T20 Policy Brief

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Task Force 03
REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE

Making the IMF Fit for Purpose: An Analysis and a Proposal for Reforming the Fund's Current Interest Rate Policy

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Abstract

In 2024, debtor countries will pay the International Monetary Fund (IMF) an effective annual interest rate of up to 8 basis points. The current lending rate policy is procyclical, it amplifies the global spill-over of monetary policy and makes it harder for IMF programs to promote economic recoveries. We recommend setting a cap on the lending rate and/or devising a surcharge-sliding scale.

Keywords. IMF, Lending Rates, Surcharges

The Challenge

The IMF's current lending policy is not fit for purpose, within excessively high and pro-cyclical policy rates that contradict the objectives of the Fund.

The exact policy rates that borrowers pay depend on several factors. The IMF has several lending facilities. For non-concessional lending from the IMF’s General Resource Account (GRA), the institution charges a lending rate. The IMF lending rate is composed of a basic rate and (if they apply) surcharges. The basic rate is composed of a fixed margin (currently at 100 basis points) over the interest rate on the IMF’s quasi-currency -Special Drawing Rights (SDRs)- plus the service (50 basis points per disbursement) and commitment fee (15-60 basis points, refundable when disbursed). The SDR rate is a weighted average of the interest rates of the United States, the United Kingdom, Japan, China, and the Eurozone (Box 1).

For countries that tap resources from the General Resources Account, the IMF nowadays imposes (see IMF, 2016a) 200 basis points to the portion of the credit outstanding greater than 187.5 percent of the quota and 100 basis points on the portion of credit exceeding the threshold of 187.5 percent of quota for more than 36 months (51 months under the Extended Fund Facility).

BOX 1. SDR rate Calculation

The SDR rate (SDR_i) is calculated as follows:

$$SDR_i = \sum_{i=1}^{5} \square \, (A_i * B_i * C_i)$$

Where A_i, B_i, and C_i are the currency amount in the calculation basket, the exchange rate against the SDR, and the three month interest rate on treasury bills/bonds, for the i-th country. Currently, the SDR basket is composed of five currencies (the US Dollar, the British Pound, the Japanese Yen, the Chinese Yuan, and the European Euro).

Source: https://www.imf.org/external/np/fin/data/sdr_ir.aspx

The current lending rate policy is procyclical. Total IMF GRA credit outstanding increased from 73.5 billion SDR at the end of 2019 to 112.8 billion SDR at the end of February of 2024 – a record high. This rise in costs of borrowing costs alongside IMF lending is unprecedented in the Fund’s history (Figure 1). Expansions of IMF lending have historically coincided with a falling SDR rate, given that economic downturns caused many countries to resort to the Fund alongside reductions in monetary policy rates of major central banks (Krahnke and Tordoir, 2023). Today, the IMF’s lending activities are procyclical for the first time.

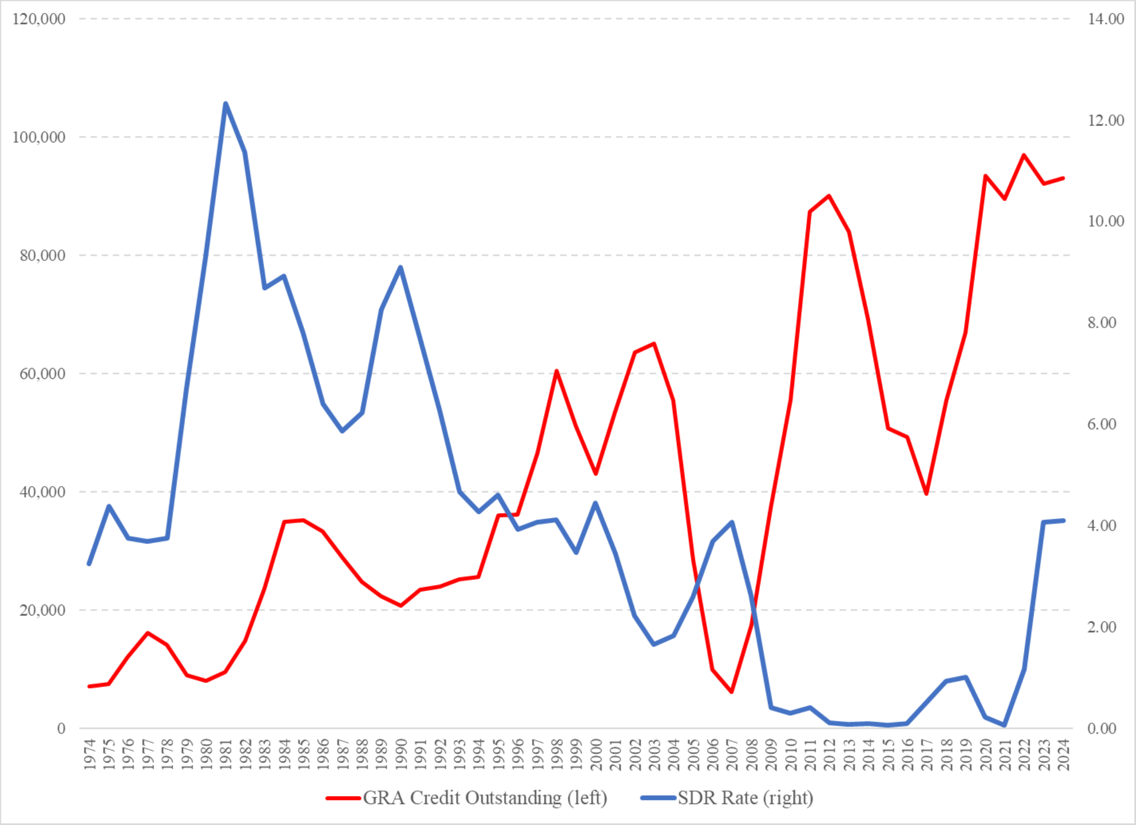

FIGURE 1. SDR rate and GRA credit outstanding

Source: authors' own elaboration based on data from the IMF.

This procyclicality may worsen further if central banks keep rates high or even increase them. According to the IMF’s estimates, the demand for its assistance is set to increase further, reflecting the impact of Russia’s invasion of Ukraine and inflation developments (Krahnke and Tordoir, 2023). For the first time this century, half of the world's 75 poorest countries are seeing an increasing income disparity with the wealthiest economies, marking a historical reversal in development progress (World Bank 2024).

The high lending rate also has knock-on effects for these countries who do not borrow from the GRA, but from the Fund’s concessional windows, like the Poverty Reduction and Growth Trust (PRGT), which low-income countries can tap for lending at a subsidized rate of zero percent. As the SDR rate increases, more funds are needed to subsidize these loans, straining PRGT finances. The higher SDR rate also affects the newly established Resilience and Sustainability Trust (RST), which assists countries with climate change challenges (Krahnke and Tordoir, 2023).

The recent increase in the SDR rate has prompted the IMF Executive Board to implement a 225 basis points cap for the lowest-income RST-eligible members. Additionally, many low-income countries drew on their SDR allocations in 2021 when interest rates were still low. These countries do not have to replenish their holdings, but they must pay the SDR rate on the amount drawn. This has now turned into expensive credit, especially for poor countries who made active use of the 2021 allocation and are in need for highly concessional financing or grants.

Surcharges increase procyclicality

Surcharges were established to mitigate credit risk by limiting the demand for IMF assistance and encouraging early repayment. Surcharges allow the IMF to build its own reserves, given that the fixed margin of 100 basis points already covers most of the IMF's operational costs. The balance of payments needs of countries in distress are so large that several have borrowed large amounts for long periods, increasing their borrowing costs to 800 basis points per year[1].

[1] Today, out of 33 countries paying charges for Stand-By Arrangements and Extended Fund Facilities 22 are paying surcharges (Angola, Argentina, Armenia, Barbados, Benin, Costa Rica, Côte d'Ivoire, Ecuador, Egypt, Gabon, Georgia, Jordan, Kenya, Moldova, Mongolia, North Macedonia, Pakistan, Senegal, Seychelles, Sri Lanka, Tunisia, and Ukraine). The total number of active Stand-By Arrangements and Extended Fund Facilities is 25, but some countries such are still paying charges and surcharges (as they have a credit outstanding).

The latest IMF policy paper on this issue states that the current surcharge policy allows the institution to accumulate precautionary balances, provides members with incentives to limit their demand for IMF assistance, and encourages early repayment (IMF, 2016b). While the IMF's income model explicitly requires the accumulation of precautionary balances, it is unclear why these should come from surcharges. Countries that request assistance from the IMF for the balance of payment needs may not have access to other sources of affordable financing (and may not be able to afford early repayment).

The current lending rate amplifies global spill-overs of monetary policy

High SDR rates reflect advanced economic decisions on monetary policy, which are made solely with an eye to fighting inflation in their domestic jurisdiction. As is well documented (Degasperi et. al., 2023; Mishra and Rajan, 2016), these policy rates are often inappropriate for macroeconomic conditions in other jurisdictions. Financial crises are also often triggered by changes in the financial conditions in the US (Rey, 2015). Countries that face worse financial conditions need to resort to the IMF to remove financial constraints while they regain market access. However, this is more difficult because the lending rate increases due to the monetary policy of the advanced economies (which affects the SDR rate).

Today, monetary policy rates are going up just when many countries struggle with high levels of debt and need support. Global public debt has reached a total of US$92 trillion, of which almost 30% is owed by developing countries. The proportion of poor countries in debt distress, or at high risk of debt distress, has more than doubled to almost 60 percent from a decade ago. Half of developing countries spend more than 1.5% of their GDP and 6.9% of their government revenues on interest payments, while 19 countries are spending more on interest than on education and 45 more on interest than on health (UNCTAD, 2023).

Borrowers are doubly penalized due to the existence of surcharges. Those that need support from the IMF must face more restrictive credit conditions and are typically affected by tighter financial constraints, for instance by climate-related natural disasters or military conflict (e.g. Ukraine). The current lending policy thus amplifies the spill-over effects of monetary policy and reinforces countries' funding difficulties (Stiglitz and Gallagher, 2022).

High lending rates will make it harder for IMF programs to promote economic recoveries. In 2011, the IMF proposed a new model to **move away from relying on lending income as the primary source of revenue to minimize the institution's exposure and sustain a steadier flow of income during times of low lending activity**. This new income model also sought to ensure the institution accumulated enough reserves (IMF, 2011). Despite these changes, lending income represents about 95% of the income for the projections for the fiscal year 2023 and about 71% for the fiscal year 2024 (Table 1).

For debtor countries, the burden of repaying high interest rates to the IMF itself takes away much-needed cash, possibly deepening their budgetary woes and hampering their prospects of economic recovery. The high SDR rate may undermine the catalytic role of the fund in ‘crowding-in private finance. The more expensive it gets for countries to service their debt from the IMF – the senior creditor – the less faith private investors will have in also being repaid.

TABLE 1. IMF Income for FY 2023 and FY 2024 (in millions of SDRs)

	FY 2023	**FY 2024**
Operational income	**2,822**	**3,825**
Lending Income	2,650	2,739
Surcharges	1,420	1,472
Investment Income	66	936
Interest-free resources	97	135
Reimbursements	9	15
Expenses	**1,131**	**1,141**
Net operational income	**1,691**	**2,684**
Net income position	**1,829**	**2,924**
Reserves	**22,900**	**22,600**

Source: IMF (2023a). The fiscal year 2024 starts May 1, 2023 and ends April 30, 2024.

Recommendations for the G20

There is a need for G20 countries -as the major shareholders of the IMF- to take action and explore options to reform the institution's lending practices. As the main shareholder of the IMF, the G20 has the soft power and voting share to promote a discussion on the lending policy.

The decision to alter the IMF lending rate is not without precedent. For instance, the basic rate was historically adjusted to reflect the Fund's operative costs, but during FY07 this would have implied a basic rate of 350 basis points (due to the reduction in the amount of credit outstanding), and this level was deemed "too high" (IMF, 2016c, page 10). In response, an exceptional circumstances clause was added to allow the margin for the rate of charge to be set on a basis other than estimated income and expenses. The Executive Board discussed and modified the lending practices in 2014, when they established a floor of 5 basis points in the context of low international interest rates.

Because the reduction of basic rate -currently 100 basis points- is not enough, **a partial solution is to put a cap on the SDR rate to reduce the lending rate**. This could be complemented with **a surcharge-sliding scale**, which means that the surcharge rate should increase when the SDR rate decreases and vice versa. The Executive Board can change the surcharge policy without changing the IMF Articles.

Considering its feasibility and its positive effects both on the IMF and the borrowing economies, we propose to the G20 to set the cap at reasonable level, for instance, 500 basis points. This could be achieved either by establishing a limit on the lending rates or by introducing a surcharge-sliding scale (so the surcharge component falls when the SDR rate increases, and vice versa).

No one profits from countries facing debt overhangs, neither debtor countries, nor their creditors. However, attention must be given to potential losers of any changes made. The lending rate reform can either more heavily impact the Fund’s operative income by “taking some fat off the IMF’s bones”, or the IMF’s net creditors by asking them to cover the costs.

Scenario of outcomes

The IMF estimates that rates will remain high for at least two years (IMF, 2023b). To avoid this, we propose the adoption of a cap on lending rates at 500 basis points. We expect this policy to have a substantial impact on borrowing countries. Countries that are currently paying surcharges will face a reduction of 300 basis points from current levels. This policy will affect the IMF finances, but the institution already holds substantial precautionary balances (Table 1), and there is no reason to expect a shortfall of incomes with rates that are at most 500 basis points per year.

Consider Argentina, Egypt, Ukraine, Ecuador, and Pakistan, which together account for about 57% of the total GRA credit outstanding (Table 2). Assuming a lending rate of 800 basis points, they will pay around 5.1 billion SDR annually. Capping lending rates at 500 basis points will imply cutting payments from those countries by about 2 billion SDRs per year. Borrowing from the IMF represents a significant share of total external indebtedness, and charges are about one-third to one-fifth of the total spending on health (Table 3).

TABLE 2. Credit outstanding and charges (in millions of SDRs)

	Credit outstanding	IMF credit to external debt*	Charges per year	Surcharges per year
Argentina	32450.00	17.03%	2596	973.5
Egypt	10980.53	12.48%	878.4424	329.4159
Ukraine	8461.71	8.75%	676.9368	253.8513
Ecuador	5826.88	6.12%	466.1504	174.8064
Pakistan	5971.52	5.56%	477.7216	179.1456
5 largest debtors	63690.64		5095.2512	1910.7192

Source: author's own calculations based on data from the IMF and the World Bank.

*Assuming an SDR to dollar exchange rate of 1,3. External debt data from 2022.

TABLE 3. IMF credit, external debt and health spending (in millions of SDRs)

	IMF credit to external debt (2022)	IMF credit to external debt in pp of national income (2022)	Current charges to spending health (2020)
Argentina	17.03%	6.79	19.63%
Egypt	12.48%	6.68	23.47%
Ukraine	8.75%	3.10	24.01%
Ecuador	6.12%	2.09	23.60%
Pakistan	5.56%	4.59	32.39%

Source: author's own calculations based on data from the IMF and the World Bank. *Assuming an SDR to dollar exchange rate of 1,3 and a basic rate of 500 basis points plus surcharges.

There are three ways in which the IMF can deal with lower income. One would be for the IMF to run down (or to slow down the rate of accumulation of) the precautionary balances. The second would be a cap on the SDR rate to reduce the remuneration that flows from net debtors to net creditors inside the GRA. The third option would be to increase surcharges in a low-interest rate environment. This would mean the Fund's income goes down when monetary policy is restrictive but goes up relative to where it would be if monetary policy is accommodative. A plausible proposal could combine these three elements.

These options also have implications for the IMF's Trust funds. An SDR rate cap would reduce the need for pledging subsidies to the PRGT and RST. A lower SDR rate (at which the Trust Fund's creditors get remunerated) lowers the needed funds to subsidize the PRGT's zero percent loans, reducing pressure on PRGT finances -which are already under strain owing to substantially stronger demand for PRGT loans-. For the RST, an SDR rate cap would reduce lending rates, but increase the pace of reserve accumulation. This is because the contributors of the RST deposit account -which is meant to generate investment income for the trust- are remunerated at the SDR rate. Hence, an SDR rate cap would immediately increase the "profit margin" of the deposit account. Finally, an SDR rate cap would directly reduce the interest rate burden for countries that tapped their 2021 SDR allocation. Reducing surcharges instead would leave the PRGT's subsidy needs, the RST's reserves accumulation, and the cost of SDR drawings unchanged.

There is an ongoing discussion concerning the rechanneling of SDRs via Multilateral Development Banks, where some central banks have emphasized the importance of the SDRs retaining their reserve asset characteristics. The proposed changes do not impact the status of the SDRs held by the members. One concern with capping the SDR rate versus adjusting surcharges is that it could negatively impact the tradability of SDRs. SDRs can exclusively be exchanged for freely usable currencies in transactions by agreement, primarily through the Voluntary Trading Arrangements (VTAs). Transactions rely on countries' goodwill to exchange, say, US dollar reserves against SDRs. A lower

SDR remuneration could, therefore, discourage them from making such a trade. However, SDR holdings are small relative to overall foreign exchange reserves. A decision to cap the SDR rate temporarily would be made by the member countries of the IMF, which could commit to continue undertaking any SDR transactions despite a slightly lower return on potential positive net SDR holdings. An SDR rate cap could, therefore, be accompanied by a VTA reform in which major creditor countries commit to maintaining VTA liquidity. Lowering surcharges would not negatively impact VTA liquidity.

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