Economic and Budgetary Consequences of the Proposed Increases in U.S. Subscriptions to the International Monetary Fund

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The International Monetary Fund is expected to play a major role in balance of payments financing and international debt reschedulings for a record number of countries experiencing financial difficulties resulting from the aftermath of the world-wide economic contraction. Much of this effort will involve temporary IMF loans along with financial counseling to problem debtor countries to facilitate a manageable debt structure to ensure private international bank refinancing. The expected magnitudes of bridge loans that the IMF will need to make in performing this function may deplete its present financial resources below safe levels. Moreover, should the resources of the IMF prove inadequate in remedying existing international financial strains, the alternative economic costs in terms of U.S. trade performance and the stability of the U.S. banking system might be substantial.

To bolster the International Monetary Fund's capabilities to deal with present international financial debt problems, the United States and other IMF member countries have proposed an increase in their contributions to IMF financial resources through subscriptions to the IMF's General Agreements to Borrow and general quota facilities. The increases in U.S. subscriptions, when called upon by the IMF, will require increased Treasury borrowing and increased interest payments by the Treasury. These costs are partially offset by interest returns on assets from the IMF which are substituted in place of funds drawn from the contributions, and in addition are further adjusted by exchange rate valuation changes.

Based on exchange rates of February 11, 1983, the requested U.S. subscriptions to these IMF facilities are expected to increase by $8.5 billion. The increase to the GAB facility will be $2.7 billion, bringing the U.S. position up to $4.7 billion. The expected quota increase of $5.8 billion will increase the U.S. quota position at the IMF to $19.5 billion.

Last year, in response to severe debt service liquidity problems experienced by many less developed countries (LDCs), the IMF increased its calls on obligated funds from the U.S. and other member countries. The call on United States funds in calendar year 1982 was at the rate of roughly $250 million a quarter for the first two quarters and $400 million for the last two quarters. Given the proposed expansion in the IMF's lending capability and the number of new IMF loans being negotiated with LDC debtor countries, this draw rate on U.S. obligations can be expected to increase.

Budget Impacts

U.S. subscriptions to IMF facilities appear in the unified budget as budget authorizations but not as current budget outlays. The authorizations are obligations to make hard currency funds available for IMF use, and do not involve any additional accounting transactions until these funds are actually called upon by the IMF. When the IMF calls on the United States and other countries to loan funds, the U.S. Treasury must raise funds in the domestic credit markets to meet its called commitment. In return, the

United States receives an SDR-denominated 1/ interest-bearing asset from the IMF. This exchange of assets does not affect the federal budget, since, by convention, the IMF note is substituted on the Treasury's books for the domestically raised funds. The budgetary consequences of this exchange of assets depend upon the differences in interest costs paid by the Treasury in domestic credit markets and interest receipts on the IMF note adjusted for changes in the SDR-dollar exchange rate.

For example, for any additional $1 billion of IMF-called commitments from the United States, the Treasury must finance the contributions at, say, the average 90-day Treasury bill rate. In 1982, for example, the rate was 10.6 percent for an implied annual interest cost of $106 million per additional $1 billion call. The interest paid by the IMF on the loan is based on approximately 85 percent of weighted average interest rates applicable to the five-country SDR basket of currencies. Last year, this SDR rate of remuneration averaged 9.5 percent, which would imply an interest receipt by the Treasury from the IMF of some $95 million annually from a called commitment of $1 billion. Finally, the dollar appreciated by a weighted average of 11.7 percent against the other four currencies included in the SDR basket. Since the dollar comprises $0.54 of the SDR, which last year

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1/ The IMF Standard Drawing Right (SDR) is a base currency unit of accounting for denominating reserve positions and transactions between the IMF and its members. The SDR currency unit is comprised of a five country currency basket from the currencies of the United States, Germany, France, Japan, and the United Kingdom.

averaged $1.10 per SDR, the dollar appreciation against the SDR was roughly 6.3 percent. This appreciation implies a downward valuation adjustment of $63 million annually on a $1 billion SDR-denominated note. The net interest cost to the federal budget for a $1 billion IMF call therefore would be $106 - $95 + $63 = $74 million.

Treasury estimates for fiscal year 1982 of net federal interest costs attributable to U.S. quota and loan transactions with the IMF were $528 million based on an average outstanding Treasury debt position with the IMF of $5.3 billion. 2/ Interest costs were $619 million, less interest receipts of $414 million, plus the SDR valuation adjustment of $323 million. The $528 million net interest and valuation cost is less than one percent of the $69.5 billion net interest cost in the federal budget for fiscal year 1982.

The expected net interest outlays for the U.S. Treasury from transactions with the IMF will always be slightly positive, although they may vary markedly from year-to-year. In a situation of near-equal U.S. and world interst rates, where no substantial exchange rate alignments from interest rate differentials would occur, expected interest receipts always will be 85

2/ The $528 million net interest cost is higher than that implied by the simple example in the preceding paragraph. Excluded from the example are methods of finance, interest costs, and valuation adjustments applicable to past transactions. A significant exclusion from the example would be the approximately $1.8 billion of the outstanding Treasury position at the IMF on which no remuneration is paid by the IMF as it represents non-interest-bearing former gold tranches.

percent of interest payments due to the method of calculating the IMF rate of remuneration from the SDR interest rate. From the February 1983 CBO Outlook for Economic Recovery, the differential between U.S. and foreign interest rates is expected to narrow, and the U.S. dollar is expected to reverse somewhat its appreciation over the past two years. Under these assumptions, the net budgetary costs from these transactions should be reduced considerably, and indeed may yield a net interest and valuation profit. For the first quarter of fiscal year 1983, the Treasury estimated a net profit of $236 million on a $6.2 billion combined outstanding position of the Treasury at the IMF.

Economic Impacts and Risks

The debt crisis in the developing countries over the past year has had, and will continue to have, negative effects on U.S. economic output and employment. One of the major economic repercussions of the continuing LDC debt crisis has been the sharp cutback in aggregate demand in the non-oil developing economies, particularly in their import demand for industrial country exports. Imports into these countries have been curtailed as scarce foreign exchange has been needed for debt service payments and, for some countries, to meet the requirement to reduce external deficits imposed as part of the conditions for IMF loans. Should multilateral lending, such as that supplied by the IMF, not prove adequate to ease the existing debt service crises being experienced by many LDCs, a further dramatic drop in

LDC economic activity will result. This would have pronounced negative implications for U.S. exports, over one-third of which normally are sold to these countries.

Borrowing and Lending Behavior

According to many analysts studying the present LDC debt problems, the current debt liquidity problems being experienced by these countries are the result of past imprudent behavior by both borrowing countries and lending commercial banks. The general contraction in world economic activity over the past two years along with record-high world interest rates are the more significant contributing factors, however, with more severe consequences for the developing economies than for the industrial economies. The resultant external debt problems of the developing countries will require that the IMF increase its role in providing balance of payments adjustment financing to facilitate a smooth debt rescheduling process.

The aggregate current account deficits expected by many analysts for the developing economies in 1982 will exceed $75 billion. In 1983 and for some years to come, these deficits may exceed $50 billion annually. The persistance of these deficits is the combined result of sharply curtailed world demand for LDC exports, and depressed world commodity prices that have reduced their export earnings even further. The substantial apprecia- tion of the dollar after 1980 also made the largely dollar-denominated

external debt of the developing economies more expensive to service in terms of their local currencies. Finally, the favorable interest rate terms initially enjoyed by these economies turned markedly unfavorable as the increasingly short-term, variable-rate debt was rolled over.

Of the estimated $650 billion developing economy external debt through June 1982, roughly half is due to commercial international banks. The Federal Reserve estimates that some $125 billion of these private bank loans is held by U.S. banks. The growth in private bank lending to developing economies since the early 1970s was a natural consequence of recycling surplus funds of the oil exporting countries to finance current account deficits in oil importing countries, increased integration of international financial markets, and what appeared to be better economic prospects for many developing economies.

Beginning in 1974, commercial banks engaged in intensely competitive lending of OPEC deposits to developing countries. With the global recession curtailing LDC development, and record high world interest rates producing increasingly unmanageable debt service problems for LDC borrowers, many commercial banks are now faced with more risky international loan portfolios. The retrenchment of many regional U.S. banks from the LDC loan syndication process has left the major commercial U.S. banks with a correspondingly larger role in refinancing LDC loans.

The U.S. Treasury and the Federal Reserve, working in cooperation with the Bank for International Settlements, have provided emergency

funding to help hard-pressed developing economies service their external debt. This temporary assistance has also been undertaken as a lender of last resort function in order to avoid the severe consequences that a series of major LDC loan defaults would have for the stability of international and domestic banking systems. Increased IMF funding will be required to facilitate a stable LDC loan rescheduling process along with the conditions that recipient countries take appropriate measures to reduce their current account deficits. 3/ In many instances, IMF bridge loans and conditionality requirements are a prerequisite for international commercial bank loan approvals.

The success of the rescheduling process will depend in large measure on recovery from the present global recession and on continued private commercial bank lending to LDC debtors. Should either of these conditions not materialize, further bilateral and multilateral efforts to shore up these economies will be required.

As part of their role in fulfilling the international lender of last resort function, the Treasury and Federal Reserve must recognize the consequences of "moral hazard"—that is, the risks to the stability of the domestic banking system that may result from underwriting imprudent

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3/ These conditions are known as IMF "loan conditionality" referring to the practice of providing financial assistance only when, in the IMF's judgment, the country involved has formulated and is committed to implementing adjustment policies designed to reestablish a viable balance of payments position.

bank lending practices. They must also recognize that by providing public funds to ease the present international financial problems, they are, in effect, spreading out the cost of past risky lending practices, with the burden of these costs being felt by the public at large and by commercial banks who were more conservative in selecting their loan portfolios. New Securities and Exchange Commission requirements for reporting commercial bank foreign loan exposure, and the increased source of information on commercial bank foreign lending to be made available through the Ditchley Group, should help in bank regulation and monitoring of foreign loan transactions.

Crowding Out

The $5.3 billion outstanding Treasury debt position for fiscal year 1982 attributable to IMF transactions represented a change of approximately $2.5 billion from the preceding fiscal year. To the extent that all of this increase was financed by the Treasury in domestic credit markets, the increased federal demand for funds competed with private credit demands, thereby adding to upward pressures on domestic interest rates. Some portion of the $2.5 billion, however, came from existing international reserves of foreign currencies and SDRs.

Sources of domestic credit funds are also dependent on interest and amortization payments made by LDC borrowers to domestic commercial banks. The debt problems being experienced by many developing countries

have interrupted these loan repayments to U.S. banks, thereby shrinking the supply of commerical bank credit to domestic borrowers. The increased IMF quota and GAB facility funds are intended in part to provide bridge loans that will help restore the flow of LDC debt repayments.