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An analysis of IMF-induced moral hazard

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Abstract

Three channels through which the IMF rescue package may affect international lending can be distinguished: debtor-side moral hazard, creditor-side moral hazard, and debtor and creditor-side moral hazard. We show that if the rescue package fully benefits the debtor, no credit contract between him and the creditor arises. The other two kinds of moral hazard, where the creditor receives the rescue package either fully or in part, increase the scale of international lending relative to the case where no rescue package is forthcoming. The increase is larger if the creditor receives the whole rescue package than if it is shared between the creditor and the debtor.

These results are based on the analysis of two sequential credit relationships, the first one between a bank and a government and the following one between the IMF and the government. Each of these credit relationships is characterized by asymmetric information and modeled by a moral hazard model. The two moral hazard models are linked by considering the different channels of the IMF rescue package.

JEL classification: D82; F33; F34; G15
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1. Introduction

The International Monetary Fund (IMF) has played a prominent role as a provider of emergency liquidity to troubled countries in the past decade. The number and size

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of the rescue packages have given rise to criticism of the IMF. Friedman (1998), Meltzer (1998) and Schwartz (1998) argue that the provision of emergency liquidity by the IMF affects the efficiency of international financial markets. In other words, the provision of an IMF rescue package has the effect that creditors lend and debtors borrow too much compared with the case when no IMF rescue package is forthcoming.

In this paper we focus on this distortion, i.e. excessive lending and borrowing due to the rescue package relative to the level that would prevail without the IMF support. We show that the existence and the extent of this distortion mainly depends on two factors; the probability that the IMF will lend money in a financial crisis; and, if this lending occurs, the question of who receives the money. The first point is to be expected, so we do not go into detail here. Rather, we concentrate on the second point. This is a special feature of the IMF rescue package because three recipient scenarios can be distinguished. First, the rescue package may be fully beneficial for the debtor. An example is where the government of a troubled country receiving financial support from the IMF uses the whole amount to finance its deficit. Second, the rescue package may fully benefit the creditor, i.e. the bank. In this case, the government of the troubled country spends the whole amount of the IMF support on meeting its obligations to a foreign bank. The third scenario is where the rescue package is shared between both parties, the debtor and the creditor.

The first and the third scenario are special features of IMF lending. The second one, where the creditor receives the rescue package in full, corresponds to the situation in traditional insurance. We will take the example of deposit insurance. Here, the bank (which corresponds to the government in the IMF case) always gives the money received from the deposit insurance to its depositor (who corresponds to the bank in the IMF case). Why does not the bank always receive the whole amount of the rescue package from the government in the IMF case? The reason is that a foreign creditor cannot enforce a repayment from a sovereign debtor. Therefore, it is up to the government whether or not to spend the rescue package for servicing its liabilities towards the bank abroad. This in turn implies that the scenarios whereby the government keeps either all or part of the rescue package are special features of the IMF's "safety net". These two scenarios also reflect the view that creditors should be involved in bearing the cost of the crisis. In these scenarios, the creditor either bears the whole cost or a part of it.

The three scenarios of recipients are three different channels through which the rescue package has an effect on international lending. All recipients of the rescue package are assumed to behave rationally. Since the various channels represent different circumstances, the behavior of the recipients is expected to be different for the three channels and compared to the one without IMF support. The rescue package implies that the government pursues a worse policy whereas the bank lends more money. For the behavior change of the recipients in the three scenarios, terms associated with moral hazard exist in the literature (e.g., Lane and Phillips, 2000). "Debtor-side moral hazard" means that the debtor is benefiting fully from the rescue package and consequently changes its behavior. The terms "creditor-side moral hazard" and "debtor and creditor-side moral hazard" describe the other two scenarios and the resulting behavior changes of the recipients.