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Chapter 1 : International lender of last resort - Wikipedia

Recourse to the IMF is almost always a last resort. The stigma of requiring support from the Fund, with its attendant conditions, means it is a politically difficult option in many countries. But for now, it remains the best of the options available to economies under strain.

Share via Email Since , the global economy has been rocked by five currency crises. Consequently, a consensus has developed that we must reduce the potential for a crisis to spread across the world. Even President Clinton has called for a "new financial architecture". The 19th century English economist Walter Bagehot argued that a LOLR, as a financial crisis manager, should lend freely at a penalty rate to provide liquidity to troubled banks. This infusion of liquidity would avert a financial panic and the resulting drastic collapse of market values. Sometimes, however, other institutions take on the LOLR function. For example, in the early years of the Great Depression when the Federal Reserve refused to operate as a LOLR, the Hoover administration created the Reconstruction Finance Corporation to provide loans to troubled banks. I have four reservations about the Fischer proposal. The first is that, in the absence of a global central bank, an international LOLR must be able to obtain money from governments whose currencies are scarce. Only then can it be assured that it can make loans freely to nations experiencing depleted foreign reserves. This requires voluntary cooperation by the G7 nations with the LOLR to provide the necessary reserves once a liquidity problem occurs. When liquidity crises are recurrent, however, each new crisis tends to require more liquidity to manage the problem than the previous one. At Bretton Woods, Keynes suggested a permanent crisis prevention "clearing union" system for the global financial system. For political reasons his proposals were not adopted. To do its management job properly, however, a LOLR should make loans freely - that is, without conditions. Conditional loans can exacerbate the crisis as the IMF loan conditions did in the Asian crisis. The IMF continues to make intrusive conditions on its loans to governments. Third, a LOLR crisis management system requires an early decision as to when a crisis is occurring and the magnitude of action to be undertaken. But it has also made some faulty ones, for example in and In the first case, the Fed would not make loans to banks that needed reserves, while in the second it fought inflation by creating a liquidity crisis. Only after the threat of a Mexican default in did the Fed back off its restrictive monetary policy - but by then these crisis managers had engineered the worst worldwide recession since the Great Depression. Finally, conventional wisdom among central bankers is that the responsibility of a LOLR should be biased towards making the economy more prone to recession than rapid expansion as the only way to contain inflationary pressures. Yet it is in the best interests of enterprise and labour for the global financial system to be biased towards encouraging rapid economic expansion while preventing domestic inflationary forces from spreading to other nations.

Chapter 2 : The Lender of Last Resort Function after the Global Financial Crisis

The IMF and the Lender-of-Last-Resort Function An External View Curzio Giannini. Recent financial crises have led to renewed interest in having an international lender of last resort.

The question is not one-sided as it also depends upon what kind of conditionalities the Fund may impose, especially related to loans repayment to China. The first and foremost need is to meet the external funding gap. There is no doubt that the country is in dire need of external financing to find some breathing space. In the past, such situations occurred multiples times and virtually always the country was bailed out by the IMF. The lender-of-last-resort never said no to the ailing economy; and the situation is not likely to change this time around. This does not mean that IMF would not bail out the country. The to-be PTI government has not yet extended formal request to the IMF for a bailout; if the government does, the Fund would come to rescue, albeit, with some conditions to not deploy IMF fund to repay Chinese or other commercial loans. The country needs flurry of loans and aid from other sources if it chooses against approaching the IMF. Apart from these, the key for Imran Khan is to call for help to Pakistani Diaspora by issuing bonds. That fades away the immediate need to go to the IMF. However, apart from the money from the IMF â€” which is primarily for balance of payment support â€” the key is to obtain a letter of comfort from the Fund. The LoC is a green-signal for western multilateral and bilateral institutions to continue fulfilling their commitments to the country. However, if the Imran wave of anti-corruption and strengthening the institutions gains traction, the comfort may establish without the LoC from the Fund. Having said that; the other factor critics have historically cited is that the IMF programme is imperative to implement tough reforms. But that ploy never worked in the past two decades or so. No key reforms which were part of IMF conditions were implemented in letter or and spirit â€” be it the VAT reform, privatization, SBP autonomy and other tax and business reforms. The US used to gain political and military support in the region while the tough economic reforms remained elusive. Any variable that can change the equation this time is the political will at home to instill reforms. Hence, if Imran forms a nimble and competent cabinet that is free from the controversial electable lot, and also appoints able and clean technocrats at the right positions, there is no reason the team can work on implementing growth and reform agendas. The foremost need is to put the fiscal house in order and to bring efficiencies in energy and agriculture chains, apart from improving the score on ease of doing business. The civil services reforms, especially in the FBR, are at the heart of any meaningful reforms. The upcoming articles will cover these aspects in detail. Coming back to the IMF question, in a nutshell, the country can survive without the IMF if the inflows keep on coming from other sources. However, a balanced, cautious approach is advised. Copyright Business Recorder,

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Chapter 3 : IMF: to go or not to go | Business Recorder

Summary: The global financial crisis (GFC) has renewed interest in emergency liquidity support (sometimes referred to as "Lender of Last Resort") provided by central banks to financial institutions and challenged the traditional way of conducting these operations.

What are the advantages and disadvantages of the International Monetary Fund? By Investopedia Updated June 1, â€” 1: Established following World War II to help with post-war recovery, the International Monetary Fund IMF serves as a lender to modern governments and an overseer of international financial markets. In its infancy, the IMF was only responsible for supervising pegged exchange rates, part of the Bretton Woods dollar-gold reserve currency scheme. The IMF grew in scope and influence in subsequent decades, particularly after the collapse of the Bretton Woods system in the s. The most notorious example was the bailout of the Greek government in Each member nation publicly accepts and supports the goal of global economic stability and, in theory, a subjugation of some sovereign authority to support that goal. The IMF is funded mainly through what are called "quota contributions" from its members. Economists frequently criticize the IMF for creating moral hazard on national scales. If a country has a balance of payments deficit , the IMF can step in to fill the gap. It serves as a council and adviser to countries attempting a new economic policy. It also publishes papers on new economic topics. Its most important function is its ability to provide loans to member nations in need of a bailout. IMF Disadvantages Despite its lofty status and commendable objectives, the IMF is attempting to pull off a nearly impossible economic feat: The IMF has been criticized for not doing much and for overreaching. It has been criticized for being too slow or too eager to assist failing national policies. Since the United States, Japan and Great Britain feature prominently in IMF policies, it has been accused of being a tool for free-market countries only. Simultaneously, free-market supporters roundly criticize the IMF for being too interventionist. Some member nations, such as Italy and Greece, have been accused of pursuing unsustainable budgets because they believed the world community, led by the IMF, would come to their rescue. This is no different than the moral hazard created by government bailouts of major banks.

Chapter 4 : Advantage and Disadvantages of International Monetary Fund | Investopedia

International lender of last resort (ILLR) is a facility prepared to act when no other lender is capable or willing to lend in sufficient volume to provide or guarantee liquidity in order to avert a sovereign debt crisis or a systemic crisis.

Thornton and Bagehot, therefore, suggested that the lender of last resort should increase the money base to offset the reduction of the multiplier. That was meant to keep the money stock constant and prevent an economic contraction. His starting point was that only a central bank could perform the task of lender of last resort because it holds a monopoly in issuing bank notes. Unlike any other bank, the central bank has a responsibility towards the public to keep the money stock constant, thereby preventing negative externalities of monetary instability. Many of the points remain controversial today but it seems to be accepted that the Bank of England strictly followed these rules during the last third of the 19th century. Why it is done can be explained by different models. The various models propose that a bank run or bank panic can arise in any fractional reserve banking system and that the lender of last resort function is a way of preventing panics from happening. The Diamond and Dybvig model of bank runs has two Nash equilibria: The bank run equilibrium is an infamously self-fulfilling prophecy: That makes them lose some interest, but that is better than losing everything from a bank run. In the Diamondâ€"Dybvig model, introducing a lender of last resort can prevent bank runs from happening so that only the optimal equilibrium remains. That is because individuals are no longer afraid of a liquidity shortage and so have no incentive to withdraw early. The lender of last resort will never come into action because the mere promise is enough to provide the confidence necessary to prevent a panic. Allen and Gale [12] introduced an interbank market into the Diamondâ€"Dybvig model to study contagion of bank panics from one region to another. An interbank market is created by banks because it insures them against a lack of liquidity at certain banks as long as the overall amount of liquidity is sufficient. Liquidity is allocated by the interbank market so that banks that have excess liquidity can provide this to banks that lack liquidity. As long as the total demand for liquidity does not exceed the supply, the interbank market will allocate liquidity efficiently and banks will be better off. However, if demand exceeds supply, it can have disastrous consequences. The interregional cross-holdings of deposits cannot increase the total amount of liquidity. Thus, long-term assets have to be liquidated, which causes loss. The degree of contagion depends on the interconnectedness of the banks in different regions. In an incomplete market banks do not exchange deposits with all other banks , a high degree of interconnectedness causes contagion. Contagion is not caused if the market is either complete banks have exchanged deposits with all other banks or if the banks are little-connected. There is a fraction of individuals travelers who need their money in a region other than home. Without a payment system, an individual has to withdraw his deposit early when he finds out that he will need the money in a different place in the next period and simply take the money along. That is inefficient because of the foregone interest payment. Banks therefore establish credit lines to allow individuals to withdraw their deposits in different regions. In the good equilibrium, welfare is increased just as in the Diamondâ€"Dybvig model, but again there is a bank run equilibrium, too. It can arise if some individuals expect too many others to want to withdraw money in the same region in the next period. It is then rational to withdraw money early instead of not receiving any in the next period. It can happen even if all banks are solvent. Depending on the view one favours for either of them, the design of the optimal lender of last resort will be rather different. Moral hazard[edit] Moral hazard has been an explicit concern in the context of the lender of last resort since the days of Thornton. It is argued, for example, that the existence of a LOLR facility leads to excessive risk-taking by both bankers and investors, which would be dampened if illiquid banks were allowed to fail. Therefore, the LOLR can alleviate current panics in exchange for increasing the likelihood of future panics by risk-taking induced by moral hazard. That encourages risk-taking and reduces the necessary diversification and led the Commission to conclude, "The importance of the moral hazard problem cannot be overstated. These countries then try to prevent moral hazard by other means such as suggested by Stern: The task of preventing it should be given to a supervisor or regulator that limits the amount of risk that can be taken. Does the lender of last resort provide liquidity to the market as a whole through open market operations or should it also make loans to individual banks through discount window lending? There are two main views on this question, the money and the banking view: What they call "banking policy" discount window lending may even be harmful because of moral hazard. The banking view finds that in reality the market does not allocate liquidity efficiently in times of crisis. Liquidity provided through open market operations is not efficiently distributed among banks in the interbank market, and there is a case for discount window lending. In a well-functioning interbank market only solvent banks can borrow. However, if the market is not functioning, even solvent banks may be unable to borrow, most likely because of asymmetric information. In times of crisis with less certainty, however, discount window loans are the least costly way of solving the problem of uncertainty. Rochet and Vives extend the traditional banking view to provide more evidence that interbank markets indeed do not function properly as Goodfriend and King had suggested. Distinction between illiquid and insolvent[edit] According to Bagehot and, following him, many later writers the lender of last resort should not lend to insolvent banks. That is reasonable in particular because it would encourage moral hazard. The distinction seems logical and is helpful in theoretical models, but some authors find that in reality, it is difficult to apply. Especially in times of crisis, the distinction is difficult to make. However, according to Goodhart, it is a myth that the central bank can evaluate that the suspicions are untrue under the usual constraints of time for arriving at a decision. Flannery [20] and others mention that the Fed has neither asked for good collateral nor charged rates above the market, in recent years. At the same time, it may increase moral hazard. While Bagehot emphasized that the benefit of the promise outweighs the costs, many central banks have intentionally not promised anything. Both the clearing-house system of New York [23] and the Suffolk Bank of Boston [24] had provided member banks with liquidity during crises. In the absence of a public solution a private alternative had developed. Advocates of the free banking view suggest that such examples show that there is no necessity for government intervention. While their legality was controversial at the time, the idea of providing additional liquidity eventually led to a public provision of this service that was to be performed by the central bank, founded in However, historical experience mainly Canada and US suggested to him that it has to be a public authority and not a private clearing-house association that provides the service. That allows him to reject the hypothesis that after the new Federal Reserve acted as lender of last resort, the frequency of panics observed did not change. The conclusion of his discussion is that the "effects of monetary policy Afterwards the Bank of England provided the necessary liquidity. According to Bordo, acting as a lender of last resort prevented panics in , , and On those occasions when panics were not prevented, either the requisite institutions did not exist, or the authorities did not understand the proper actions to take. Most countries developed an effective LLR mechanism by the last one-third of the nineteenth century. Some public authority must provide the lender of last resort function Such an authority does not have to be a central bank. This is evident from the experience of Canada and other countries. When a lender of last resort existed, panics did not turn into crises. When the central bank failed to act, crises such as in France in , however, happened. He concludes "that LOLR action contains a crisis, while absence of such action allows a localized panic to turn into a widespread banking crisis. There, central banks could not provide liquidity because banks had been borrowing in foreign currencies, which the central bank was unable to provide. More than any central bank before or since, it adhered to the strict classical or Thornton-Bagehot version of the LLR concept. Some say its lender of last resort policies have jeopardized its operational independence and have put taxpayers at risk. Michel, a financial researcher, even goes as far as saying that the Federal Reserve made the Great Depression worse by failing to fulfill its role of lender of last resort. While most authors agree that there is a need for a national lender of last resort and argue only about the specific set-up, there is no agreement about the basic question of whether there can be an international lender of last resort. There are mainly two opposing groups: Fischer argues that financial crises have become more interconnected, which requires an international lender of last resort because domestic lenders cannot create foreign currency. Fischer says this role can and should be taken by the IMF even if it is not a central bank since it has the ability to provide credit to the market even though it cannot by itself print new money since there is no international currency. Our analysis has indicated that an ILOLR can play a useful role in providing international liquidity and reducing such international contagion. There is no international money and so there can be no international lender-of-last-resort. Besides this point considered "semantic" by opposing authors , Capie and Schwartz provide arguments for why the IMF is not fit to be an international lender of last resort. Schwartz considers a domestic lender of last resort suitable to stabilize the international financial system, but the IMF lacks the properties necessary for the role of an international lender of last resort. That is because the reasons that the lender of last resort is necessary in the banking sector can be applied to the government bond market analogously. Just like banks that lend long-term while borrowing short-term, governments have highly illiquid assets like infrastructure and maturing debt. If they do not succeed in rolling over their debt, they become illiquid just as banks that run out of liquidity and are not supported by a lender of last resort. The distrust of investors can then increase the rates the government has to pay on its debt, which, in a self-fulfilling way, leads to a solvency crisis. Because banks hold the greatest proportion of government debt, not saving the government may make it necessary to save the banks, in turn. The two institutions cannot guarantee that they will always possess enough liquidity or "fire power" to buy debt from sovereign bond holders.

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Chapter 5 : Last Resort - Internet Movie Firearms Database - Guns in Movies, TV and Video Games

The IMF as a global lender of last resort could be an appropriate solution if it provides the necessary liquidity via a global "liquidity circulation fund", which serves as a collecting point for overflowing liquidity (in particular currency reserves in form of central bank money / legal tender and short term debt obligations, e.g. treasury bills or sweep accounts), all under the.

Business IMF bailouts â€" roads to stability or recipes for disaster? The International Monetary Fund IMF has been described as the lender of last resort for countries in financial distress. But the stiff medicine doled out by the fund is still subject to huge controversy. Following the ravages caused by World War II, the International Monetary Fund IMF was originally established to allow countries with payment deficits to borrow money temporarily and repay their debt to others. The hope was that this would create financial stability, foster global cooperation, facilitate trade and growth, as well as reduce poverty. Now, more than 74 years later, the debate about the methods used by the IMF to achieve its goals continues to thrive. Proponents of IMF bailout programs claim that the liquidity provided and the reforms demanded are preventing more extreme financial hardship. But the opponents argue that their ingredients make troubled countries more dependent on IMF aid and their populations poorer. Allan Meltzer, a renowned economist at Carnegie Mellon University, who died last year, once said: Khan, IMF director for the Middle East and Central Asia, for example, has looked into the bailouts for 69 developing countries during the period of to Among those rated as "IMF success stories," were loan programs for Mexico in the s, as well as for India and Kenya. Is inequality good or bad for the economy? Originally set out by British economist John Williamson in , the principles included lower government borrowing to discourage high fiscal deficits, cuts in government subsidies and lower corporate taxes. Other "structural adjustments" recommended were freely-floating currency exchange rates, free trade policies, relaxing rules that hamper foreign direct investment and competition, as well as the privatization of public assets. The neoliberal economic policies proposed in the Washington Consensus have since become pillars of bailout conditions enforced not only by the IMF, but also by its Washington-based offspring, the World Bank. During the Greek debt crisis, the IMF has become the prime target for peoples hatred One size fits all Joseph Stiglitz, chief economist at the World Bank between and , had serious doubts about the viability of the new doctrine. But it would take only a few years that its failures became obvious. Some economists even regard the legacy of the bailouts in Latin America as the beginning of the financial crisis in Asia in the late s. They claim that the IMF had sent a clear signal to the world that if anything goes wrong, the lender would come to the rescue of investors. Argentina has been in permanent crisis mode for the past two decades. When it became apparent in that private enterprises would not be able to meet their payment obligations, international currency markets panicked and Asian currencies plummeted. The IMF treated the Asian meltdown like other emergency situations, giving assistance only in exchange for structural adjustment policies. The Fund instructed governments to cut spending, with the result that this deepened the economic slowdown. In South Korea, for example, a country whose income approaches European levels, unemployment skyrocketed from approximately 3 percent to 10 percent. In Indonesia, the worst-hit country, poverty rates rose from an official level of 11 percent before the crisis to 40 to 60 percent, and GDP declined by 15 percent in one year. Malaysia stood out as a country that refused IMF assistance and advice. Instead of further opening its economy, Malaysia imposed capital controls, in an effort to eliminate speculative trading in its currency. While the IMF mocked this approach when adopted, the Fund later admitted that it succeeded.

Chapter 6 : Last resort for IMF | Business | The Guardian

Is IMF last resort to control inflation? Approaching IMF to mend losses incurred in past: Hammad Azhar Devaluation of rupee has increased $1 billion debt: Miftah Ismail.

The classic lender of last resort has the capacity 1 to lend unlimited amounts of funds to solvent institutions 2 on appropriate terms. Thus, to transform the IMF into a more effective international lender of last resort involves two components: With respect to the design component, a number of elements of an improved global financial safety net are at various stages of approval. That expanded tool kit could include the unilateral offer by the IMF of FCLs for multiple qualifying countries as well as other special facilities and relaxations of existing facilities. The first two of these three elements have already been approved by the IMF executive board and a moderate version of the third may be approved before the Seoul Summit. The G leaders should endorse this progress and call for the further elaboration of the global stabilization mechanism. However, this enhanced capacity to lend must be embedded in a broader policy framework that would address systematically the moral hazard issue facing all lenders of last resort. When central banks lend to solvent financial institutions, they in principle combine essentially unlimited access to funds with close supervision and regulation of the potential recipients of those funds; those are the "appropriate terms. Comprehensive prequalification would work as follows: As an integral part of these reviews, the IMF staff should, in the future, indicate the policy terms for lending to every member country potentially eligible to borrow from the Fund. For a country with very strong policies and a track record of policy performance, the staff would state its judgment that the country would be eligible to borrow under the FCL. For the country with sound policies. The staff would also state what changes in policies or policy commitments would be necessary for it to qualify for lending under the PCL. For the country with weak policies or a weak track record, the staff would outline the necessary changes in policies as part of a traditional stand-by arrangement SBA , or perhaps a high-access precautionary SBA HAPA. This framework would apply to all countries. The IMF executive board could comment on the staff recommendation, as it now does on the staff policy assessment. But the board would not be required to act on the staff recommendation. Implementation of the approach should be supported by a commitment to make these staff reports public promptly and without significant modification. Under this framework, it would also be necessary to link the Article IV consultations more closely to financial sector assessments and to the work of the Financial Stability Board FSB. Such a plan would include further concrete actions to control healthcare costs. The policy conditions would also include implementation of planned and additional financial sector reforms. Action in each of these areas was recommended in the most recent staff report for the US Article IV consultation. The multilateral consultation process would be introduced into the proposed framework via assessments of the global economic and financial environment. These assessments could lead to a staff recommendation with respect to support for a group of countries, as with the multilateral lending facility or global stability mechanism. The comprehensive prequalification approach as a whole should help to reduce the stigma problem of borrowing from the IMF. Countries would in effect be responding to an invitation from the IMF staff to borrow on specific terms subject to the approval of the executive board. A softer and more limited version of this approach was presented to the IMF executive board in March. Most executive directors reportedly were not enthusiastic. They were reported to have disliked the feature that, along with a positive list of countries qualifying for an FCL, there would also be a negative list of countries that did not even qualify for a PCL. This reluctance to accept supervision and regulation in the form of IMF surveillance illustrates the moral hazard problem with a more expansive approach to IMF lending. The two aspectsâ€”financing and ex ante surveillanceâ€”must be tied together. There is also the issue of insolvency or illiquidity. Here countries are different from banks and businesses. Establishing the insolvency of a sovereign government is technically, as well as politically, challenging. This fact is underappreciated by those excessively concerned about the moral hazard associated with IMF lending. The IMF, however, requires the availability of financing on a much larger scale if it is to be credible in its role as the international lender of last resort. Doubling IMF quotas would rebalance the IMF toward its traditional structure of a quota-based international financial institution. It also would provide each member of the IMFâ€"in , the earliest at which the increase in quotas would take effectâ€"with an increase in its quota for the first time since In the period since then, global GDP is projected to have increased by more than percent, global trade more than percent, and global financial transactions by substantially more than that. This would just match the historical average annual rate of increase of IMF quotasâ€"5 percent. But the IMF needs more financial resources if it is to enhance its role as the international lender of last resort. Therefore, in addition to the steps already outlined here, the G leaders in Seoul should encourage the IMF to put in place the procedures and mechanisms to borrow in international capital markets, which is permissible under the Articles of Agreement. Such a provision could perhaps be subject to endorsement by the International Monetary and Financial Committee IMFC prior to action by the executive board and not require an 85 percent weighted majority vote of IMF governors. A reduced supermajority of, say, 60 percent by the executive board might be required. The subsequent cancellation of the SDR over a five-year period would follow a declaration of the end of the crisis and might require only a majority vote. Those currencies would be used by the IMF to lend to other central banks to support their financial institutions. This specific proposal has four advantages: It would help to centralize in the IMF this type of lender of last resort lending. It is at best uncertain whether the Federal Reserve will be comfortable in repeating such operations on a comparable scale in the future. The mechanism would permit the issuing central banks to use the SDR to obtain foreign currencies if they need them to offset exchange rate pressures resulting from the liquidity support operations. The mechanism, along with the other features I propose, would enhance the role of the SDR and hopefully limit somewhat the precautionary demand for increases in international reserves. This posting was adapted from a paper prepared by Mr.

Chapter 7 : The IMF as an International Lender of Last Resort | PIIE

AN INTERNATIONAL LENDER OF LAST RESORT, THE IMF, AND THE FEDERAL RESERVE Vice Chairman Jim Saxton (R-NJ) Joint Economic Committee United States Congress.

Would this make sense and, if so, would it be appropriate for the IMF to play such a role? The string of foreign exchange crises of the last few years has brought the lender-of-last-resort function once again to the fore. This time, what is at issue is whether and how this function can be adapted to the international environment. Making the relevant decisions is no easy task, however, because of all the functions a central bank may carry out, serving as the lender of last resort is by far the most difficult to pin down. For one thing, the desirability and appropriate contours of the function cannot be identified independently of the monetary policy framework. Suppose bank deposits were not defined in nominal terms, much like mutual fund shares, or that monetary policy could be run in a purely discretionary manner without raising credibility problems. Would a lender of last resort still be needed? Many would doubt it, to say the least. But there is more. Intervention by a lender of last resort amounts to a suspension of market discipline, since it means lending in situations where other lenders are not. Hence, the very existence of a lender of last resort raises a potential moral hazard problem, which can be kept within acceptable limits only by relying on the broader legal and institutional setupâ€”on regulation in the broadest sense of the word. In short, what the Tao Teh Ching says of the wheel could equally well be said of the lender-of-last-resort function: Evolution of concept When Walter Bagehot, the nineteenth-century economist whose Lombard Street is still the classic in this field, was writing, the monetary framework was pretty rigid. This helps explain the Bagehot doctrine: The present situation at the national level is very different from the one Bagehot had before his eyes. For instance, in the industrial world, rigid monetary frameworks have been replaced with "illuminated discretion," namely, stability-oriented monetary policy devised and implemented by an independent central bank. Moreover, in most financial systems, clublike behavior is but a vague memory, having long since been swept away by financial liberalization and heightened competition. As a consequence, the function of a lender of last resort has also undergone momentous changes. The market-support operations to which Bagehot referred have become extremely rare. In countries where they are still carried out, such as the United States, they take the form of open market operations, which by their very nature cannot embody a penalty rate. By contrast, lender-of-last-resort operations directed at individual institutionsâ€”often even at those verging on insolvencyâ€—have become much more common. Under these circumstances, constructive ambiguity has become the main check on moral hazard. Since ambiguity means discretion, however, this way of containing moral hazard is subject, like all other forms of discretionary policymaking, to the risk of inconsistency over time. Its credibility rests on the availability of resources and high-quality information, as well as on sufficient technical autonomy and effective sanctioning powers. The latter are really key: If it did not have, or never availed itself of, such powers, constructive ambiguity would be a rhetorical fiction. Total forbearance would then be an apter name. Bagehot did not need to spell all this out, because the informal threat of expulsion from the City club was sufficient, on average, to deter imprudent behavior. Limitations on international organizations Under the Bretton Woods regime, extensive reliance on capital controls, the fragmentation of the regulatory setup, and the room for flexibility implicit in the adjustable multilateral currency peg all contributed to keep the lender-of-last-resort function within national borders. But now, with nearly free capital mobility, an intensely competitive climate in the international financial system, and many emerging market countries still relying on exchange rate pegs or even currency boards to "anchor" their economic policies, the need to decide what can be done to carry out a lender-of-last-resort function for countries has become inescapable. When addressing this issue, however, one should not forget that the international environment differs from national environments in at least three respects. First, international organizations typically enjoy less technical autonomy than comparable national institutions. National governments, especially the stronger ones, do not wish to surrender the power to handle emergenciesâ€”since the payoffs and costs of alternative remedies are difficult to predictâ€—but prefer to respond in ways they believe will further their national interests. If the IMF has enjoyed considerable autonomy during its first fifty years, this is due, in no small degree, to the wisdom of its founders, who appropriately scaled down its tasks and ambitions, leaving the lender-of-last-resort function, in particular, out of the edifice. Second, international organizations deal with national authorities, which are subject to domestic political constraints and agendas and, moreover, are largely responsible for the information on which any "objective" assessment of the need for, and desirability of, intervention by a lender of last resort has to be founded. In such conditions, it is sensible for any lending to be rationed, even in crisis times, and for conditionality to continue to play its very important role in IMF programs. Finally, and perhaps most important, international organizations seeking to deter moral hazard on the part of creditors can directly count neither on adherence to informal, clublike norms of behavior norâ€"lacking an international bankruptcy regimeâ€"on formal sanctioning powers. As a result, the grip of both the IMF and the World Bank on international investors depends largely on the cooperation of national authorities, which, however, may find it hard to coordinate their actions because of diverging national interests. Hence, in apportioning the costs of their emergency lending, international organizations tend to lean more heavily on debtor countries than on their creditors. Changes at the margins Things being as they are, any grand design to set up an international lender-of-last-resort function should be regarded with suspicion. If we are to improve the international setup for handling crises, we must work at the margins. The good news, however, is that such margins do exist. What these countries need most is not money, since some enjoy high saving rates, and a larger number can, under appropriate circumstances, tap international financial markets if they wish to sustain growth. What they need, first of all, is credibility. So, why should a country rely on a peg if other means to discipline policymaking are available? One should hasten to add that, in this area, the IMF is already doing its part. Although few outside the IMF have noticed, in recent years exchange rate pegs have become a less and less frequent component of IMF programs. In the process, fixing the exchange rate is becoming less important and for a very simple reason: So, no revolution is really needed in this area. One has only to appreciate more fully the scope and implications of trends that are already under way. The recent decision by the IMF to establish Contingent Credit Lines within the framework of the Supplemental Reserve Facility could prove to be a step in the right direction, to the extent that it strengthens the attractiveness of IMF programs as precautionary arrangementsâ€"arrangements undertaken to prevent, rather than ameliorate, economic and financial crises. A further improvement upon current practices would be the explicit adoption within IMF-supported programs, where feasible, of monetary frameworks based on inflation targeting rather than on rigid net domestic asset regimes. But the notion of balance of payments need, as traditionally defined, has long since become obsolete, for the very same reasons Article VI is now outdated, and there is little we can do about it. At the same time, though, we must be aware that adopting inflation targeting means much more than setting a low target for the consumer price index. Pervasive institutional changes are needed to make it both effective and credible as a monetary framework. This is why we should not expect the approach to be applicable to all emerging market countries. But the bigger and more institutionally robust among them seem ready to meet the challenge. In this regard, the experiment under way in Brazilâ€"where, after the recent crisis, inflation targeting has replaced, with the endorsement of the IMF, the crawling peg previously in placeâ€"should be followed with great attention. The international lender-of-last-resort function, as a consequence, will return once more to the wings, where it arguably belongs. A second marginal improvement would be making creditors more sensitive to the risks they take. This is the area where confusion looms largest. In recent years, a big fuss has been made about involving the private sector, achieving a more equitable burden sharing, and the like. But reality is much simpler. Because of the characteristics of the international environment, rescue packages orchestrated to stem capital outflows tend to overprotect creditors. Unfortunately, things do not work that way. Since institutions in developing countries are frequently less than robust, domestic policymaking often tends to be myopic. Moreover, when a crisis erupts, the international community has a vested interest in avoiding social unrest, because countries, like big financial intermediaries, often have a going-concern value that is positive even when their "market" value is nil. Moral hazard, therefore, cannot effectively be checked by acting on debtors alone. Hence, the lack of grip on international creditors amounts to a significant institutional defect; until this problem is addressed, the whole international financial architecture will rest on shaky foundations. Here, too, we are not starting from scratch, however. Informal ways to deal with the problem have already been experimented with in the course of the Asian crisis, especially in Korea. At the same time, without much publicity, the IMF has developed over the years an important tool, in the form of lending into arrears making conditional loans to member countries that are in arrears to private sector creditors , to encourage recalcitrant creditors to negotiate debt restructurings. But moral suasion of the kind used in Korea cannot be expected to work in all possible circumstances, as recent experience with Brazil has reminded us. Clearly, more needs to be done in this area. Moving forward I think that, as experience with lenders of last resort in particular countries has shown, what is needed is a blend of carrot and stickâ€”that is, of incentives and coercion. In this context, providing a carrot essentially means including among the conditions for granting access to IMF resources the existence of contingent credit lines with the private sector, like those in place in Argentina and Mexico, as well as adherence to internationally agreed transparency and supervisory standards. By itself, however, this is not going to solve the problem; foreign investors may hedge their exposures during crises, leaving the overall finance made available to the debtor country unaffected. Nor can good supervision entirely eliminate the risk of instability. Here is where the stick comes in. Investors must be confronted with a credible threat that they will be made to pay for their allocative choices in foreign markets when those prove to have been ill considered. With the establishment of the Financial Stability Forum last March, however, the international community has sent the market a strong signal that the regulatory option will be given top priority in the overall strategy. Concern that making moratoriums easier to declare would push the balance of power too much in the direction of debtorsâ€”and, possibly, give too much leeway to international organizationsâ€”probably played an important part in this decision. But whatever its motivation, the creation of the forum is a far-reaching move. Ultimately, this means reducing the degree of competition in financial marketsâ€—the more so if creditors are to be "involved" in crisis management. It also means coordinating safety-net practices across countries to avoid competitive distortions. This is a daunting task, indeed. Let us all hope they will,for historical experience shows that financial instability, if protracted and unchecked, tends to nurture protectionist pressures and inward-looking policies, neither of which is wealth-creating in the long run. Meanwhile, the IMF would be well advised to further refine its role as provider of credibility services; insist on the need for smoother workout procedures; and avoid thinking of itself as an emerging world central bank, sinceâ€”as the experience of the last few years has shownâ€—the world is definitely not yet ready to move in that direction. Suggestion for further reading:

Chapter 8 : Lender of last resort - Wikipedia

Stanley Fischer, first managing director of the International Monetary Fund suggests turning the IMF into a permanent international lender of last resort (LOLR).

While no comprehensive mechanism has been implemented, in late the International Monetary Fund instituted the supplemental reserve facility SRF , designed to make large short-term loans with policy conditions at penalty rates during crises. Other less than comprehensive mechanisms have been proposed but not adopted. The first is International or Sovereign Bankruptcy, which would impose a stay on payments by a country in crisis. The second involves the use of credit lines for sovereigns to draw upon in times of crisis. A flexible credit line FCL would be made available with few or no conditions to countries with very sound economic and financial policies, while a precautionary credit line PCL could be made available to countries that do not meet FCL criteria but nonetheless display essentially sound policies. A third proposal, broader and less clearly defined, calls for a global stabilization mechanism whereby the IMF could temporarily use an expanded "tool kit," with instruments including the unilateral offer of FCLs for multiple qualifying countries as well as other special facilities and relaxations of the terms of existing facilities. Particularly prominent in recent years is offering countries an alternative to self-insurance through accumulation of foreign exchange reserves , which, in spite of a high cost of carry , has been widely practiced in emerging economies since the Asian financial crisis , the Russian financial crisis and the bailout of Long-Term Capital Management. An ILLR might also provide a cushion against shocks and volatility, as well as reduce the likelihood of financial panic within countries and financial contagion across countries. Finally, having an ILLR with established rules and procedures in place before a crisis might make collective action problems less likely than in the case of an exclusively ex post response. The functions of an ILLR could be undertaken by a new institution such as a global central bank , but current proposals have generally suggested the creation of a fund or facility within an existing institution, particularly the International Monetary Fund. A leading role has also occasionally been suggested for the Bank for International Settlements. Based on the traditional doctrine, four desirable aspects of a feasible ILLR can be set forth: Sufficient to meet short-term financial obligations and avoid a collapse either of demand or supply ; Expediency: Timely, immediate disbursements to prevent crises rather than cure their consequences or, if already underway, mitigate and resolve them at minimum cost; Certainty: Constant monitoring of whether liquidity provision fails to restore normalcy or fundamentals continue to deteriorate in order to be prepared to change diagnosis on the nature of the financial crisis and switch to alternative interventions to strengthen solvency. There are, in addition, important distinctive characteristics of a feasible ILLR to bear in mind: In the absence of actual collateral or legal senior creditor status, ILLR financial safety needs a reliable, satisfactory country risk assessment; Ex ante eligibility: In the absence of prudential regulation and other legally binding assurances, ILLR needs to resort to the satisfaction of conditions. In order to be expedient and certain, eligibility conditions including the above risk assessment ought to be set ex ante, in normal times. Conditions for eligibility require minimum standards to comply with the financial safeguards mentioned above and standards of country economic health depending on the objective of the particular application of the ILLR concerning the soundness of fundamentals, the quality of the policies in place and the degree of commitment to sustain them. In all cases, criteria should be parsimonious, easily quantifiable and as objective as possible. Because of the absence of a mandatory legal framework, if countries are reluctant to make individual applications for protection under the ILLR in normal times, the integrity of the safety net will require proactive participation promotion. It should be noted that any ILLR arrangement assumes a high level of trust and cooperation among international financial actors. Reserve asset countries, for example, would be expected to provide liquidity on demand to the ILLR. That liquidity would in turn be drawn from a network of Central Bank swaps and other reliable sources, including regional arrangements in a position to co-finance and committed to fulfilling their obligations. Trust and cooperation would also be implicit in the function of channeling liquidity to qualified countries. Criticisms[edit] The greatest single objection to ILLR is fear of moral hazard , as access to a liquidity facility may lead countries to opt for bolder policies with less liquidity self-protection e. A variety of more specific objections have arisen as well: