Institute for International Economic Policy Working Paper Series
Elliott School of International Affairs
The George Washington University

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IIEP-WP-2020-18

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October 2020

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The IMF's Financial Catch 22: Global Banker or Lender of Last Resort?

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IMF's Financial Catch 22: Global Banker or Lender of Last Resort?

The International Monetary Fund (IMF) has dual institutional roles: a steward of international financial stability and a global banker safeguarding the resources of its sovereign shareholders. But, how does the IMF behave when its balance sheet becomes exposed to higher-than-usual credit risk, creating a financial catch-22? We expect the IMF varies its lending behavior, based on the nature of sovereign credit crises. When there is high contagion risk, the IMF aims to preserve global financial stability as a lender of last resort by extending large loans, notwithstanding its balance sheet strains. The IMF employs policy conditionality to hedge its lending risk, but prioritizes alleviating global market turmoil over program compliance. When market contagion is contained, however, the IMF is more likely to act as a traditional banker, suspending programs for non-compliance. Ironically, given its tendency to forgive non-compliance as a lender of last resort, our theoretical framework suggests that the Fund intensifies its moral hazard problem.

We test our theoretical priors by conducting a comparative case study analysis of IMF decision-making over time for two of its largest borrowers: Argentina and Greece. Leveraging volumes of hundred-paged minutes from IMF executive board meeting archives and extensive field research interviews, we illustrate the lending stances of IMF directors evolve in response to changes in global contagion risk. By examining the IMF's own institutional agency under high financial risk, this study offers new insights for the study of international political economy and international organizations.

Keywords: IMF; lender of last resort; financial crises, institutional financial risk; contagion risk; Argentina; Greece

Word count: 11,768 words

Introduction

Developing countries across the globe are battling the coronavirus pandemic on two policymaking fronts as both a financial crisis and a public health emergency. Since the beginning of the pandemic, they have witnessed over $100 billion in capital outflows, nearly twice as large (in terms of GDP) as those experienced during the 2008-09 global financial crisis. In response to these capital outflows and heightened risk aversion globally, national currencies also depreciated by as much as 25 percent during the first-half of 2020.[1] Moribund global trade, depressed commodity demand, and tourism have further constrained the budgets of developing countries, leaving them unable to both service their dollar-denominated debts and fully fund emergency health and economic programs. By May 2020, a hundred and ten countries had asked the International Monetary Fund (IMF) for financial support.

Beyond these short-term measures, the IMF estimates that emerging market and developing economies will need $2 to $3 trillion of financing over the course of the pandemic. With available funds of about $1 trillion,[2] however, the IMF has to balance providing emergency liquidity support today with protecting its limited resources over the longer-term horizon.

The pandemic thus intensifies a longstanding policy dilemma for the IMF between being the international lender of last resort (ILLR) and a global banker. The Fund aims to both provide global liquidity to offset international financial instability, but also to protect its own balance sheet given its finite financial resources. Given these dual roles, when does the Fund prioritize global stability through liquidity provision over responsible lending through conditionality enforcement? Over the last several decades, the

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[1] Brazil and South African currencies have been two of the biggest underperformers.
[2] IMF, March 16, 2020.

international political economy scholarship has sought to examine the multiplicity of IMF's roles by assessing the Fund's successes and failures as an ILLR,[3] and evaluating both the neoliberal roots[4] and development consequences of IMF conditionality.[5]

In this paper, we advance this literature by developing a series of theoretical priors about the IMF's internal decision-making process regarding its financial risk assessments. The theoretical framework conditions IMF lending choices on the likelihood of global market contagion. During periods of global financial contagion, the IMF targets global financial stability as an ILLR. The Fund willingly prioritizes liquidity provision over compliance with its policy conditions, and even its own financial health. However, when there is little risk of global financial contagion, the IMF tends to act as a traditional banker and protect its balance sheet by using policy non-compliance as a rational for deleveraging its financial ties, or ceasing its lending programs.

Testing the theoretical priors requires close examinations of the rationales and context behind each decision. Thus, we employ a comparative case study analysis of IMF decision-making in two of its largest borrowers over time: Argentina and Greece. These two countries are similar along economic and political indicators: they are high income democracies that have been major IMF borrowers, yet these cases maximize the variation in the main independent variables– global contagion risk vs. the Fund's credit risk.[6]

In this paper, we concentrate on stress-test, or high balance sheet risk, cases of Fund lending based on the assumption that these are precisely the conditions that create the tension between the IMF's role as an ILLR and as a banker. To assess the IMF's evaluations of global financial contagion risk, we analyze both the Fund's formal

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[3] Chapman et al. 2015; McDowell 2017.
[4] Helleiner 2017.
[5] Vreeland 2003; Barro and Lee 2005; Nelson 2014; Nelson 2017.
[6] King, Keohane, and Verba 1994.

publications, such as its *World Economic Outlook*, and informal discussions using Executive Board Meeting minutes. We supplement the archival evidence with our field research interviews with the IMF economists and government officials to trace the causal logic of IMF's policymaking.

This article makes several important scholarly contributions. First, it brings new primary and secondary data on the Fund's evaluations of its own credit risk and global financial contagion risk and suggests they are important considerations in Fund's lending decisions. Our findings also clarify the Fund's internal limitations to sustaining its ILLR commitments, which will be essential to examining the capacity of the international community to deal with financial fallout of the coronavirus pandemic. Lastly, this article provides an understanding for the IMF's continued commitment to conditionality. Despite its controversial history, conditionality is the Fund's way of mitigating financial vulnerabilities on its balance sheet, which is arguably the riskiest ledger in the world.

The manuscript unfolds as follows. We begin with a review of the literature on the IMF. We then develop our argument by explaining the conditions under which the IMF fulfills its mandate of preserving international financial stability, and when it instead acts as a global banker safeguarding its own financial resources. In the subsequent section, we provide empirical support for this theory using primary and secondary data from Argentina and Greece. We then use the insights to interpret another high-profile case of IMF borrowing in Brazil. Finally, we conclude with discussion and implications.

Theoretical Framework

> "The IMF's mandate is directed squarely at the promotion and maintenance of macroeconomic and financial stability."
>
> –IMF Managing Director Rodrigo de Rato, 2004-2007.
>
> "The Fund, from its inception, was burdened by a mismatch between its aspirations of its architects, and the authority and instruments they gave the institution to pursue those ambitions. Its authority over the policies of its members was limited. Its resources were small, and the facilities established to deploy those resources were modest relative to the problems they were designed to address."
>
> –Timothy Geithner, U.S. Treasury Secretary, 2009-2013

In his 2004 remarks about the role of Bretton Woods institutions in the 21st century, former Treasury Secretary Timothy Geithner, put his finger on the International Monetary Fund's (IMF) core institutional dilemma. It has agency, given its mission to promote global financial stability, as articulated above by former IMF Managing Director Rodrigo de Rato.[7] However, its limited resources (particularly relative to the size of crises) make it difficult to meet these policy aspirations.

Over the last three decades, the political economy scholarship has significantly enhanced our understanding of IMF lending by examining the Fund's two main functions as an international lender of last resort (ILLR), and as an economic advisor to national governments. Created in the era of limited capital mobility, the Fund was initially not designed for an ILLR role. Yet after providing extensive liquidity to debt-ridden countries during the Latin American debt crisis, the Fund fully matured into its crisis lender role in the 1980s.[8] Scholarly interest in the Fund's role as the ILLR grew in the 1990s during emerging market credit crises around the globe. They examined the fundamental

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[7] Article I of its Articles of Agreement establishes macroeconomic stability and growth as part of the Fund's central mission, while Article IV allows for financial surveillance.

[8] See McDowell (2017) for the Fund's history as an ILLR.

questions of why the Fund should act as the ILLR[9] and whether the Fund has an effective ILLR capacity.[10] More recently, McDowell (2017) shows the Fund's lack of responsiveness and resources limit its ability to function as an ILLR, finding that the U.S. plays a complementary role. Other research examines the conditions under which IMF programs catalyze private financing,[11] attract foreign aid,[12] improve national creditworthiness,[13] and facilitate growth,[14] but find a less-than-satisfactory record.[15]

Another strand of IMF scholarship instead focuses on the Fund's more nuanced role as an economic advisor by closely examining three key determinants of IMF conditionality. First, some scholars find that borrowers with close geopolitical and economic ties to the IMF's major shareholders receive favorable treatment.[16] Second, others focus on the Fund's global policy making network and the formation of economic ideas.[17] Some find evidence that greater shared beliefs and professional ties between national government and Fund officials are associated with more lenient conditionality and weaker program enforcement.[18] Relatedly, public choice models find that the Fund increases conditionality when there is more demand for IMF loans.[19] Finally, other researchers demonstrate how domestic politics affects international standards,[20] including how political constraints lead to weak enforcement of conditionality.[21]

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[9] Fischer 1999.
[10] Goodhart 1999; Schwarts 1999
[11] For example, see Chapman et al. 2016.
[12] Bird and Rowlands 2007; Stubbs, Kentikelenis and King 2016
[13] Cho 2014; Gehring and Lang 2020
[14] Vreeland 2003; Barro and Lee 2005
[15] For example, findings on the IMF program's catalytic effect and economic growth, are mixed.
[16] Momani 2004; Dreher, Sturm and Vreeland 2009; Copelovitch 2010
[17] McNamara 2008; Moschella 2010; Gallagher 2014.
[18] Nelson 2014; Chwieroth 2015
[19] Dreher and Vaubel 2004; Vaubel 1994
[20] Mosley 2010.
[21] Caraway, Rickard, and Anner 2012

The crux of these analysis have thus centered on the role of IMF policy conditionality in promoting both global financial stability and national economic reforms, including how the Fund mitigates moral hazard risk inherent in its ILLR operations. However, we know little about how the Fund's ILLR mission affects its lending decisions, leaving a critical question unanswered. Under what conditions might the Fund not act as an ILLR, despite its mission to protect the global financial stability? Why might the Fund refuse to initiate a program with a troubled debtor? Alternatively, when is the Fund more likely to adhere to its ILLR mission and disburse loans, notwithstanding a high risk of borrower non-compliance?

We argue that these lending decisions reflect how the Fund balances two operational goals: preserving global financial stability and protecting its limited balance sheet resources. The Fund's balance sheet is inherently risky. Compared to more traditional creditors, the IMF's core mission of providing financial support to crisis countries makes its operations highly vulnerable. Not only is the Fund investing in speculative grade debt, but those loans are concentrated among a few large debtors, creating a high level of risk for the IMF's balance sheet.[22]

The Fund's management and staff have been quite attuned to these funding risks, often addressing the limits of the IMF's financial support. In 2004, IMF Managing Director Horst Köhler, warned that:

"The IMF is not a lender of last resort in the traditional sense; it isn't capable of providing an unlimited amount of financing."[23]

His successor, Manager Director Rodrigo de Rato, regularly championed the same theme:

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[22] More than four-fifths of IMF loans are channeled to its five largest borrowers (Felushko and Santor 2006).

[23] Truman 2006.

"[W]e clearly need a Fund that can say 'No' selectively, perhaps more assertively, and, above all, more predictably than has been the case in the past."[24]

The Fund's staff also underscores the importance of being a responsible creditor. For example, an IMF official we interviewed emphasized that "whether a country repays to the Fund is the criteria of a successful program."[25] In other words, the idea that its debtors have to repay their loans is deeply embedded in the Fund's culture.[26]

We thus argue that the IMF's decision to originate or terminate a lending agreement reflects a trade-off between the state of the IMF's own balance sheet and its core mission of preserving global financial stability. The IMF leadership has to protect its shareholders' investments in the Fund, given that shocks to the IMF balance sheet could place national taxpayers' dollars at risk. Indeed, the IMF's Articles of Agreement specify that the Fund should have "adequate safeguards" on its lending, which provide "members with the opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity."[27]

The IMF aims to overcome this inherent tension between its financial health and institutional mission with policy conditionality: it extends credit provided that borrowing governments follow the Fund's policy advice. If borrowers do not comply with the IMF's recommendations, the policy drift provides a rationale for the Fund to exit its lending relationship. However, if the prospect of contagion risks upsetting international financial stability, the Fund has the flexibility to extend national-level waivers on policy targets, or loosen policy conditions. The IMF is thus most likely to suspend its lending programs when financial volatility is contained internationally. In the following pages, we first

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[24] Rodrigo de Rato, "The IMF at 60—Evolving Challenges, Evolving Role." *IMF/Bank of Spain Conference*. June 14, 2004.
[25] Author's interview, July, 2017.
[26] Lütz et al. 2019.
[27] See IMF's Articles of Agreement, Article 1, section 5.

operationalize the concepts of the IMF's *financial risk* and *global contagion risk*, and then develop our theoretical priors about IMF lending.

The IMF's Financial Risk

The IMF's quota system is not only its main source for financing, but also instrumental in determining representation. With a membership of 184 countries, nations pay a subscription quota, or financial contribution, based on their relative position in the world economy, and the size and openness of their domestic economy. These quotas account for 90 percent of the Fund's total balance sheet liabilities; they also largely align with a country's voting power and access to IMF financial resources. Countries with the largest quotas (i.e. the U.S., Japan, China, Germany, France, and the U.K.) tend to have the loudest individual sovereign voices on the IMF Executive Board, but smaller nations also form regional and ideological blocs to better represent their interests, ranging from emerging market borrowers and creditor nations to continental constituencies and global financial centers.[28]

Beyond the quota system, the IMF can also raise resources by borrowing multilaterally and bilaterally. In 2017, such borrowing accounted for about 6 percent of the Fund's total balance sheet liabilities.[29] To temporarily supplement member quotas, the IMF draws from either a $200 billion multilateral facility, dubbed the New Agreement to Borrow (NAB), or a $340 billion bilateral facility drawn from more than 40 eligible countries. Technically, the IMF can also borrow from private resources, but to date, there has been little precedent for such financial activity. In addition to these financial backstops, the IMF also opted to hike its precautionary balances in response to the string of financial crises at the turn of the 21st century. Serving as such a balance sheet buffer,

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[28] Woods and Lombardi 2006.
[29] See footnote 7.

precautionary balances are derived from retained IMF earnings,[30] and are meant to cover any unexpected income losses, or mounting arrears.

Moving to the other side of its balance sheet, we know that the IMF mainly extends loans to member countries to help them navigate financial turbulence. In 2017, the Fund's credit outstanding was SDR48.3 billion ($70.3 billion), equivalent to about 9.2 percent of its total balance sheet assets (including the IMF's SDR and gold holdings), or one-tenth of the IMFs quota financing-system ($692 billion). In the event of an unexpected payment shock, the Fund held SDR16.7 billion ($24.3 billion) in precautionary reserves.

To put these numbers in perspective, the IMF extended a $57 billion credit line to Argentina in July 2018, which amounted to a whopping 8 percent of the IMF's total quota in 2017. Beyond Argentina, we have also seen the emergence of extensive financial contagion upon the coronavirus pandemic. To meet the financial demands during the current pandemic crisis, the Fund has noted that it can tap the aforementioned $540 billion in multilateral and bilateral credit facilities, but the financial fallout from the coronavirus could be as high as $2 to $3 trillion. Notwithstanding innovated proposals to further expand IMF credit,[31] such efforts have catalyzed some political controversy among its major stakeholders, who have to answer to their often-thrifty national constituencies.

The bottom line is that the IMF is more sensitive to financial risk than a typical lender of last resort. Bounded by limited resources, an inability to print money, and the political will of its stakeholders, the Fund must strategically optimize its balance sheet risk. We suspect the Fund is more likely to cease funding when it deems its financial risk to be high.

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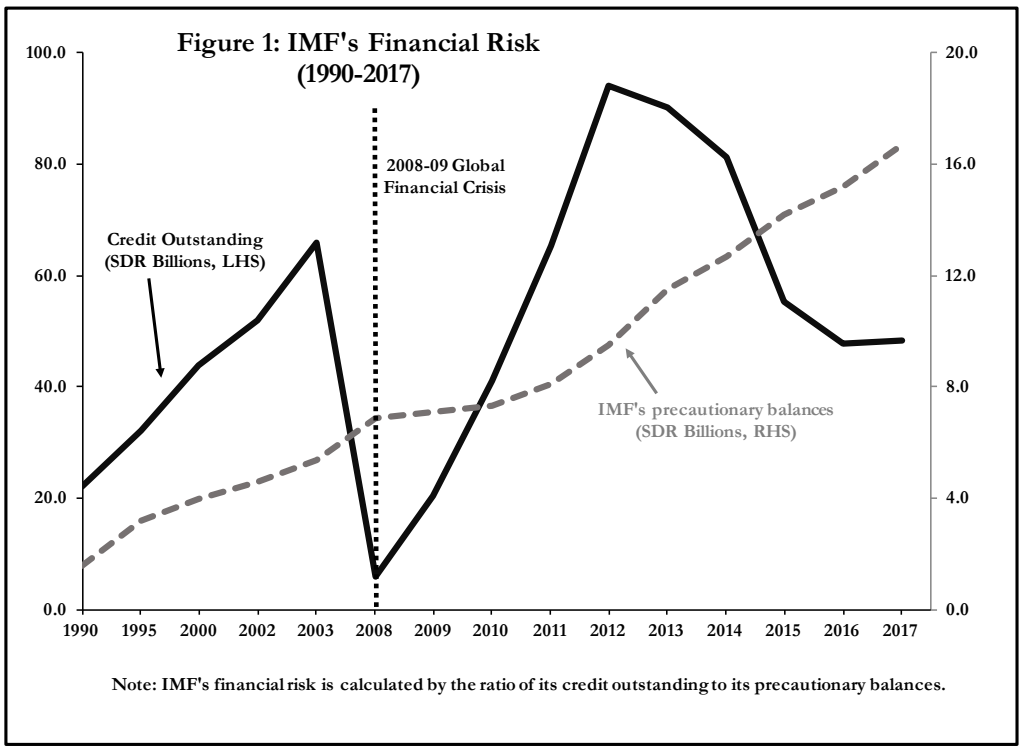
[30] IMF (2018)

[31] For example, the IMF could create Special Drawing Rights (SDRs), with the approval of 85 percent of IMF voting members, which would allow cash-strapped nations to borrow reserve currencies at below-market interest rates. However, the Trump administration has blocked such initiatives with its veto (see Gallagher, Ocampo, and Volz 2020).

To measure the Fund's *financial risk*, we employ the ratio of the IMF's precautionary balances to its total credit outstanding; the same ratio that the Fund uses in the risk management section of its annual report. The Fund's financial risk decreases (increases) as this ratio moves higher (lower). For example, prior to the 2008-09 global financial crisis, there was fairly low demand for the Fund's resources, and its precautionary balances accounted for more than 100 percent of the IMF's total lending portfolio. When the IMF expanded loans to countries mired in the doldrums of the crisis, it entered into a new phase of high balance sheet risk. To help mitigate this growing credit risk, the Fund simultaneously expanded its precautionary balances (see Figure 1). However, these precautionary balances have averaged less than one-quarter of the IMF's total lending portfolio, and reached a valley of one-tenth of total IMF credit outstanding in 2012.

Figure 1. IMF's Financial Risk, 1990-2017



Unlike the private sector which can contain balance sheet risk by raising risk premiums for its lending, the Fund's mission of global stability necessitates lending to

countries at subsidized interest rates. When does the Fund, then, shift from a lender-of-last-resort role to being more of a traditional creditor? We expect the Fund's lending behavior to reflect the extent of global financial instability, and in particular global contagion risk across international markets.

Global Contagion Risk and the IMF

Given its limited balance sheet resources, we argue that the Fund conditions its lending on the likelihood that national financial volatility spills into global markets. Global contagion is defined as a "significant increase in cross-market linkages after a shock."[32] When there is a financial or economic shock, international investors often aim to enhance their liquidity and protect their profitability by selling other high-risk assets in their investment portfolios. For example, Argentine central bank director, Horacio Liendo, deemed that his country's financial turbulence in 2018 was a reflection of a shock across emerging market economies. In our August 2019 interview, Dr. Liendo explained,

> "I believe it wasn't related to Argentina specifically, so I think you cannot understand the sudden stop if you see the Argentine numbers or Argentine behavior before the sudden stop. I think it was related to the whole emerging markets, … of course, we are not the best emerging market country, we are not the worst, we are in the middle of the table, but if it got someone, it got us."[33]

In other words, "anytime there is uncertainty, there is flight to quality, and that's bad for Argentina," as put even more succinctly by former Vice Finance Minister Miguel Braun in our interview.[34]

When countries are experiencing such capital flight and currency volatility, the IMF is willing to supply liquidity to mitigate potential spillovers into other financial markets, financial institutions, and economies throughout the globe. By "restoring balance-of-

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[32] Claessens and Forbes 2001.
[33] Author's interview, August, 2019.
[34] Author's interview, August, 2019.

payments viability and macroeconomic stability,"[35] the IMF views such national lending as central to its fundamental mission of global financial stability.

If it did not offer such a funding backstop, the IMF could incur reputational risk that might undermine its credibility as the global guarantor of financial stability. IMF bureaucrats have at times openly voiced such institutional concerns, but they are also shared by the Executive Board's country representatives who fret about the material cost of financial volatility flowing across their borders. For example, in 2010, the Executive Board modified its "exceptional access criteria," which historically conditioned lending on debt sustainability, to nevertheless allow for financing aimed at containing contagion. But, how do we know when a shock in one country has a potential to spillover?

To gauge *global contagion risk,* we measure global credit conditions, and hence, the likelihood that market contagion will upset the international financial system. Given the important role that U.S. Treasury securities play as a financing benchmark in global asset markets, we employ the U.S. interest rates as a proxy for the global credit environment. Specifically, we use a country's sovereign risk premium, or the premium paid for its borrowing above comparable U.S. treasury bond yields, to gauge how its financial assets are performing relative to their sovereign peers. We also interact these sovereign risk measures with the IMF's qualitative assessments of market contagion from official staff reports, executive speeches, and the minutes of Executive Board meetings.

To hedge its financial risk, recall that the Fund employs policy conditionality. As explained by senior IMF economists during our 2017-2019 interviews, the Fund offers "a co-insurance pool that's enforced with conditionality," whose "implementation is critical because we (the IMF) want to be repaid."[36] Notwithstanding borrowers' compliance, we

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[35] IMF Conditionality Factsheet, March 30, 2020.
[36] Authors' interviews, July 2017; June 2019.

expect that the Fund lends extensively when its stakeholders are concerned about global financial contagion. However, when it places more emphasis on emergency liquidity than borrower compliance, the Fund reduces its credibility in enforcing conditionality, which intensifies its moral hazard.

By contrast, when financial volatility is contained to a single nation, we expect the Fund to more stringently enforce conditionality, and even recoil from its lending relationships. Without the worry of generating further financial turmoil in other regions, it can focus on its own balance sheet risk, and even terminate out-of-compliance programs.

In sum, the IMF toggles between being an ILLR and a thrifty banker. The IMF willingly acts as an ILLR, providing the most liquidity and the least onerous conditionality when facing the threat of global financial contagion. By contrast, the Fund becomes more austere when contagion is contained, often using borrower non-compliance as a justification for reducing its own high financial exposure.

Comparative Case Evidence

To test these theoretical priors, we conduct a comparative case study analysis of IMF decision-making over time in two of the Fund's historically largest and most high-profile debtor cases: Argentina and Greece. These two countries also maximize the main independent variables of interest facing the IMF as a creditor –the Fund's financial risk and global contagion risk.[37] Recall that we expect the Fund's lending to be conditional on the likelihood of global market contagion. We thus limit the domain of the study to periods of high IMF financial risk and examine the variation in global contagion risk, which allows for a better understanding of the limits of the Fund's willingness to be an

[37] King, et al. 1994.

ILLR. In other words, we can observe to what extent the IMF and its sovereign shareholders balk over extensive credit risk.

The case selection allows us to conduct both within- and cross-country matched comparisons to examine the variation in the Fund's different lending decisions over time for Argentina (between 1998 and 2001) and Greece (between 2010 and 2015), while holding constant national-level institutional factors.[38] We use process tracing within each case study[39] to examine the internal determinants of IMF lending decisions.

Within the IMF, shareholder debates frequently determine lending outcomes through both formal and informal pathways. Formally, these policy choices are discussed during IMF Executive Board (EB) meetings. Informally, outside of EB meetings, IMF officials consult with borrowing government officials on program design and funding decisions. Employing both archival evidence from EB meeting minutes to track the formal channel, and primary interviews with IMF staff and national government officials to evaluate the informal channel of IMF decision making, we find that the Fund's lending is conditional on the likelihood of global financial contagion.

I. Argentina and the Revolving IMF Door: 1998-2001

Argentina's long and turbulent history with the IMF sets the stage for a fascinating puzzle. During the late 1990s, why did the Fund lend extensively and continuously to Argentina despite the country's non-compliance, but then terminate Argentina's program in 2001?

In line with this study's domain, the Fund faces high balance sheet risk during this entire period, underscoring the limits of its financial capacity. To deal with these institutional limitations, we find that the IMF varies its national-level financial exposure based on the expected extent of contagion risk globally (see Table 1). In the following

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[38] Gerring 2007.
[39] Bennett 2008.

pages, we show that the Fund approved Argentine loans during periods of high contagion risk (e.g. after the 1998 Russian default), but suspended existing programs when contagion risk stabilized (e.g. emerging market assets decoupled from those in Argentina).

Table 1. Overview of global contagion risk and IMF decisions regarding Argentina, 1998-2001

	1998		1999		2000		2001	
	1st half	2nd half	1st	2nd	1st	2nd	1st	2nd
IMF financial risk	← HIGH →							
Global contagion risk	LOW	← HIGH →						LOW
Key market event	Asian Countries' Recovery	Russian Default			Developed Country Recession			'Decoupling' Argentina
IMF decisions regarding Argentina	Program Suspension	← Continued Lending →						Program Suspension

The IMF's Financial Risk, 1998-2001

After extending sizable financial commitments during the Asian Financial Crisis, the Fund's available resources became very tight in late 1990s. During this period, the IMF increased its lender-of-last-resort operations around the globe in response to successive emerging market crises, including extending the largest loan ($58.4 billion) in IMF history to South Korea (1997), and $22 billion in financing to Argentina during its crisis (1998-2001).

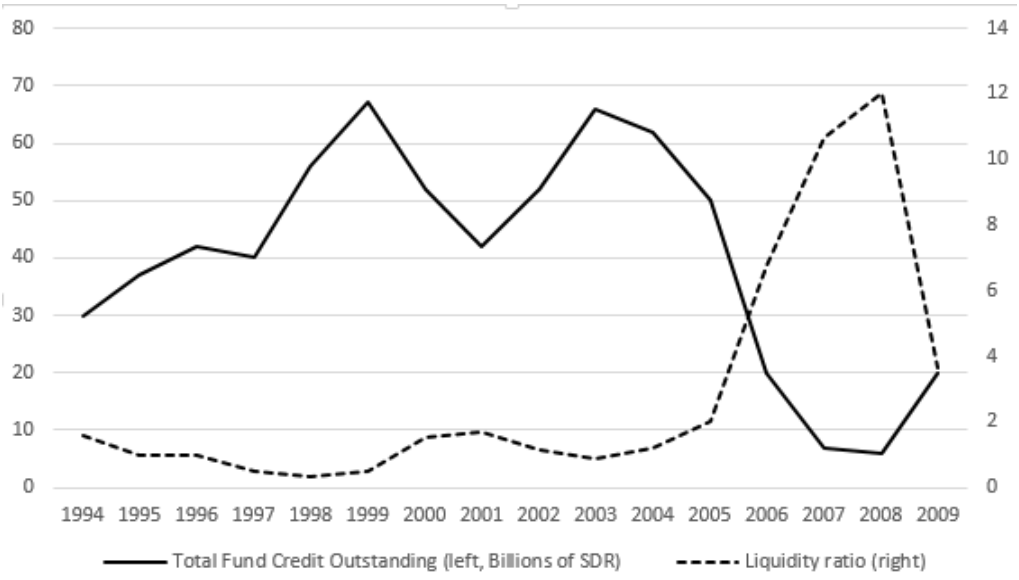
Given these outlays, the IMF's total credit outstanding nearly doubled during the late 1990s before finally stabilizing a bit in the early 2000s (see Figure 2). In its annual financial statement, the Board of Governors expressed serious concern over the IMF's financial health; they "stressed the critical importance in current conditions of augmenting the IMF's resources and urged all members to accelerate the process leading to the implementation of the agreed quota increase."[40] By January 1998, the IMF Board

[40] IMF annual report, 1998. Appendix VI. (p.184).

of Governors had sharply increased its quota, requiring all members to raise their capital by 45 percent to strengthen the Fund's balance sheet.

Still, the Fund's balance sheet remained precarious, as illustrated by the Fund's liquidity ratio (see Figure 2). When its liquidity ratio – the ratio of the Fund's available resources to its liquid liabilities – is below 1, it means the Fund might not be able to provide sufficient funds to its borrowers. This ratio remained below par between 1997 and 2002, despite a brief improvement in the early 2000s after the IMF's quota increase.

Figure 2. IMF internal financial risk, 1994-2009



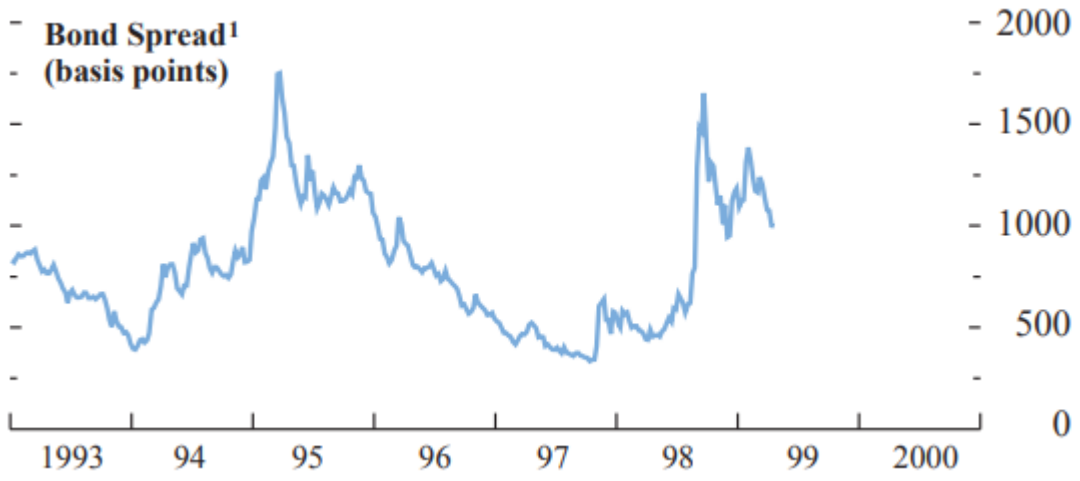
* Source: IMF annual reports.

Early 1998: Low Contagion Risk and IMF Program Suspension

According to our theoretical priors, low financial contagion risk in early 1998 should have enabled the Fund to prioritize its creditor role over its LOLR role, using stringent policy conditionality to protect its balance sheet. By comparison, during periods of high contagion risk, including both the 1998 Russian default and the 2000-01 developed country recession, the IMF should lend most readily, and with fewer conditions, to contain potential financial spillovers (Table 1). We find robust evidence of these patterns.

By early 1998, global financial markets had stabilized against the backdrop of successful IMF reforms in South Korea and Thailand. In its May 1998 report, the IMF noted this improved economic and financial outlook, saying that "the financial turmoil in Asia that erupted in mid-1997 has abated since January... and confidence should recover gradually during 1998.[41] Sovereign risk premiums had also declined considerably from their previous peak prior during the 1994-95 Mexican Peso Crisis (see Figure 3).

Figure 3. Financial Conditions in Emerging Market, 1993-1999



Data: JP Morgan Emerging Market Bond Index (EMBI) spread relative to comparable U.S. Treasuries.

In February 1998, as the world was emerging from a period of financial contagion, the IMF approved an Extended Fund Facility (EFF) to help Argentina contain its stubborn financial risk due to its high indebtedness. Although negotiations had begun during the 1997 East Asian crisis, our theory suggests that the IMF could increasingly act as a banker in these discussions as global volatility subsided. In other words, the IMF could use policy conditionality as a tool to hedge its lending exposure as a creditor, and provide a rationale for exiting its lending relationship in the event of Argentina's non-compliance.

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[41] IMF 1998

In line with these expectations, we find that Argentina's 1998 program included 20 quantitative performance criteria, mostly fiscal austerity and labor reform, while the average Fund programs in that same year had only six (See Table 2). This stringent criteria was also a reflection of the wide-ranging skepticism within the IMF about the program's feasibility, with the Research, Policy Development and Review, and Fiscal Affairs departments all lobbying for a program with a shorter duration than the EEF because of Argentina's stalling reforms.[42] Only the Western Hemisphere department believed "on balance, the risks [were] still acceptable."[43]

Table 2. Number of Conditionalities in Argentina IMF Programs

	1998	1999	2000	2001	2002
Prior Actions	0 (2)	0 (2)	0 (1)	0 (1)	0 (1)
Quantitative Performance Criteria	20 (6)	24 (6)	26 (6)	28 (7)	0 (7)
Indicative Benchmark	8 (2)	4 (2)	2 (2)	4 (2)	4 (2)
Structural Benchmark	0 (2)	7 (2)	7 (2)	26 (2)	3 (2)
TOTAL	28 (12)	38 (12)	35 (11)	58 (12)	7 (12)

Note: Numbers in parenthesis represent the number of conditionality in average IMF programs.

By July 1998, and in line with our theoretical priors, however, the IMF cancelled Argentina's IMF program because of the country's conditionality breaches and lack of reform progress. Not only had the Menem government missed a series of fiscal targets, but it had also pulled an about-face on its labor reform vows. Proposed labor legislation – backed by the IMF – would have resulted in government cost savings. However, it also meant job and wage cuts, a prospect that President Menem and his plummeting popularity could not afford.[44]

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[42] Internal memo to top IMF management, April 28, 1997.
[43] IMF 2004, 37.
[44] By early 1998, Carlos Menem had a 26 percent approval rating, with 15-16 percent unemployment rates.

The Fund could suspend Argentina's program because it did not impose substantive risks to other emerging market economies. Counterfactually, however, if global contagion risk had been higher, we surmise that the outcome of the IMF's program would have been much different, notwithstanding these thorny political issues. The Fund would have likely adhered to conditionality less stringently, or helped Menem build a reform consensus. For example, the IMF's Independent Evaluation Office (IEO) found in a 2004 report that when Argentina did not meet its fiscal reform targets, the Fund "did not employ all the available tools to bring about reforms" including consulting with opposition parties.[45]

In summary, the IMF's engagement with Argentina during the program illustrates that the Fund was less interested in facilitating economic reforms than preserving the soundness of its balance sheet. After receiving warnings from various internal departments prior to the program's approval, we find that the Fund had planned for the possibility of non-compliance. By stringently enforcing policy conditionality, it allowed the Fund to have a politically-feasible exit strategy. Ironically, however, the Fund's decision to disengage with Argentina to protect its balance sheet led to more serious fallout for both Argentina and the Fund during the 2001 crisis.

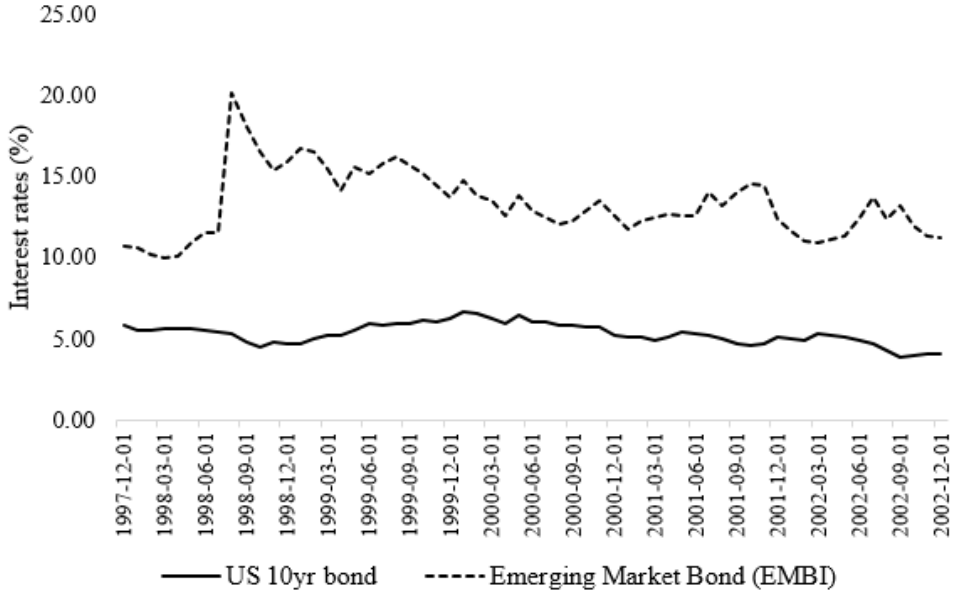
Late 1998-early 2001: High Global Contagion and the IMF as a Lender of Last Resort

In August 1998, the Russian debt default unleashed a bout of global financial turbulence that uprooted the economic recovery within emerging market economies. The yield on emerging market bond spreads more than tripled in the month following Russia's default, showing the rapid loss of investor confidence in global financial markets (Figure 4). Investors re-allocated their emerging market bond holdings into safer, more liquid

[45] IMF 2004.

developed country assets, and continued to demand higher risk premiums for emerging market assets throughout the 2000 and 2001 crises in Turkey and Argentina.

Figure 4. US 10 year government bond yield (%) and the EMBI spreads.[46]



Given the heightened global risk, our theoretical framework anticipates that the IMF will return to focusing on its core mission of preserving global financial stability. We also expect that the Fund will not stringently enforce conditionality because it cannot credibly exit its lending relationship, without jeopardizing global financial stability. To prevent financial fallout, we anticipate that the IMF will lend to Argentina, whether or not the country adheres to its program. Indeed, it helps explain why the IMF would fund the Menem government again, even though it had only lost more political popularity, and thus reform capital, since failing to comply with its IMF program a few months earlier.

A careful examination of the Funds internal decision-making offers strong support for these theoretical priors. For example, the Fund's research department sent a memorandum

[46] OECD statistics; JP Morgan's EMBI.

to the Executive Board (EB) emphasizing the importance of its lender-of-last resort role in Argentina, notwithstanding its stalled labor reforms.

"We realize that management opted for completing the review despite the staff's suggestion that it be conditional on…approval of …labor market reforms, which has not occurred…We see merit in the argument that the current turmoil in international market justifies the continuation of Fund support."[47]

In particular, the EB directors were concerned that the ongoing suspension of the program would make Argentina and other countries susceptible to contagion risks from the Russian default. The directors argued that "rather than wasting its scarce resources on a country [Russia] that would not follow Fund's advice, it might be better to instead spend those resources on other countries who face potential contagion [Argentina]."[48]

Notably, there were some dissenting opinions among IMF directors about resuming Argentina's program. A few directors, representing middle- or low-income countries that were less affected by the crisis (e.g., Middle East, Eastern Europe and Central Asia), were cautious about the program.[49] For example, Greg O'Loughlin (Belize) stated,

"We wonder if the staff report may not be too sanguine on prospects in light of ongoing international developments...these (adverse global conditions) could well lead to slower growth and wider current account and fiscal deficits than projected (in the program)."

Despite such concerns, representatives from high income countries and emerging economies that were most susceptible to the crisis (e.g. U.S., Mexico, and India) outnumbered these voting blocks,[50] and highlighted contagion risk as their chief reason for supporting Argentina. For instance, Karin Lissakers (U.S.) explained:

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[47] Paul Mason, Research Department's senior advisor. Cited in Blustein (2001)
[48] IMF, 9/23/1998. EBM 98/103.
[49] See statements from Mr. O'Loughlin (Belize), Mr. Milleron (France), Mr. Munthali (Malawi), *Dairi* (Morocco), and Szczuka (Poland) in IMF Executive Board meetings minutes, 9/23/1998 (EBM 98/103).
[50] See statements from Mr. Donecker (Germany), Ms. Lissakers (U.S.) Mr. Sivaraman (India), Mr. Grilli (Italy), Mr. Mr. Guzman-Calafell (Mexico), Mr. Kwon (South Korea), and Mr. Lehmussaar (Estonia) in EBM 98/103.

"The precautionary arrangement with the Fund serves as...I think, a very important signal of the Fund's continued support for these efforts and our readiness to provide financial assistance should external pressures increase substantially."

For this reason, the EB ultimately resumed the Argentine program in September 1998. Due to the "uncertainties regarding the duration of the current turmoil in international financial markets," the IMF decided to prioritize helping Argentina "maintain cautious stance to weather the danger of contagion" over requiring full compliance.[51]

In later explaining the Fund's decision to restart Argentine financing, IMF Deputy Managing Director Murilo Portugal, also highlighted the linkages between global contagion and Argentina's IMF program during an EB Meeting in May 1999:

"In certain circumstances, authorities' best efforts and the solidity of the macroeconomic situation may not be sufficient to contain pressures resulting from market over-reactions and contagion. In those circumstances, it is essential that the international financial community stand ready to provide support."[52]

Notably, despite its financial support to Argentina, the IMF placed less weight on policy conditionality as a tool to hedge its lending risk. Given its concerns about renewed global contagion, the IMF was more willing to overlook Argentina's non-compliance in 1999 than during June 1998, when it suspended Argentina's program during a period of waning global volatility.[53] Compared to its earlier dealings with President Menem, the IMF enforced conditionality less stringently (see Figure 5), even though he had failed to meet Argentina's fiscal targets and deliver on labor reforms. For example, the final program review in May 1999 showed that Argentina had only met five out of twenty four of its IMF lending conditions.

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[51] IMF 9/23/1998, EBM 98/103.
[52] IMF 5/26/1999, EBM 99/56.
[53] The Fund may have accepted some non-compliance because of Argentina's October national elections.

These patterns continued over the course of 2000 and the first-half of 2001 (see Table 1), a period characterized by growing emerging market credit risk. In particular, the Fund had fretted about the potential for an Argentine default to fuel global financial contagion.[54] Consequently, from 2000 until late 2001, the Fund made a series of large and risky loans, which ultimately amounted to $17 billion, or more than 5% of Argentina's GDP in 2000.

Figure 5. Argentina's compliance with IMF conditionality[55]

Importantly, the Fund stated that these lofty disbursements "allow(ed) the government to purchase the undrawn amount under the SBA immediately, regardless of the review status."[56] The Fund was thus prioritizing liquidity to prevent market panic, rather than conditionality to ensure Argentina's debt repayment.

Throughout the course of this lending cycle, there were some dissenting opinions. For example, during the EB meeting in May 2001, multiple board directors from Europe

[54] IMF 2004.
[55] Author's calculation based on IMF's MONA dataset.
[56] IMF 2004, 40.

questioned if the Argentine crisis posed sufficient contagion risk to warrant the investment. Stephen P. Collins (U.K.), highlighted that,

"The program remains fraught with risks.... the Fund should therefore, in its public statement, be circumspect in reference to the risks."[57]

Notwithstanding contagion risks, Collins raises concerns about the Fund's credit risk. Similarly, Jean-Claude Milleron (France) also showed a cautious stance:

"Clearly, the risk of fall-out is something, which cannot be ignored at this stage. In this connection, I would appreciate hearing from the staff what countries, beyond Brazil, they see as the most susceptible to a contagion crisis."[58]

Nonetheless, the Board eventually approved a loan in May 2001. Despite the U.S. and Western Europe's disproportionate voting power within the Executive Board, it was directors from African, Southern European, and Asian countries that persuaded them to support Argentina. For example, a director representing a group of African countries opposed Collins' remarks about Argentine risks:

"I was a little puzzled by Mr. Collin's suggestion that we should be circumspect about the risks. On the contrary, at this delicate juncture, we should fully support what we are doing right now in Argentina in order to avoid any negative perception."[59]

In response, the U.K. Director compromised by saying "the board's concerns should remain private."[60] Similarly, Milleron (France) also shifted his position, saying:

> "We, the Fund, and the authorities have to make sure that, this time, the plan [the IMF program] works. Part of the success of this plan hinges on a recovery of confidence...This is probably where the Fund can help the most: by providing unqualified support."[61]

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[57] IMF 5/21/2001, EBM 01/53
[58] Ibid.
[59] IMF 5/21/2001, EBM 01/53
[60] Ibid.
[61] Ibid.

Notably, the IEO later acknowledged that "the importance of Argentina's stability for the region and emerging market economies in general" was the main reason the IMF granted Argentina waivers during 2000-2001.[62]

In summary, the case of IMF lending to Argentina from mid-1998 until mid-2001 confirms our theoretical priors that the global financial environment wields considerable influence over IMF decision-making. The Fund was willing to resume a highly risky Argentine program to reduce the risk of global contagion, notwithstanding the Fund's own considerable balance sheet risk. The IEO later found that the Argentine program imposed tremendous financial risks for the IMF. Specifically, "in the event of a non-payment of principal, the IMF's precautionary balances would not be sufficient to cover the total amount of arrears that could arise."[63] Yet, the Executive Board discussions did not emphasize these internal financial risks, as they were afraid that "withholding support at this junction [2001] was tantamount to shying away from the mandate of the IMF."[64] The promise of new IMF funds to a previously non-compliant borrower, however, created a moral hazard problem, sowing the seeds for future debt problems.

Late 2001: Decoupling Argentina and IMF's Restoration of its Balance Sheet

By the summer of 2001, emerging market credit risk began improving amid growing sentiment that Argentina's default risk would be contained financially. While the Fund had allowed Argentina to access another $8 billion in August, its management had increasingly viewed that emerging economies were showing signs of normalization.

For example, the IMF's research department concluded that contagion from an Argentine default would "likely be limited because a 'credit event' was already widely

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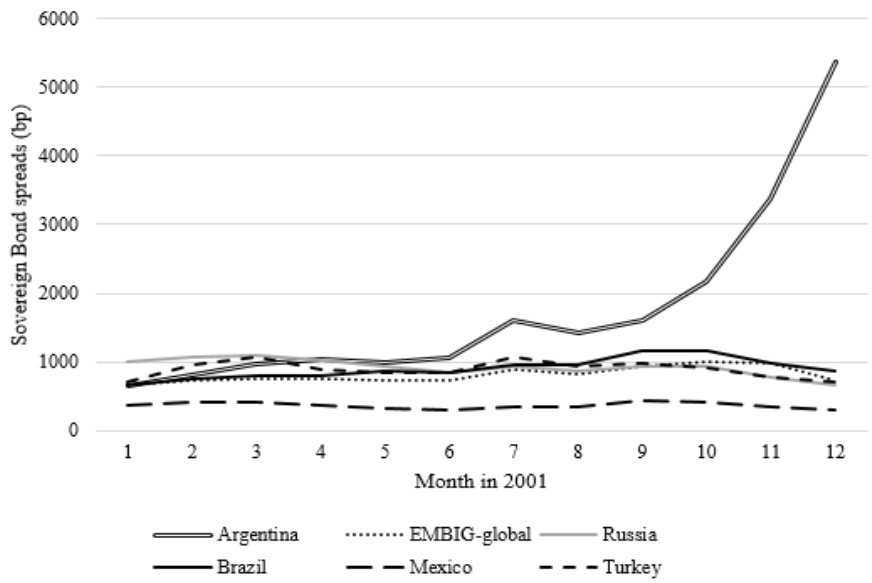
[62] IMF 2004, 47
[63] Ibid, 61.
[64] Ibid.

anticipated and had been partly discounted by markets for some time."[65] In October 2001, the Fund noted that the "the potential for future contagion is less than it was in the past."[66]

These sentiments were echoed in global financial markets. For instance, Deutsche Bank's Scudder Investment, which was the fourth-largest asset manager globally, highlighted that markets had "started to price in the default risk…the decoupling or separation of Argentina," meaning that "any impact from a real default would be a knee-jerk reaction."[67]

Figure 6 shows that emerging market economies (i.e. Brazil, Mexico, Russia, and Turkey) that were susceptible to contagion showed signs of normalization by late 2001. By contrast, Argentina's sovereign risk premium spiked higher. The emerging market global index (EMBI), which shows the aggregate risk for all emerging economies, also supports the Argentine "decoupling" narrative.

Figure 6. Sovereign Bond Spreads in Emerging Economies in 2001 by month



[65] Ibid. 52.
[66] IMF 2001.
[67] Yoon Cho. "The Outlook for Emerging Market Debt" *The Street*. Dec 12, 2001. Available at: https://www.thestreet.com/personal-finance/meet-the-street-the-outlook-for-emerging-market-debt-10005241

In line with this change in market sentiment regarding the likelihood of financial spill-overs from Argentina, the IMF began to shift its position regarding its lending. Consistent with our theory, the improving global economy in late presented a window of opportunity for IMF's exit. In November, Domingo Cavallo, the Argentine economy minister, tried multiple times to visit the IMF's headquarters only to find out that the Fund would not receive him.[68] On December 3, the IMF refused to complete the fifth review, cut off the flows of funds and completely withdrew its mission from Argentina.

We surmise that had the global economy been vulnerable to financial turmoil in late 2001, the Fund would have likely followed a different path with Argentina. Its stated reason for not completing the review was Argentina's fiscal non-compliance: the government had breached its fiscal deficit target by $2.6 billion, intensifying Argentina's debt problem. However, this was the first time during 2000-2001 that non-compliance had led to a program cancellation. Ironically, Figure 5 shows that Argentina's non-compliance was actually worse in 1999 than 2001. Yet, the IMF had provided Argentina with numerous fiscal waivers during its program until the last quarter of 2001, when it was confident it could contain the regional fallout from Argentina's default.

In summary, the Fund's lending stance toward Argentina from 1998-2001 reflects the variation in global contagion risk over time. The Fund's internal documents demonstrate its vigilance about the high risk associated with Argentina's IMF programs. However, the Fund lent to Argentina whenever its default posed a potential contagion risk globally. These conditions created a moral hazard problem, where the Fund had difficulty enforcing conditionality because of its willingness to supply Argentina with funds to buttress global

[68] Kedar 2013, 177

stability. Ironically, however, Argentina's expanding indebtedness prompted the IMF to exit its lending relationship once global financial markets had stabilized.

II. The IMF's Underwriting U-turn in Greece: 2010-2015

The 2010 Greek Sovereign Debt crisis also illustrates how varying global contagion risk influences the Fund's lending decisions. In 2010, the Fund was concerned about the financial spillover from Greece to the rest of Europe. Despite questions regarding Greek's debt sustainability, the IMF lent extensively to Greece with an ambitious set of conditions. However, it then disregarded Greece's non-compliance because it fretted that cutting lending might foment global instability. In contrast, when regional credit markets stabilized in 2013-14, the IMF shifted its focus to its internal financial risk (see Table 3). The Fund used conditionality to protect its financial resources. It demanded full compliance with conditionality, notwithstanding Greece's lack of political capacity. When Greece did not adhere to conditionality, the IMF ceased disbursing money and refused to join later Eurozone-orchestrated rescue packages.

In the following pages, we first show that the Greek case fits into the study's domain of high IMF financial risk. We then investigate why the Fund, despite its high internal financial risk, first approved unprecedentedly large loans in 2010 and 2012, and later reverse course by terminating its programs in 2013 and 2014.

Table 3. Global contagion risk and IMF decisions regarding Greece, 2010-2015

<table>
<tr><th></th><th>2010</th><th>2011</th><th>2012</th><th>2013</th><th>2014</th><th>2015</th></tr>
<tr><td>IMF financial risk</td><td colspan="6">HIGH</td></tr>
<tr><td>Global contagion risk</td><td colspan="3">HIGH</td><td colspan="3">LOW</td></tr>
<tr><td>Key market events</td><td colspan="2">Eurozone Crisis</td><td>Europe's Recovery</td><td colspan="2">Ireland, Spain, Portugal's 'exit' from bailout programs</td><td></td></tr>
<tr><td>IMF decisions regarding Greece</td><td colspan="3">Loan approval & continued lending</td><td colspan="2">Delayed Reviews</td><td>Refused to bailout</td></tr>
</table>

The IMF's Financial Risk, 2010-2015

From early January 2010 (when the Greek Prime Minister first inquired about IMF lending) until July 2015 (when the Fund refused to lend), the Fund's usable resources were nearly depleted. Due to high global demand for IMF funds after the 2008 financial crisis, the Fund had made unprecedentedly large commitments between 2009 and 2015.[69] As a result, its ratio of precautionary balances to credit outstanding hit all-time lows every year during 2010-2012 and stayed low from 2013 until 2015 (Table 4; also see Figure 1). In a public release, the Fund also noted that resources would not have been available to lend during 2010-2014 if it had not borrowed additional funds.[70]

Table 4. IMF's internal financial risk
(Billions of SDR)

Year	'07	'08	'09	'10	'11	'12	'13	'14	'15	'16	'17
Precautionary balances to credit outstanding	104	112	35	18	12	10	13	16	26	32	35

*Source: IMF Financial Operations (2014; 2018)

2010-2012: Contagion Risk in Europe and the IMF as a Lender of Last Resort

In response to Greece's request for a bailout package to avoid a default on its sovereign debt in May 2010, the IMF (along with the EU and ECB), announced a €110 billion loan in exchange of an extensive list of reforms. For the IMF, its €30 billion commitment was highly risky because of both Greece's questionable debt sustainability, and its deteriorating domestic political outlook. Indeed, eroding government support and increasingly violent riots clouded the likelihood that Greece would implement its reform agenda.

[69] The Fund's total commitments were 120 billion SDRs in 2010, and peaked at 220 billion SDRs in 2012.
[70] IMF 2018.

Notwithstanding these vulnerabilities, contagion risk compelled the Fund to act as an ILLR. During the May 2010 Executive Board (EB) Meeting, several directors emphasized that Greece's program was a "very challenging program" especially given the Fund's own financial situation.[71] Directors also fretted about Greece's high debt and poor implementation record historically. Nonetheless, contagion fears outweighed the Fund's internal risk. Many directors agreed that "given the growing concern of contagion from Greece,...we have no other choice but to support the program."[72]

For example, Arvind Virmani (India) and Michael Patra, a senior Fund advisor, warned that the Greek crisis could morph into a global crisis:

> "There is a danger that the overarching desire to avoid loss of market confidence and access could force other countries with large fiscal deficits (14 out of 16 in the Euro area) to proactively begin to front-loaded exits, precipitating a global deflation. If the sovereign crisis intensifies, it could spill over into a banking crisis."[73]

Given the importance of the Greek crisis for future global stability, they concluded that "the Fund must address the issues related to debt resolution in a time-bound manner."[74] Others championed the same theme: "We need to put all our forces in finding a solution that can contain the spillovers."[75]

To assess the extent of the IMF's emphasis on contagion, we conducted a content analysis of the May 2010 meeting minutes, where it approved Greece's IMF program. Counting word frequency, we find that "spill-over(s)," "contagion," and "Eurozone" were spoken more than "expenditure" and "tax," and in aggregate, more than "growth" or "government" (Table 5).

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[71] For example, Paulo Nogueira Batista (Brazil) warned that the Fund should not ignore "the credit risk for the Fund." IMF Minutes of Executive Board Meeting. May 9, 2010. EBM 10/45-1

[72] Ibid. Directors from Singapore, Philippines, Japan and Switzerland were one of many showing serious concerns for potential contagion.

[73] Ibid.

[74] Ibid.

[75] Ibid.

Table 5. Words frequency during the EB meeting in May 2010.

Fiscal (179)	Debt (156)	European (124)	Reform(s) (101)	Euro (78)
Growth (61)	Government (60)	Implementation (50)	Spillover(s) (47)	Europe (26)
Sovereign (25)	Eurozone (22)	Contagion (20)	Expenditure (13)	Tax (5)

Note: Numbers in parenthesis indicate the counts of words in the EB Minutes.

Scrutinizing the word frequency from the May 2010 meeting with other meetings, the IMF was seriously concerned about contagion risks when it approved the Greek program in 2010. Table 6 below compares the word frequencies for 'spillover', 'contagion', and 'Eurozone' during 2010 and 2013, finding that their frequencies decline substantially over time in contrast to the stickiness of 'fiscal', 'debt', 'growth' and 'reform.'

Table 6. Words frequency during EB Meetings on Greece in 2010 and 2013.

	Spillover	Contagion	Eurozone	Fiscal	Debt	Growth	Reform	Tax	Implementation
2010	47	20	22	179	156	61	101	5	50
2013	4	4	0	109	130	85	106	83	41

Because of its contagion concerns, the Fund also revised its "exceptional access criteria," which mandated a "high probability" of debt sustainability as a prerequisite for extraordinary large loans. In the May 2010 meeting, Fund officials decided to exempt Greece from these criteria after considerable debate,

> "Directors considered Fund exceptional access as justified given *the high risk of international systemic spillovers*. Going forward, to ensure the principle of uniformity of treatment, Directors recognized that the Fund would follow this approach regarding this criterion in similar cases with a *high risk of systemic spillovers*."[76]

[76] Ibid.

Reflecting these concerns, contagion risk started to materialize in Southern Europe in mid-2010.[77] For instance, the 10-year government bond yields for Spain, Ireland, Portugal and Italy, spiked after the outbreak of the Greek crisis (see Figure 7). In line with our argument, the Fund, therefore, prioritized global stability over mitigating its internal financial exposure. Despite the risk of default, the Fund disregarded Greece's breach of IMF conditionality. Indeed, the IMF granted waivers for all of Greece's unmet conditionality from 2011-2012, even after initially requiring more conditionality (to hedge its risk) than other IMF programs (see Table 7).[78]

Table 7. Number of Conditionalities in the Greek vs. average IMF Programs

	2010	2011	2012	2013	2014
Prior Actions	4 (0)	15 (0)	13 (0)	9 (0)	23 (0)
Quantitative Performance Criteria	15 (5)	23 (4)	24 (3)	21 (3)	21 (3)
Indicative Benchmark	3 (2)	4 (2)	8 (2)	9 (1)	2 (2)
Structural Benchmark	12 (2)	11 (2)	17 (2)	14 (1)	15 (1)
TOTAL	34 (9)	53 (8)	62 (7)	53 (5)	61 (6)

Note: Numbers in parenthesis are the average number of conditionality for all IMF programs in the given year. Data: Kentikelenis, A., Stubbs, T., & King, L. (2016).

In addition, rather than terminating Greece's program for non-compliance, the Fund transformed the Greek Stand-by Arrangement into an Extended Fund Facility in March 2012. This rescheduling decreased the adjustment burden on the Greek society by shifting its repayment schedule from 5 to 10 years, but it also embedded long-run debt sustainability issues into the economy.

[77] De Santis 2014, Bhanot et al. 2014

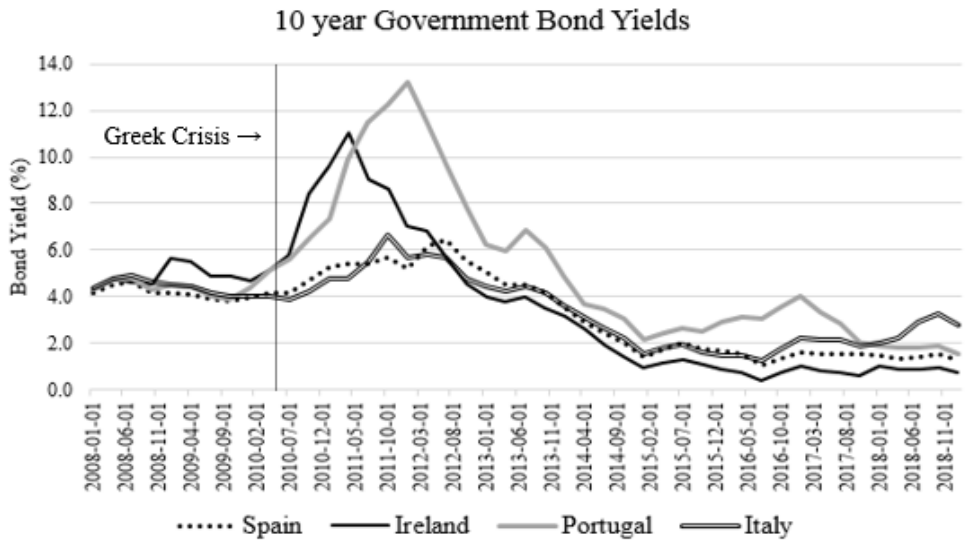
[78] In 2011, the Greek authorities missed its targets for civil service and other reforms, but received IMF waivers. The fiscal and privatization performance criteria were also missed in December 2011.

To summarize, the Fund's concerns about global contagion compelled the IMF to prioritize the health of the global economy over its own risky balance sheet between 2010-2012. While the Fund aimed to hedge its financial exposure with conditionality, it did little to enforce conditionality given the high contagion risk over Europe.

2014- 2015: The IMF as a Greek Banker

With Europe's regional credit environment stabilizing between 2013-2105, the Fund was able to shift its focus from being an ILLR to a global banker. Investor confidence first improved in July 2012 after President of the European Central Bank (ECB), Mario Draghi, declared that "the ECB is ready to do whatever it takes to preserve the Euro."[79] For example, the 10-year government bond yields for Spain, Ireland, Portugal and Italy all returned to pre-Greek crisis levels by 2013.

Figure 7. 10-yr Government Bond Yields. 2008-2018.[80]



[79] Wilson, Wigglesworth and Groom. 2012. "ECB 'ready to do whatever it takes,'" *Financial Times*, July 26.
[80] OECD 2019.

The IMF was cognizant of these dissipating contagion pressures. Recall that the frequency of Executive Board comments regarding contagion declined significantly between its 2010 and 2013 meetings (Table 6). With the turnaround in investor appetite, the Fund both required more conditionality (see Table 7), and also enforced them more strictly in 2013-14 compared to 2011-2012.

These binding conditions would eventually provide the Fund with an 'exit' option from Greece's program. By mid-2014, the Antonis Samaras government had hoped to 'graduate' its IMF-EU program and receive its final €7.2 billion loan installment. However, during the review process, Greece missed its program targets for sales tax implementation, market liberalization, and union bargaining. In contrast to earlier in the program, the Fund did not grant Greece any waivers, and refused to release the tranche.

During the November 2014 negotiations, the Fund was "the most immovable among the creditor institutions [ECB, and EU]."[81] To those Greek and Europeans involved in the discussion, it appeared that "the Fund had resolved to block approval, period."[82] Some Fund officials fretted that such rigid demands for Greece could backfire, warning that "current plans for the primary fiscal surplus… could threaten social cohesion and wreck any prospect of economic recovery."[83] However, the Fund did not allow any adjustments in program targets and instead delayed the review by extending the program into 2015, without disbursing any money – a stark change from its steady disbursements during 2010-12.

After Greece defaulted on the IMF's loan in June 2015, the Fund continued to protect its balance sheet amid relative global financial stability. Greece's initial default of $1.5

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[81] Blustein 2016, 386
[82] Ibid. 388
[83] Reza Moghadam, 2015, "Halve Greek debt and keep the eurozone together," *Financial Times*, January 26.

billion was manageable; however, a prolonged default could cost the Fund as much as $26 billion.[84] High-profile cases of debt arrears could also create reputational risk by undermining the Fund's credibility as a 'super-safe repository' of member states' money.[85] The Fund thus announced it would no longer bailout Greece, who did not meet the IMF's exceptional access criteria this time, lacking both the "institutional and political capacity" for reforms, and a "high probability" of debt sustainability.[86]

Some Greek and other European officials pressured the Fund for greater flexibility. Yanis Varoufakis, the former Greek finance minister, argued that the Fund could modify its lending rules because "they've already violated their rules twice to do so."[87] When the IMF last waived Greece's exceptional access criteria in 2010, however, there was a high risk of international systemic spillover.

By contrast, there was little fear of contagion in 2015. According to a "confidential summary" of the July 2015 Executive Board meeting disclosed in the *Financial Times*, the lack of contagion risk influenced the board's decision. The minute states,

> "In 2010, the systemic waiver was applied as a restructuring of the debt in hands of the private creditors was needed to restore debt sustainability, which could have caused major contagion…Currently, a restructuring of official debt is required and staff could think only of a few instances in which public debt restructuring could create contagion."[88]

Consistent with our theory, the variance in the Fund's lending decisions about Greece reflects shifts in contagion risks. While the Greek program had always posed risks to the Fund's balance sheet, the Fund nonetheless extended loans and overlooked non-

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[84] Steil and Walker, 2015, "A Full Greek IMF-Debt Default Would Be Four Times All Previous Defaults Combined", *Council of Foreign Relations*, June 24.
[85] Ibid.
[86] Peter Spiegel, 2015, "Greece disqualified from new IMF bailout, board told." *Financial Times*, July 30.
[87] Ibid.
[88] Ibid.

compliance when contagion fears were high. Once contagion fears dissipated, however, the Fund refused to lend unless Greece adhered to its conditionality.

Conclusion

Under what conditions might the IMF, notwithstanding being the world's lender of last resort, cut its lending, or refuse financing to a troubled national lender? In this paper, we show that its financial exposure and global contagion risk play a central role in answering these questions. To manage its balance sheet risk, we find the IMF varies its policy conditionality, employing it less stringently during periods of global contagion. When financial contagion is contained, however, the IMF tends to act as a traditional banker, scrutinizing its financial risk, and even suspending lending programs for non-compliance.

Employing the Argentine (1998-2001) and Greece cases (2011-2015), we show that the IMF's willingness to lend was conditioned by global contagion risk. In Argentina, the Fund toggled from being a responsible banker (when the global economy stabilized in early 1998) to an ILLR (following the 1998 Russian default), and back to being a traditional banker (when contagion risk later diminished in 2001). In Greece from 2011-12, the Fund extended sizable loans, notwithstanding their high risk, to help alleviate market panic in the wake of the European sovereign debt crisis. With Europe's recovery, however, the IMF demanded that Greece fully implement its program, and refused to join further bailout programs at Greece's non-compliance.

The evidence from case studies is thus consistent with our theoretical expectations. These findings are robust, as we control for country characteristics (e.g. geopolitical relations and economic development) by examining the Fund's decisions within these countries over time. To examine whether or not the relationship between IMF lending

and global contagion holds beyond Argentina and Greece, we briefly extend the analysis to another high-profile case in Brazil where the IMF refused to renew its lending.

Case Extension: Brazil 1993-94

After its unsuccessful completion of its 1992 IMF program, Brazil hoped to receive a new program in 1993. The IMF was financially constrained (see Figure 1); and it could focus on its own financial soundness, rather than its mission of preserving global financial stability, because there was little threat of financial contagion.

At its July 1993 Executive Board meeting, major IMF stakeholders were reluctant to lend to Brazil. Alexander Kafka noted that Brazil had hoped to "enter into negotiations with the Fund staff on a stand-by arrangement." However, Thomas Dawson (U.S.), who has veto power over IMF lending, balked at lending because of Brazil's past non-compliance.

> "Brazil's performance under the 19-month stand-by arrangement...has been a bit disappointing...the experience suggests that it might be better to take a wait and see attitude...."

Similar to the Argentina and Greece cases, the IMF used conditionality to hedge its balance sheet risk during a period of relative global stability. Rubens Ricupero, who was the Brazilian Minister of Finance, recalled in our interview that Brazil's negotiation failed because of the Fund's "excess orthodoxy in demanding a fiscal position that was politically not feasible."[89] Notwithstanding continuous requests from the Brazilian authorities, the Fund instead approved 'a staff-monitored program' in March 1994, which did not entail any loans.

It is noteworthy that the Fund tried to support Brazil, but only to a degree that it would not risk the Fund's own balance sheet. According to Ricupero, while no loans were granted, "there was a sort of a tacit agreement" between the Fund and the government to

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[89] Authors' interview, August 2017.

improve the situation, with the Fund informally helping Brazil reach a debt agreement with commercial banks:

> "They [the IMF] did know that we were acting under severe political constraints, so although they did not support our plan, on the other hand, they did not try to create difficulties. This is the basic reason we were able to sign with the commercial banks because I suppose the commercial banks, at some point, asked the IMF and they must have given them the green light."[90]

The Fund's stance shows how it was safeguarding its own resources while it tried to help a country under crisis. This banker-first attitude, however, changed when the Mexican Peso crisis erupted in late 1994, unleashing concerns about contagion. After the Mexican peso collapsed, foreign investors not only liquidated Mexican assets, but also fled from the emerging market asset class.

Given this heightened contagion risk, the Fund shifted to being a lender-of-last resort. During its June 1995 meeting, the IMF executive directors emphasized that "the underlying effects of the Mexican crisis on the Brazilian economy remain of concern." They "welcomed the increased intensity of the dialogue between the Fund and the Brazilian authorities,"[91] and inquired "can we do anything besides giving advice to that country (Brazil)?"[92] Without a formal request from Brazil, which was mired in national elections, the IMF could not lend. Yet, if Brazil had requested IMF support, the board meeting minutes suggest that the Fund was ready to support Brazil in 1994, unlike 1993.

The Brazilian government also noted such changes in the Fund's stance. Ricupero told us that "the interplay with international financial trends was very strong - the Mexican crisis, all those problems had a tremendous influence, and later with the Russian crisis and the Asian crisis of 1997. All those episodes had a strong impact (on the Fund's

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[90] Ibid.
[91] EBM 6/21/1995
[92] Ibid.

decision to grant us a formal program.)"[93] Indeed, the Fund extended a program to Brazil in 1998, when the contagion pressure was high following the Asian and Russian crises.

Implications

In conclusion, these findings offer important new insights for the international political economy literature, which has found that IMF conditionality reflects geopolitics, domestic politics, and global technocratic networks. Public choice models have also found that IMF conditionality increases with the growth of its loan portfolio, arguing that IMF bureaucrats exploit the opportunity to increase their prestige and power.[94] However, our findings have shown that positive association between the stringency of IMF conditionality and global demand for IMF programs instead reflects the staff's desire to hedge the Fund's financial risk.

This paper also advances existing knowledge about IMF lending and moral hazard. Recent scholarship points to IMF politics as a source of moral hazard, with borrowers with close ties to the Fund's major shareholders more likely to pursue imprudent economic policies.[95] By comparison, our study suggests that moral hazard is also likely to be a product of the Fund's ILLR mission, with conditionality more likely to be waived when there is high contagion risk. The IMF's willingness to cut financial ties, when there is little threat of contagion, also risks contributing to national boom-bust cycles as we have observed recently in Argentina.

In contrast to national central banks' often sustained liquidity commitments during crises, the IMF toggles between prioritizing liquidity and conditionality with its lending. In 2018, it extended a $57.1 billion loan to Argentina, a country with a known default

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[93] Authors' interview, August 2017.
[94] See footnote 20.
[95] Lipscy and Lee 2019.

history. Noting that contagion was one of the chief risks for emerging market countries,[96] the loan was in part oriented toward avoiding contagion in similar asset classes internationally. The Fund also willingly endowed Argentina with considerable flexibility in its program design. For example, in our 2019 interviews about IMF negotiations, Argentina's Vice Minister of Finance Miguel Braun and Central Bank Director Horacio Liendo characterized the IMF as "internally more flexible," and "very reasonable."[97]

By 2019, however, Argentina had again decoupled from other emerging market assets, with investors questioning the Macri government's incremental approach to economic governance amid currency depreciation and rising public indebtedness. The IMF's financial backstop and flexibility helped contain global volatility in the short-run. However, it also intensified Argentina's moral hazard problem when Alberto Fernández's unexpectedly won a sizable primary electoral victory against Macri in summer 2019. Argentina's financial decoupling limited the IMF's willingness to provide more liquidity without further reform guarantees. Ironically, however, the IMF's shift from prioritizing liquidity today to conditionality tomorrow undermined its mission as an ILLR.

This institutional trade-off raises an important long-run question amid the current coronavirus pandemic. With the massive financing necessary to resolve developing countries' spiraling debt problems, might IMF reform be necessary to ensure a sustained commitment to ILLR? At the same time, could there be better alternatives to country surveillance than conditionality mechanisms? The Fund's mandate of preserving global stability means it is reliant on the sovereign borrowers' voluntary reform adoption. Perhaps, the G20's mutual assessment process (MAP) – which would allow the Fund to

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[96] IMF 2018.
[97] Authors' interviews, August 2019.

have ongoing policy discussions with systematically important economies – or independent surveillance mechanisms might yield better results.

To conclude, this study highlights the limits of the IMF, and more broadly, institutionalism. Rather than simply fulfilling a functionalist role as an ILLR, we show that the IMF has constrained agency. Credit risk is inherent in the IMF's operations. Not surprisingly, the Fund's directors and staff are extremely conscious about the institution's financial risks. When evaluating the risk of its lending portfolio, they do not only consider the economic and political fundamentals of sovereign borrowers, but also the broader global environment and the Fund's own financial soundness.

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