - How should they work?
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# Are IMF and WB doing the same job?

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## □ IMF: A Junior WB?

- IMF engaged in lending to LDCs after the first oil shock
- IMF engaged in concessional lending (SAF, ESAF, PRGF)

## □ WB: tackling macro issues

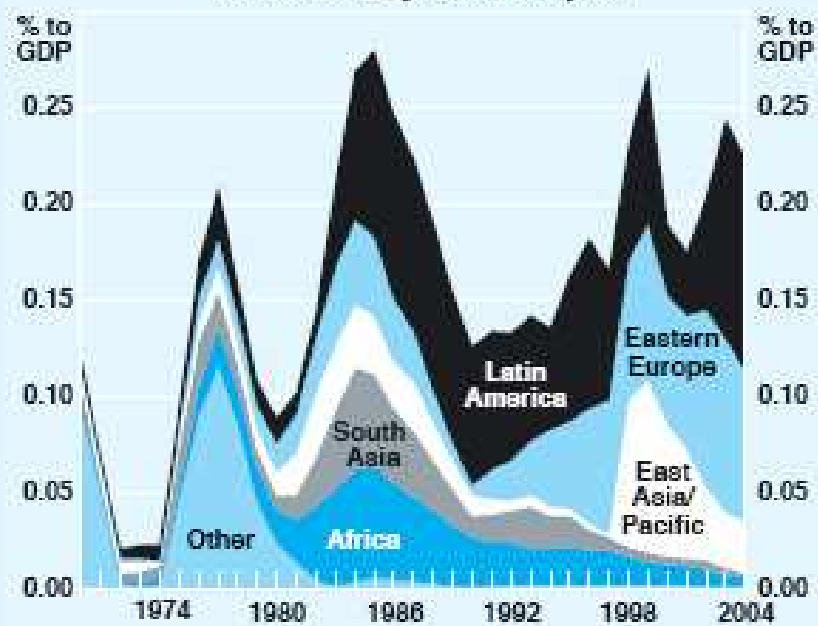
- The problem with project lending
  - Cross conditionality
  - Sectoral vs Macro: does it work?
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# Resources

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- IMF resources are low (and international capital flows increasing very fast).
    - General Resource Account depends on quotas
    - SDRs creation is very limited
    - In case of crises, money comes also from the US Treasury
    - The very role of IMF is signalling
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**IMF Credit Outstanding – Relative to World GDP**  
IMF financial year (end April)



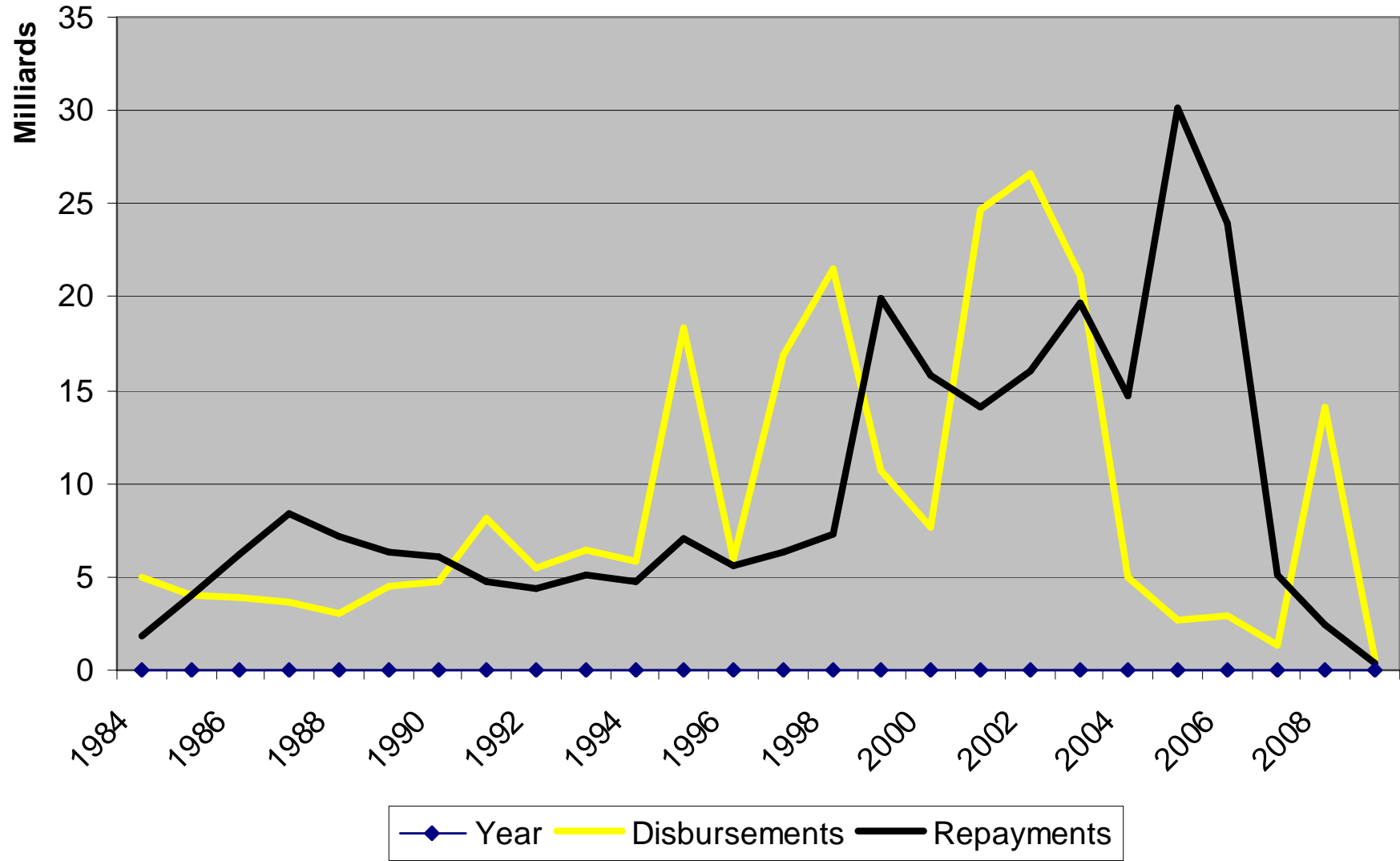
Source: IMF

**Value of IMF Arrangements Approved**  
IMF financial year (end April)



Source: IMF

### IMF Disbursements/Repayments (to Feb 28, 2009)



# IMF Resources Q3 2008

## Available Resources

### GRA

<b>Usable resources</b>	<b>163.2</b>
<b>Uncommitted usable resources</b>	<b>162.4</b>
<b>Repurchases one-year forward</b>	<b>0.2</b>
<b>Prudential balance</b>	<b>34.9</b>
<b>One-year forward commitment capacity (FCC)</b>	<b>127.8</b>

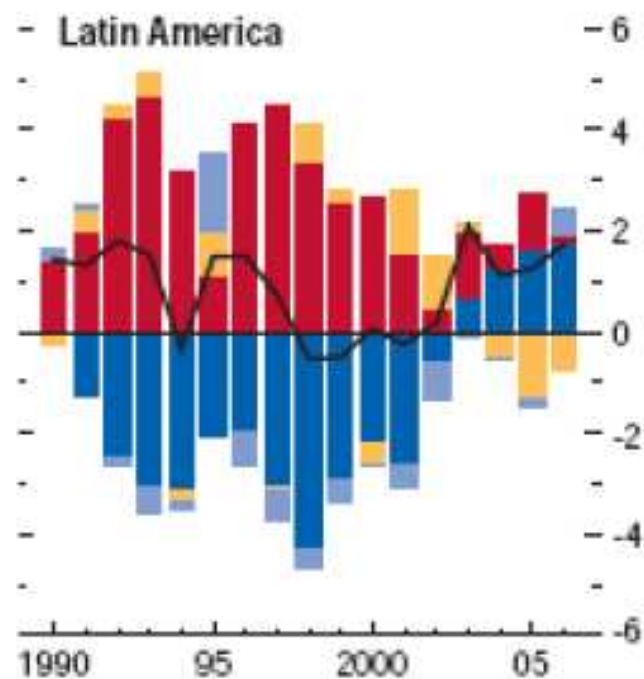
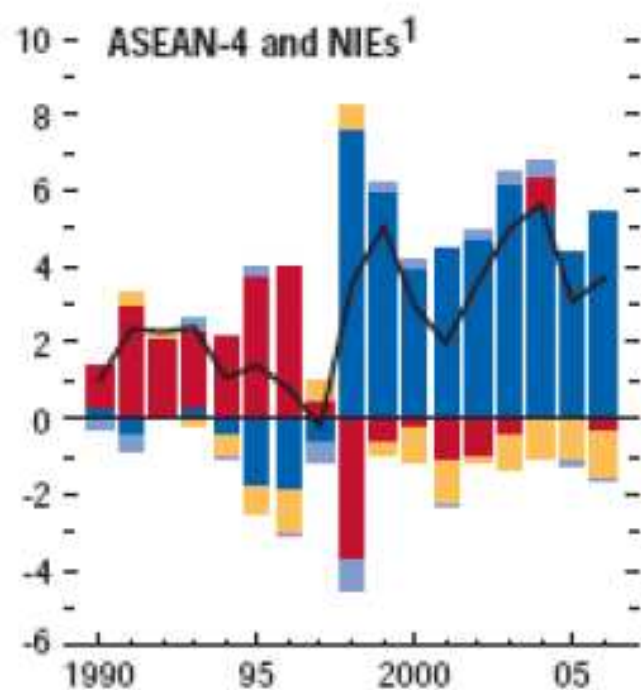
### PRGF-ESF Trust

<b>Total loan resources</b>	<b>15.8</b>
<b>Cumulative commitments, net</b>	<b>13.7</b>
<b>Of which: Cumulative disbursements</b>	<b>13.2</b>
<b>Uncommitted loan resources</b>	<b>2.0</b>

# Resources: WB

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- ❑ IBRD Outstanding loans: \$ 100 B (capital: \$ 189 B) (end 2005)  
Lending: US\$11 billion/year in 40 countries
  - ❑ IDA Outstanding loans: \$127 B (end 2005). Lending: about US\$9 billion in annual interest-free credits in 2002-2007 in 55 countries.
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- Current account
- Net private capital flows
- Net official flows
- Errors and omissions
- Change in reserves

# Power and Money

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## IMF: Quotas

- Quotas are calculated according to GDP, trade
- Voting power depends on quotas + on the structure of the Board of Governors (directors)
- Access to IMF resources depend on quotas

## More money is likely to modify the balance of power

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# Examples (5/31/2008):

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	Quota	% of quotas	% of votes
USA	\$37 B	17.1%	16.8%
Mali	\$93 m	0.04%	0.05%
Total	\$ 352 B		

Majority vote: 85%

Europe (even Eurozone > US) but not unified

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# Governance: Lack of legitimacy

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- Reform of quotas (2006): more power to emerging countries, not to LICs
    - Should the Managing Director always be European?
  
  - Further reform: one country, one vote (UN?)
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# Governance and Accountability

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- Accountability to shareholders
    - Results in darling-pushing
  - Financial responsibility
    - From Senior Creditors (an incentive to loan pushing) to
    - Debt relief (1996 HIPC, 1999, EHIPC, 2005, MDRI) : BWI bailed out by G8 members
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# WB

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- IBRD and markets:
    - Public or private? Example PPPs
    - Better economic management, low spreads and ...no need of a public institution
    - countercyclical? Resources?
  - IDA
    - Concessional Loans or Grants ? Amounts, incentives, Countercyclical devices.
  - Alan Meltzer Commission: only grants, only LICs
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- Why do we need BW institutions?
  - What kind of?
  - **How should they work?**
    - Quick
    - Relevant
    - Effective
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# Quick?

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## □ IMF Problems:

- Information
  - Conditionality
  - Negotiations and strategic behaviour
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# Information

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- ❑ Art 4, Norms and Codes
  - ❑ Information is slow, not always relevant (misreporting: example Mauritania)
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# International LLR

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- Limit moral hazard problems : IMF should make it clear, that it will extend liquidity only to Gov that put the proper measures in place to prevent excessive risk taking
  - Problem; strategic behaviour of Gov: if IMF wants to avoid extreme hardship and political instability, politicians may exploit these concerns and resist necessary reforms, hoping IMF will cave in (example: Russia).
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# How should IMF operate?

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## Macro or Micro?

Focus on macro budget imbalances (unpopular) or micro (problems in the finance sector) (helping hand)

## Quick!

LLR have to engage very quickly (one day in the case of the Fed). IMF slow, negotiate conditions; should be prepared in advance to bail out countries provided they meet in advance some conditions like:

Properly supervising its banks or keeping budget deficit low) : 1999 Contingent Credit Line

Flexible Credit Line 2009

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# Is IMF macro framework relevant?

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- Conceptual framework: Polak Model, Monetary Approach of the BoP, Financial Programming
  - An extreme monetarist approach of the BoP
    - GDP in the short run depends only on supply (factors+TFP). Increases in demand result in inflation
    - Excess money creation results in BoP imbalances.
    - Excess Government expenditure results in excess money creation and/or crowding out of private sector
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# Policy advice

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- ❑ Current account liberalization: Asia 97
  - ❑ Focus on government spending: Asia 97 (Stiglitz)
  - ❑ Focus on exchange rate management: Argentina 2001
  - ❑ Stabilization with growth?
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# Effective

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## □ Conditionality

- Difficult to manage: too many, too difficult too assess, sanctions not credible.
- Usually does not work (Killick: a tiger without teeth) (Burnside & Dollar, 1999)
- Reform (selectivity): less conditions, more focus on core reforms

## □ Example: Burkina Faso

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**Table 2. Burkina Faso: Quantitative Performance Criteria and Indicative Targets, 2009**

(CFAF billions, cumulative from beginning of year)

	2008	2009			
	Proj.	Mar. <sup>5</sup>	Jun. <sup>6</sup>	Sep. <sup>5</sup>	Dec. <sup>6</sup>
	Projections				
<b>Performance criteria and indicative targets</b>					
Ceiling on the overall fiscal deficit including grants <sup>1</sup>	195.6	57.0	72.3	127.0	187.3
Ceiling on the amount of new nonconcessional external debt contracted or guaranteed by the government <sup>2,3</sup>	0.0	0.0	0.0	0.0	0.0
Ceiling on the amount of new external debt of less than one year's maturity contracted or guaranteed by the government <sup>2,3</sup>	0.0	0.0	0.0	0.0	0.0
Accumulation of external arrears <sup>2</sup>	0.0	0.0	0.0	0.0	0.0
<b>Indicative targets</b>					
Government revenue	475.0	125.1	283.8	403.0	524.7
Poverty-reducing social expenditures	195.0	45.4	106.0	164.4	216.4
Large taxpayer non-filer rate <sup>4</sup>	7.0	7.0	7.0	6.0	5.0
Accumulation of domestic arrears	0.0	0.0	0.0	0.0	0.0
<b>Maximum upward adjustment of deficit ceiling including grants due to:</b>					
Shortfall in grants relative to program projections	25.0	25.0	25.0	25.0	25.0
Excess in concessional loan financing relative to program projections	15.0	15.0	15.0	15.0	15.0
<b>Adjustment factors</b>					
Shortfall in grants relative to program projections	0.0	0.0	0.0	0.0	0.0
Excess in concessional loan financing relative to program projections	0.0	0.0	0.0	0.0	0.0
<i>Memorandum items:</i>					
Grants	219.1	54.3	116.8	179.3	232.3
Concessional loans	160.2	36.9	73.7	110.6	162.1

Sources: Burkinabè authorities; and IMF staff estimates and projections.

<sup>1</sup> The ceiling on the overall fiscal deficit is to be adjusted in line with the TMU definition. It is calculated on a commitment basis.

<sup>2</sup> To be observed continuously.

<sup>3</sup> Excluding Treasury bills and bonds issued in CFA francs on the regional West African Economic and Monetary Union (WAEMU) market. This ceiling excludes supplier credit with a maturity of one year or less.

<sup>4</sup> Applies to average over respective quarter.

<sup>5</sup> Indicative target.

<sup>6</sup> Performance criteria.

**Table 3. Burkina Faso — Structural Conditionality for the Period October 1, 2008–  
December 31, 2009**

Measures	Deadline	Performance criterion/benchmark
<b>Tax policy and Tax administration</b>		
Submit to Cabinet detailed proposals concerning the reform of business tax, the investment code, and VAT, based on the IMF's recommendations, the overall tax policy reform strategy, and WAEMU directives (MEFP ¶20)	April 30, 2009	Structural benchmark (fourth review)
Submit to National Assembly the tax policy reform including measures on VAT, business tax, and the investment code, to take effect with the 2010 budget (Text Table 1). On the VAT, incorporate into the budget the higher thresholds for small, medium, and large enterprises in January 2010, and make small enterprises liable for simplified taxation instead of VAT, in accordance with IMF recommendations and WAEMU directives (MEFP ¶20)	October 31, 2009	Performance criterion (fifth review)
<b>Customs administration</b>		
In Q4 2008, assign at least 30 percent of customs declarations to green and blue channels and keep below 10 percent the proportion of returns thus selected but assigned to inspectors for additional controls (MEFP ¶17).	December 31, 2008	Benchmark (fourth review)

## Public financial management and governance

Prepare an action plan to improve the effectiveness of ex-ante and ex-post expenditure controls, including the elimination of redundant procedures (MEFP ¶23).	December 31, 2008	Benchmark (fourth review)
Ensure the operational implementation of a general system for the tracking of poverty-reducing spending incorporating all domestically funded expenditures except for salaries (MEFP ¶14).	February 28, 2009	Benchmark (fourth review)
Submission to Cabinet of plan to clear outstanding payments identified in the domestic debt audit. (MEFP ¶15 ).	March 31, 2009	New benchmark (fourth review)

## Financial sector

Submission to Cabinet of financial sector action plan with timetable of reforms. The action plan, based on the FSAP recommendations, will cover the following areas: (i) facilitating cotton sector financing; (ii) reducing government ownership in the banking sector; and (iii) improving microfinance supervision (MEFP ¶24).	March 31, 2009	New performance criterion (fourth review)
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## Cotton sector

Conduct financial an audit of SOFITEX with a view to supporting transparency and privatization (MEFP, par. 26).	March 31, 2009	New benchmark (fourth review)
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# References

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- IMF Institute: *Financial Programming and Policy, the Case of Turkey*, 2000, IMF, Washington.
  - Killick, *IMF Programmes in Developing countries, design and impact*, Routledge 1995.
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