

## GLOBAL ECONOMIC GOVERNANCE INITIATIVE



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# Understanding the Consequences of IMF Surcharges

## THE NEED FOR REFORM

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The International Monetary Fund (IMF) provides a global public good when it lends emergency balance of payments support to countries that otherwise could not access such financing at comparable terms. No country borrows from the IMF lightly, and only does so as a last resort in the face of an economic crisis. In exchange for IMF lending, governments surrender some sovereignty, self-determination of their economic policies, and implicitly admit that the government, on its own, could not manage the travails through which it is going. A lesser known but also costly trade-off is that the IMF imposes significant surcharges—akin to the penalty rates imposed by banks—on countries with large borrowings from the IMF that are not paid back within a relatively short time. Indeed, IMF surcharges are pro-cyclical financial penalties imposed on countries precisely at a time when they can least afford them. This brief note examines the economic implications of the surcharges from a global distributive perspective. In so doing we stress the need to eliminate excessive surcharges in the COVID-19 era and call for a more fundamental reform of IMF financing.

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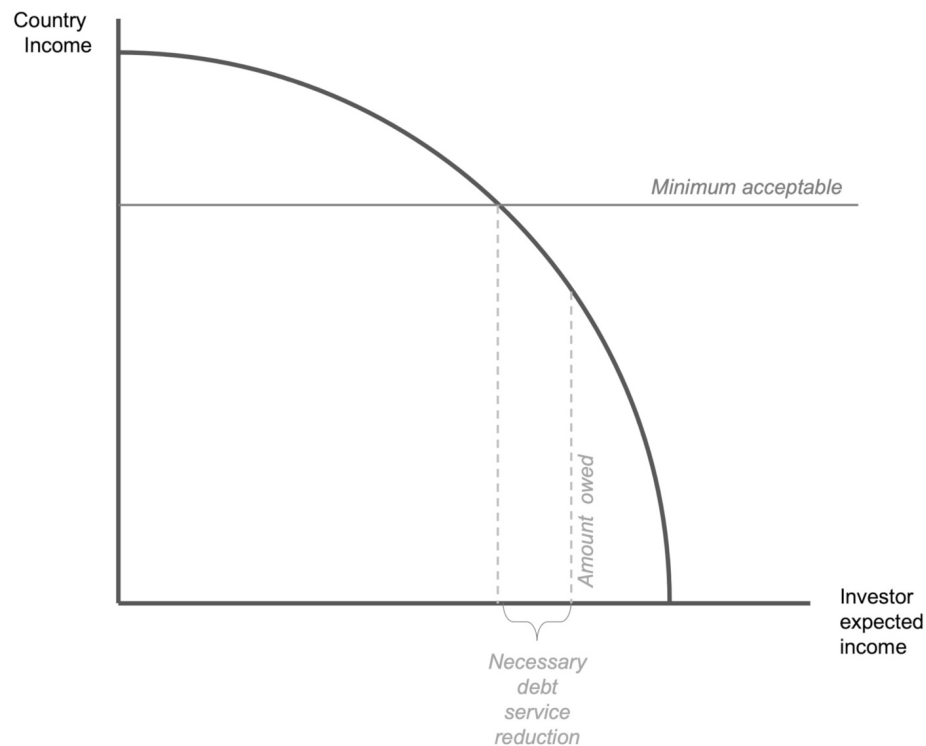
## Sovereign Debt Crises and IMF Surcharges

One of the reasons that countries turn to the IMF for support is that they have foreign exchange obligations, e.g., associated with payments to service debt denominated in hard currencies, beyond their ability to pay. Private lenders are not willing to provide additional funds, not willing to engage in meaningful debt renegotiation, or are demanding usurious rates that would only postpone the day of reckoning. With low-interest loans from the IMF the country is ideally able to resuscitate its growth, which, combined with appropriate restructuring of the debt obligations, can reduce debt repayment obligations and increase economic growth to the point that the debt-to-GDP ratio becomes sustainable.

There are thus three pieces to a successful IMF “program” for a country with a high level of indebtedness: a) addressing the liquidity shortage by providing foreign exchange that otherwise would not be available; b) restructuring debt to bring down hard currency obligations to a sustainable level; and c) creating a new economic program which, together with the temporary infusion of funds, restores growth and makes the debt sustainable. The three pieces are intricately interlinked: without funds, for instance, the country might have to impose austerity measures that shrink the economy, which will increase the debt-to-GDP ratio and make the debt even less sustainable; without restructuring, the new funds are likely to simply go to creditors and render the country unable to make the necessary counter-cyclical investments that enable growth to be restored.

Figure 1 depicts standard analyses, focusing only on non-IMF creditors and the country, where the creditors can get more but only at the expense of the well-being of the country's citizens. There may be a constraint—the maximum amount that is politically acceptable for the country. There is a large and contentious literature about the consequences of a country defaulting (See Panizza et al, 2009).

**Figure 1: Standard analysis model of the relationship between non-IMF creditor and country income**



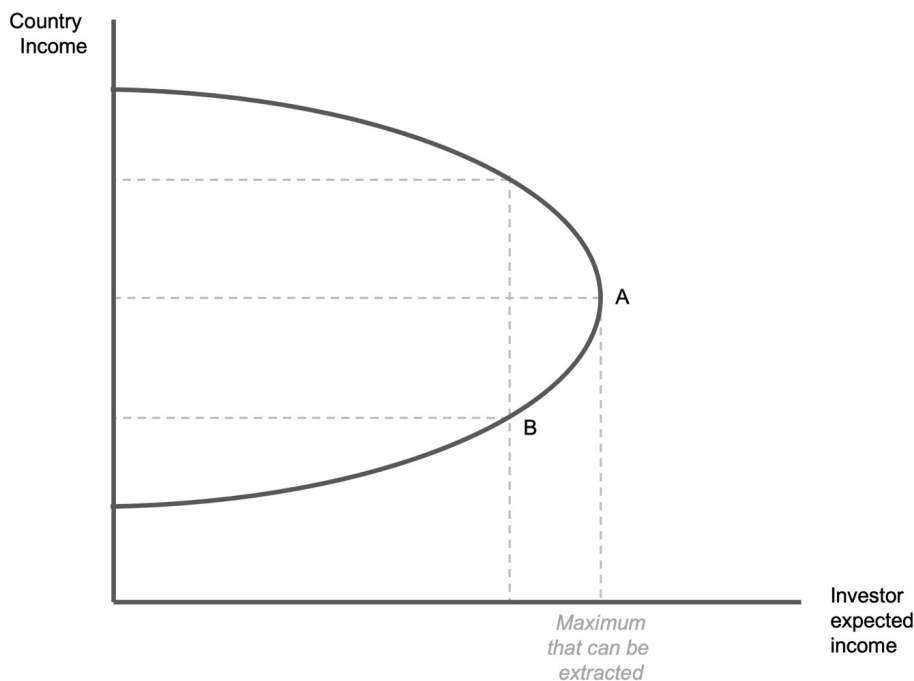
Source: Authors' elaboration.

Given sovereign immunity, there is a limit to the extent to which sovereign debt contracts can be enforced.<sup>2</sup> Some argue that countries face large costs in defaulting, others that the costs are small, or at least small relative to the domestic political costs they may confront in not defaulting. Citizens and politicians may differ in their judgments (see Panizza et al for debate). While acknowledging these subtleties, in the figure we assume that there is a limit on repayment, which in the relevant cases is below full repayment. From this perspective, creditors do what they can to increase what the country pays knowing, of course, that they are hurting the country, putting more people in poverty, slowing future potential growth, worsening health and education, and so on. Financial institutions argue that they have a fiduciary duty to those who have supplied them money to extract as much from the country as possible, regardless of the cost to the country.

The traditional role of the IMF has been to act as a collection agency for the creditors—to exert collective international pressure to increase what the country pays, obviously at the expense of the citizens in the country (Kentikelenis et al, 2019). The argument is sometimes put that the provision of liquidity and the advice proffered shifts the “frontier” of possible outcomes (illustrated as the curve in Figure 1) outward, in such a way that the possibilities are better for both the country and the creditors collectively. There is little evidence that that is the case; the fact that so many programs are associated with low growth and another debt restructuring within five years suggests that it is not the case, or at least that the extent to which the frontier is shifted out is limited.

There is another, perhaps more relevant depiction, more consistent with modern analyses of credit markets, and which we refer to in Figure 2: Attempts to force excessive repayments are counterproductive because they lower the economy’s productive potential. Both creditors and the country itself are worse off. In this view, there is a maximum that can be feasibly extracted from the country (labelled as point A in Figure 2).

**Figure 2: A new model of the relationship between non-IMF creditor and country income.**



Source: Authors' elaborations.

<sup>2</sup> Those limits are, of course, ambiguous, especially after Judge Griesa's 2014 rulings in the case of Argentina. In 2015, the UN General Assembly overwhelmingly reaffirmed the principle.

The problem is that inter-creditor bargaining—as each creditor tries to get as much as possible and does not consider the total level of debt facing the country—may result in that critical threshold being exceeded. There is ample evidence that in past debt restructurings, the amounts demanded by the creditors are beyond what is sustainable (Panizza et al, 2009). The country suffers, but the creditors themselves do not get back what they had hoped, as the economic potential of the country—and therefore the amount that it can repay—is lowered from point A to point B in Figure 2. That situation is clearly worse for both the country and the investor. In a number of these cases, it appears that there were alternatives that would have been Pareto superior, at least as viewed from the perspective of creditors as a whole and the country itself.

Agency problems for creditors and in the borrowing country may also result in Pareto-inefficient debt agreements.

From this perspective, one of the roles of the IMF is to identify the sustainable level of debt—to ensure that creditors do not make (and countries do not accept) excessive demands. While rationally, creditors should welcome an objective determination of the maximum debt level that is sustainable, in the presence of agency problems within creditors that might not be the case; and the recognition of these limitations could affect inter-creditor bargaining. As noted earlier, if creditors are competing among themselves they aren't thinking about the aggregate debt level, just what they, in particular, are owed.

## Introducing Surcharges

We describe above how IMF programs might affect the creditor-country bargaining frontier and the equilibrium outcome, suggesting in the former case that it might succeed in garnering somewhat more for the creditors at the expense of the country; in the latter case that it might succeed in garnering more for both. Holding all other dimensions of the program constant, an increase in surcharges (payments in hard currency to the IMF) *must necessarily move the frontier inward*, worsening potential outcomes for both the country and investors.

In Case 1, if the country has correctly identified the maximum amount of debts that can be politically extracted from it, then an increase in surcharges necessarily must come at the expense of the other creditors. The gains to the IMF are at the expense of the other creditors.

But this does not correctly reflect the standard bargaining process, in which IMF programs are typically finalized after an agreement with other creditors has been made (Shlegel et al, 2019). In that case, the surcharges are at the expense of the country. They are simply a transfer of resources from the people of the country to the IMF. Whether one believes that appropriate or desirable depends on one's conception of multilateralism and the role of the IMF, a subject to which we turn later in this note.

But the more relevant case is that where there are further consequences of the transfer of resources to the IMF, it affects not just the level of poverty, health, education, and over-all well-being in the country in crisis, but also its potential growth. Typically, as we note above, such countries face a foreign exchange constraint, which limits public investment and debt repayment options. If that is the case, the additional transfer of resources to the IMF comes at the expense not just of the borrowing country but of the creditors, too, even though the creditors have already seemingly made a settlement. The reason is that the lower growth reduces the sustainability of the debt restructuring, decreasing the probability that the other creditors will actually receive the agreed upon amounts. Indeed, in Figure 2 the additional amounts demanded may be Pareto inferior—the gains to the IMF may be less than the combined losses to the creditors and the country.

## Justifications

The preceding analysis suggests that the surcharges are at a minimum simply a transfer payment to the IMF from other creditors and/or the country. More generally, the surcharges have an adverse effect on both the creditors and the country greater than the amounts the IMF collects, with the extent of pareto inferiority especially grave in the situation we identify in Figure 2.

What might be the justifications for these regressive transfers? The oft-cited rationale is to limit the demand for IMF programs, to offset the risk of non-repayment, and to encourage borrowers to pay back ahead of schedule. Of course, it is important for member countries not to become over-reliant on the IMF for liquidity, but regressive and procyclical surcharges are not the most efficient way to create such incentives amid a global economic crisis. The unintended consequences are two-fold. First, the surcharges disproportionately affect middle income countries with lower quotas that, by definition, need both extensive IMF financing to repay and longer repayment periods to recover from crises. Second, they require borrowing members to pay more at exactly the moment when they are most squeezed from market access in any other form.

There are at least two objections to the specious argument on non-repayment. The first is straightforward: Because of the IMF's preferred creditor status and the central role it plays in the international financial system, non-repayment is simply not a common occurrence, or at least, hasn't been so far in the organization's history. Instead, the effect of the surcharges in practice seems to be its transfer effect, and the IMF has not produced evidence that it would become a problem if surcharges were reduced or eliminated.<sup>3</sup> The IMF estimates that countries will pay over \$4bn in extra surcharges on top of interest payments and fees from the beginning of the COVID-19 crisis through the end of 2022. What's more, the IMF estimates the surcharges have become the Fund's largest source of revenue, accounting for almost half of revenues during this period (IMF, 2021a). Estimates are that by FY2027, they will amount to almost two thirds of lending income—almost twice the level in FY 2018.

The second objection is that now the IMF is risking non-repayment *because of* its high surcharges. There can be multiple equilibria: At a low interest rate, the probability of repayment is high, justifying the low interest rate; but at a high interest rate, the probability of repayment is low, justifying a high interest rate. But the high interest rate/low probability of repayment equilibrium is a worse outcome for both creditor and borrower, and the IMF should not want to fall into this trap. Our analysis above explains why a high surcharge increases the probability of non-repayment and decreases the welfare of the country.

*This is especially true in the post-pandemic world, where so many countries have found themselves with debt burdens beyond levels that they would normally have undertaken, and where debt negotiations framed in a pre-pandemic world may have put many countries into the Pareto-inferior equilibrium of point B in Figure 2.*

There is another even more specious argument: that high interest rates (surcharges) are necessary to prevent moral hazard, to discourage countries from borrowing excessively from the IMF and to encourage them to repay more quickly. As we already noted, countries typically do everything they can to avoid going to the IMF, even borrowing from others at far higher rates. Moreover, because there is no automatic right to borrow, the IMF could always curb excessive borrowing.

<sup>3</sup> Historically, the only instances of protracted arrears are a handful of cases of war-torn countries, so called "failed states". By 2015, the only existing protracted arrears were from Sudan, Somalia, and Zimbabwe.

## The Nature of the IMF and its Funding

If the high effective interest rates charged to the countries in crisis can't be justified as offsetting the risk of non-repayment, what is the use of these funds? Strikingly, these charges are effectively funding a large part of the IMF's operating costs and the build-up of precautionary balances, supplementing the institution's firepower. Of course, since funds are fungible, the money could be thought of as simply supporting the Fund's balance sheet and cash flow.

Charging the countries in most dire straights for the basic support of the world's critical financial institution seems peculiar. It is a regressive transfer—and likely to be increasingly so in the post-pandemic world, as an increasing number of poor countries will face surcharges. But, as we argue above, it is a counterproductive transfer, since “it takes away with one hand what it gives with the other.” (IMF, 2021b) As it supplies liquidity, aimed at helping countries meet their basic needs and restore growth, it takes away needed foreign exchange, with exactly the opposite effect. By taking away foreign exchange from countries in dire need, it makes already complex debt restructurings even more complicated. Politically, by both claiming preferred creditor status and demanding a spurious “risk compensation” as if it did not have preferred creditor status, the IMF puts itself even more in the crosshairs of other creditors, who increasingly (though in our view mistakenly) argue that it should not have preferred creditor status.

The IMF might better be conceptualized as a multilateral “self-help” club—a cooperative. Most countries can never be sure whether or when they will need help. The few countries that know that they won't need that help still have an interest in supporting the club simply because it enhances global stability, from which everyone benefits. Any such well-designed cooperative would provide assistance from all others to those in need; that is, the operating costs and balance sheet of the institution would be supported by those *not* in crisis—just the opposite of what happens as a result of the surcharges today. This is already partially recognized within the Fund with respect to Special Drawing Rights (SDRs). Members voluntarily exchange hard currency for SDRs from countries that can show need, and the IMF has not had to use its power to designate a country to do so, as it can if no volunteers are forthcoming.

Fortunately, the IMF is a relatively trim and efficient organization. The international community can easily pay for its operating costs. With the capitalization of the member countries (not all of the money has to be in the form of paid-in capital), the IMF doesn't have to rely on its own precautionary balances for lending; it can borrow from capital markets and/or take advantage of access to funds from member countries or their central banks. The IMF should not be in the business of making a profit off of countries in dire straits. It should eliminate the surcharges immediately in the midst of the COVID-19 crisis and reappraise the question of how best to support its important work.

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*The views expressed in this Policy Brief are strictly those of the author(s) and do not represent the position of Boston University, or the Global Development Policy Center.*

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