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Daily Observations
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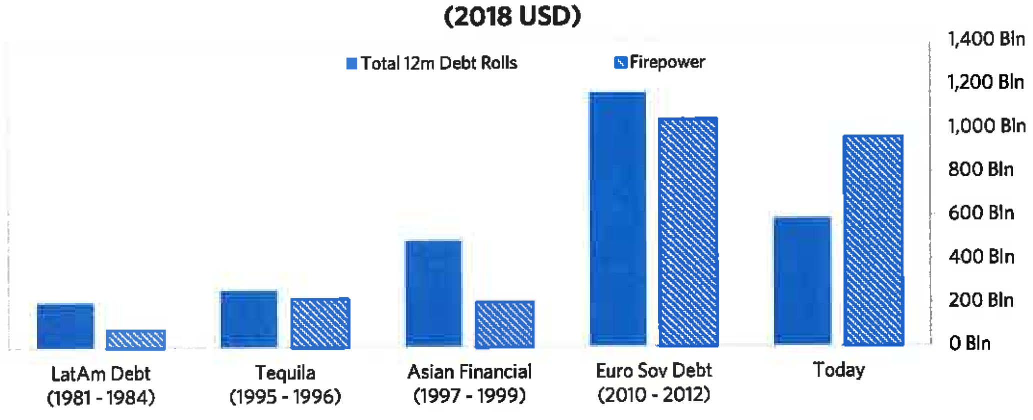
Will the IMF Be Able to Play Its Critical Role?

Looking across the many historical balance of payments crises, they tend to follow a typical script. The bottom is often formed when monetary policy is tightened enough and the currency is depreciated to bring consumption back in line with incomes; and an international bailout (often, but not necessarily from the IMF) is extended, which provides capital and credibility to the country in need. As we move through a Fed tightening, emerging market balance of payments strains surface as a consequence, and as anti-globalist sentiment in the developed world challenges the consensus about international institutions, it is natural to ask whether the IMF will be able to operate in its historical role as international lender of last resort and enforcer of disciplined economic policies. To us, answering this question will be an important factor in assessing how systemic today's challenges to emerging economies will prove to be.

In today's *Observations*, we will walk through the resources available to the IMF, the size of the funding needs we see today, and political risks to the IMF's role as a backstop, as well as provide some perspective on market and economic conditions following IMF programs. Following the global financial crisis and the European debt crisis, the IMF's financial capacity was bolstered, giving the IMF around $1 trillion of available resources. However, the IMF has historically deployed those resources by finding consensus among its key member states, which always had some political elements to it—both from the borrowers' and the lenders' perspectives (where the US has veto power). Today's political backdrop may make deployments more challenging. And going forward, it will be interesting to see whether the IMF members renew their commitments to this process and framework. A sizable portion of the IMF's resources has been pledged only through the end of 2019, and there will be meetings starting in the spring to decide whether and under what conditions these resources will be extended. One can easily imagine these conversations putting a spotlight on the willingness of the US and others to continue the high levels of support for the IMF. The chart below gives some perspective on the resources that may be available to the IMF relative to the needs (proxied with the amount of foreign-held debt rolls over the next 12 months for the vulnerable economies).

Historical Needs vs Firepower
(2018 USD)



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For context, we show how we screened for EMs at risk today in the table below. We discussed the risk of contagion in more detail in our August 23 *Observations*.

Today: Emerging Market Susceptibility

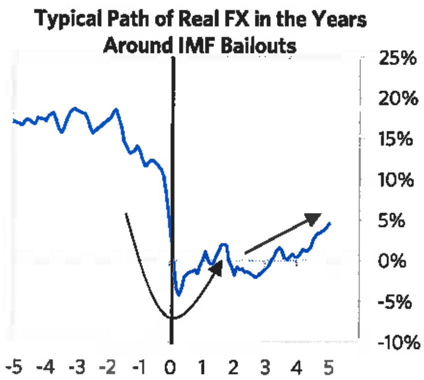
	Reliance on Foreign Capital				Ability to Manage				
Country	Current Account (%GDP)	Financial Inflows (%GDP)	Hard FX Ext Debt (%GDP)	ST Ext Debt (%Total Ext)	FX Pegged or Heavily Managed	Net Reserves (%GDP)	Ext Debt in Local FX (%Total)	Aggregate Susceptibility	
Argentina	-5%	9%	31%	10%	No	3%	13%	Very High	EMs "at risk"
Turkey	-7%	3%	45%	16%	No	1%	6%	Very High	
Chile	-1%	4%	54%	14%	No	19%	8%	Med	
South Africa	-3%	7%	19%	--	No	11%	59%	Med	
Indonesia	-2%	1%	25%	8%	No	6%	15%	Med	
Brazil	-1%	1%	28%	6%	No	14%	4%	Med	
Hungary	3%	-2%	59%	25%	No	8%	23%	Med/Low	
Poland	0%	-1%	49%	11%	No	13%	--	Med/Low	
Malaysia	4%	4%	55%	24%	No	17%	15%	Med/Low	
Czech Republic	1%	-1%	68%	32%	Yes	51%	--	Med/Low	
Taiwan	14%	4%	26%	23%	No	58%	--	Med/Low	
Mexico	-1%	2%	25%	7%	No	10%	25%	Med/Low	
India	-2%	5%	13%	5%	No	12%	36%	Med/Low	
Philippines	-1%	0%	17%	5%	No	19%	3%	Low	
Peru	-1%	1%	27%	7%	No	19%	--	Low	
Thailand	12%	2%	19%	13%	No	40%	35%	Low	
Russia	3%	-1%	22%	6%	No	21%	27%	Low	
South Korea	5%	2%	20%	8%	No	26%	27%	Low	

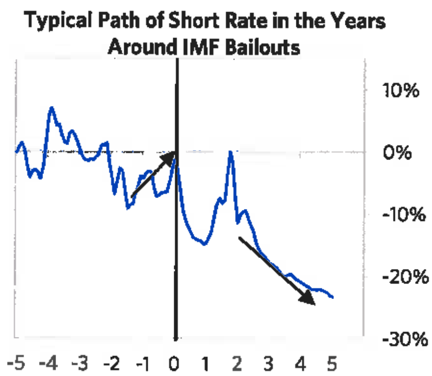
IMF Programs Typically Contribute to Bottoms in Economic and Market Conditions

One of the reasons we're monitoring the ability of the IMF to act as a backstop is that it has historically often played a key role in alleviating balance of payments strains. As one way of seeing this, both market and economic conditions have typically improved almost immediately following aid packages. Getting a big cash infusion and being forced to enact more disciplined economic policies typically support growth, the currency, and domestic asset prices, though of course they are not the only drivers.

Below, we look at the market and economic conditions around the main IMF bailouts from 1985 to today. The first set of charts shows that markets recover almost immediately after the bailout announcement (t=0): the currency stabilizes at more competitive levels, central banks are able to ease monetary policy, credit spreads tighten, and equities markets rally.

Market Impact





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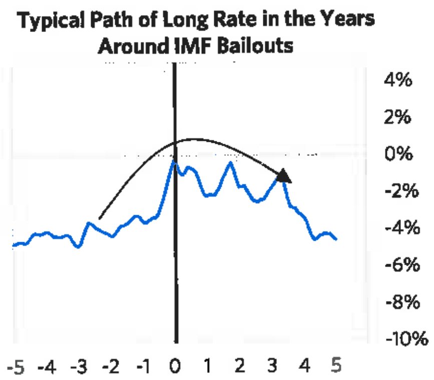
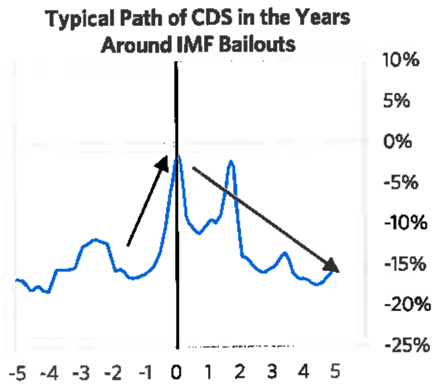
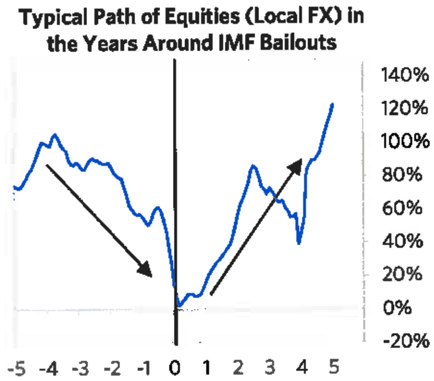
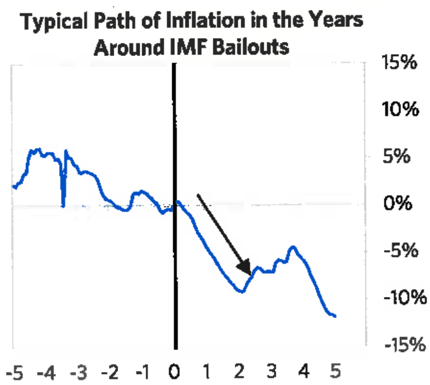


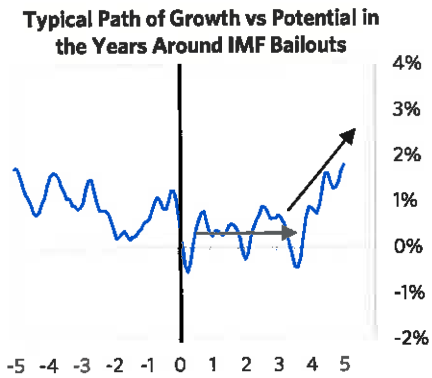




When we look at the real economy, we see a similar picture—economic activity quickly recovers to its pre-crisis level, inflation comes down as the currency stabilizes, and external imbalances close. That said, as with market behavior, it is unclear how many of these changes are due to the IMF's actions, and there's a wide range of circumstances and outcomes across cases.

Impact on the Economy





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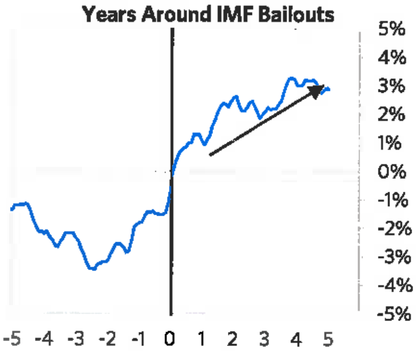
Typical Path of Current Account in the Years Around IMF Bailouts



Below, we walk through the resources available to the IMF, as well as the political hurdles to deploying them.

The IMF Has a Lot of Firepower, but Roughly Half Has to Be Renewed in 2019

The IMF vastly increased its firepower in the wake of the European sovereign debt crisis, and it now has around $1 trillion in funds available to lend. However, while ~$260 billion are by and large available on demand, the rest is more contingent and expires between 2019 and 2022. Below is the breakdown of the IMF's current resources:

- **~$260 billion of "ready cash":** This pool of resources comes from the currency "quotas" that each member country deposits with the IMF, is held on the IMF balance sheet, and is essentially available on demand with the approval of the IMF board. The decision to use these funds has historically been consensus-driven and made by technocrats, but of course can be influenced by political considerations.

- **~$220 billion in multilateral borrowing arrangements:** This pool of resources comes from multilateral arrangements established with 40 of the IMF's member countries. To put these funds to work, the arrangements need to be activated first, which requires a consensus of 85% of the creditor countries. In addition, these arrangements are set to expire in November 2022.

- **~$440 billion in bilateral borrowing arrangements:** This pool of resources comes from additional bilateral arrangements between the IMF and its member countries, mostly through national central banks. To be used, they need both activation, as in the previous case, and all other resources available to lend need to fall below $140 billion. These arrangements are set to expire by the end of 2019 and can be renewed for a year if the creditor countries agree.

The table below shows the composition of the IMF's resources in more detail.

	SDR Bln	USD Bln
First Line: "Real Cash"		
Funds on the IMF Balance Sheet	468	655
(-) Credit Outstanding	(49)	(69)
(-) Funds of Countries Unable to Lend	(70)	(98)
Usable Funds	349	489
(+) SDR Portfolio	26	36
(+) Pre-Committed Credit Lines	3	4
Total Usable Resources	378	529
(-) Resources Committed but not Drawn	(111)	(155)
(-) Liquidity Buffer	(80)	(112)
(-) Net Borrowings Coming Due	1	1
Net Credit Capacity ("Ready Cash")	**188**	**263**
Second Line: Commitments that Need Activation		
Multilateral Borrowing Arrangements (NAB)	182	255
(-) Already Borrowed	(20)	(28)
(-) Pre-Committed Credit Lines	(3)	(4)
Net Multilateral Borrowing Arrangements	159	223
Third Line: Commitments that Need Activation and Other Funds to Fall Significantly		
Bilateral Borrowing Arrangements	316	442
Total Firepower		
Total Firepower	663	928

The IMF Disbursement Process Has Typically Been Technocratic, but Politics Could Play a Bigger Role Going Forward

The IMF's decisions are made through a consensus-driven decision-making process among key members, and so are inherently informed by politics on some level. As populism becomes a bigger factor in the developed world, we see a rising risk that politics may influence this process more than in prior cases. This may limit the extent to which the IMF can play its crucial role as lender of last resort going forward.

This tension may come to the fore in mid to late 2019 during the IMF's 15th quotas and governance review, and just before a sizable amount of the IMF's firepower is set to expire. The IMF board wants to preserve its current level of financial resources and protect against the "cliff edge" (the expiration of borrowing arrangements with 40 member states). It is also seeking to increase the "ready cash" portion of its firepower, which concomitantly requires the review of member states' voting shares. This will be welcomed by some countries (such as emerging economies and China) and will likely be problematic for others—for both budgetary/fiscal considerations and for reasons connected to power preservation. For example, European countries, on the hook for much of the bilateral borrowing arrangement after the Eurozone debt crisis, face domestic pressures against increasing IMF quotas and as a result could see their voting power diminished. The Trump administration, already ill-disposed to international institutions, may be more so in the run-up to the 2020 presidential elections; and the US has veto power on all important IMF decisions.

The table below walks through the political hurdles we see.

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Political Hurdles to Using IMF Firepower

First Line: "Ready Cash"

Amount: $263 billion

What it is: Member states pay their quotas in currency, which is held on the IMF's balance sheet as account balances or non-interest bearing promissory notes that are encashable by the IMF on demand.

Hurdles: **Low Stringency**

- Disbursement requires board approval, where the USA has the only veto power based on its current voting share. In practice, however, the IMF has traditionally reached decisions by consensus.

Second Line: Multilateral Borrowing Arrangements (NAB/GAB)

Amount: $223 billion

What it is: Credit line arranged with 40 countries and available upon activation. Currently not active. To be activated, it requires the consent of participants representing 85% of the total credit pool.

Hurdles: **Medium Stringency**

- Currently inactive and it requires activation by the 40 creditor countries to be used.
- Once active, it will remain active for 6 months and can be extended if renewed.
- Agreement expires in November 2022. Renewal may pose challenges: in the USA, for example, as it requires congressional approval and may be difficult for fiscal/budgetary reasons as well as power preservation.

Third Line: Borrowing Arrangements Lines

Amount: $442 billion

What it is: Bilateral loan and note purchase agreements with countries and central banks. Currently not active. To be activated, it requires consent of participants representing 85% of the total credit pool and can only be used if the amount of other resources available for lending (first and second line) have fallen below $140 billion.

Hurdles: **Higher Stringency**

- Currently inactive and it requires activation to be used.
- Agreements to expire at the end of 2019 and could be extended to the end of 2020 if countries agree. Renewals may pose challenges: the majority of funds was committed by central banks during the sovereign debt crisis, and especially by euro area central banks; the question is whether they would want to retain those lines today.
- The renewal of these lines is tied to the Quota Review; see below

A Larger Hurdle: the 15th Quota and Governance Review

What it is: IMF wants to increase/redistribute quotas with the 15th review in 2019. Quotas are the key determinant of the voting power in IMF decisions. Quotas have been determined at the IMF's inception, are reviewed through time, and are meant to loosely represent the economic size of member states.

Considerations: **Review Is Key to Maintaining Current IMF Firepower**

- The IMF would like to maintain the total firepower unchanged but wants member states to increase their commitment in ready cash while reducing the credit lines. In doing so, the IMF would also like to increase the voting shares of emerging economies to better represent their new economic status (this can occur if EMs swap more credit lines into cash than DMs do)
- Committing to quota increases may pose a challenge for some key member states while embraced by others.
  - The USA has a veto on any review
  - The Trump administration and many within Congress may resist, for fear of losing their unique veto power.
  - China may agree to quota increases commensurate with voting power shift to its benefit. Or it may opt to find cover behind Trump administration and undermine IMF firepower (thus its role) as it enhances the role of competing, mostly regional multilateral institutions.
  - Advanced economy countries may resist quota increases both for fiscal/budgetary reasons and because they would not want to dilute their voting power.
  - European members may not want to undermine IMF capabilities while likely not renewing bilateral borrowing agreement and fighting meaningful dilution of their collective voting power.
  - Not clear how other key members, such as the UK, Japan, Russia, India, and Saudi Arabia will assess their equities in this debate.

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