Australia's Financial Relationship with the International Monetary Fund

Emily Poole*

The global financial crisis led to a significant increase in demand for actual and precautionary funding from the International Monetary Fund (IMF). As a result, the IMF expanded its available resources. Alongside many other countries, Australia has increased the amount it is willing to lend to the IMF to help the IMF fund its current and future commitments, although so far the IMF has only drawn on a small portion of the funding Australia has agreed to provide. These loans from Australia to the IMF are seen as having low risk, given the 'safeguards' the IMF has in place, and are treated accordingly as part of Australia's official reserve assets.

Introduction

The significant increase in IMF lending commitments since the onset of the financial crisis has necessitated a large increase in IMF resources. As part of a global response, Australia has committed to lend the IMF SDR4.4 billion, if required, under a multilateral borrowing arrangement, and has pledged a further SDR4.6 billion under a bilateral arrangement (currently equivalent to A$6.4 billion and A$6.8 billion, respectively).[1] These commitments made by Australia are contingent loans to the IMF itself, not directly to those countries that borrow from the IMF. When Australia lends to the IMF, the associated risks are judged to be low, with the IMF having a number of safeguards in place to protect country contributions. As a result, Australia's outstanding lending to the IMF, referred to as Australia's Reserve Position at the IMF, is classified by the IMF as a reserve asset.

The IMF is provided with foreign currency (often US dollars) out of foreign exchange reserves when it draws on funding from Australia. A broader measure of Australia's foreign assets, known as official reserve assets (ORA), is not affected by such transactions, as the fall in foreign exchange reserves is offset by an increase in Australia's Reserve Position at the IMF. While the transactions do change the composition of Australia's ORA, the overall effect on the risk and returns to Australia's ORA is not significant. Transactions related to Australia's Special Drawing Rights (SDR) allocation (a separate IMF mechanism designed to enhance global liquidity) also affect the composition, but not the level, of Australia's ORA.

This article examines the implications for Australia of the IMF's lending programs, in particular the effect on the Reserve Bank and Australian Government balance sheets and Australia's ORA. It also discusses Australia's holdings of SDRs as part of the IMF's SDR allocation mechanism.

Recent Developments in IMF Lending Programs and Financing

The global financial crisis has led to substantial changes to the IMF's lending programs.[2] In particular, the average size of countries' borrowing programs

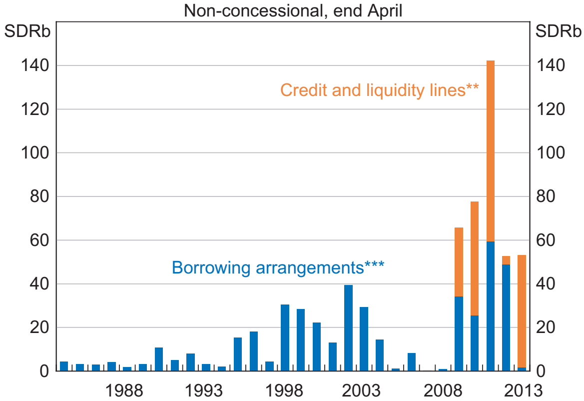
* The author is from International Department.

1 The Special Drawing Right (SDR) is both the IMF's unit of account and a claim on the four 'freely usable' currencies. The current currency composition of the SDR basket is: US dollar (41.9 per cent), euro (37.4 per cent), Japanese yen (9.4 per cent) and British pound (11.3 per cent). The SDR currency basket is re-evaluated every five years.

2 See Edwards and Hsieh (2011) for more information on the changes in IMF lending programs since 2008.

from the IMF have been much larger than in the past, both in absolute terms and relative to countries' shares in the IMF (quota shares). An important reason for this has been the large programs for Greece, Ireland and Portugal. In addition, several new types of precautionary facilities, or 'credit lines', have been introduced to address countries' potential, rather than actual, balance of payments needs (Graph 1). Among these new types of lending facilities, the Flexible Credit Line (FCL) has been utilised the most, including large credit lines for Mexico and Poland. To date, very little has actually been drawn down under these precautionary facilities.

Graph 1
Value of New IMF Lending Commitments*
Non-concessional, end April



* 2013 observation is year-to-date; new commitments include new arrangements and augmentations to existing arrangements
** Includes Flexible Credit Lines, Precautionary Credit Lines, and Precautionary and Liquidity Lines
*** Includes Stand-by Arrangements and Extended Fund Facilities
Source: IMF

The increase in the IMF's lending commitments, and the possibility of more countries requesting loans in the future, has required a commensurate increase in the IMF's resources. IMF lending is financed through country quotas supplemented by borrowing arrangements. Each country in the IMF is required to pay in a quota subscription, with the quota broadly guided by a formula that takes into account factors such as countries' relative economic size, openness to the global economy and vulnerability to balance of payments shocks. Quotas also determine a country's voting power on the IMF's Executive Board and maximum access to financing in 'ordinary' circumstances. Australia's current subscription is around SDR3.2 billion, which equates to a quota share of 1.36 per cent. At the most recent general quota review in late 2010, a doubling of aggregate quota subscriptions was approved (from a total of a total of SDR238.4 billion to SDR476.8 billion), the first general quota increase since 1998. However, the quota increase and associated governance reforms are yet to be implemented because the ratification requirements have not been met. The reforms require ratification by a sufficient number of members accounting for at least 85 per cent of quota shares.

In 2009, the IMF secured an agreement from member countries to expand and amend the New Arrangements to Borrow (NAB). The NAB is one of two longstanding multilateral borrowing arrangements that the IMF can use to supplement resources in times of financial crisis.[3] The very large NAB expansion, from SDR34 billion to SDR367.5 billion, came into effect in March 2011, with Australia committing just under SDR4.4 billion. The IMF decides on the amount of NAB resources to 'activate' on a six-monthly basis, based on existing financing needs as well as its view on financing needs that may arise over the next six months.

As of September 2012, total activated IMF resources stood at SDR545 billion (Graph 2).[4] Of this, around half (SDR275 billion) is available for new lending programs ('uncommitted usable resources'). The remaining resources are either already committed under IMF programs (drawn and undrawn) or deemed 'non-usable'. Non-usable resources include the IMF's gold resources, the use of which is subject to legal restrictions, and currencies paid as quota

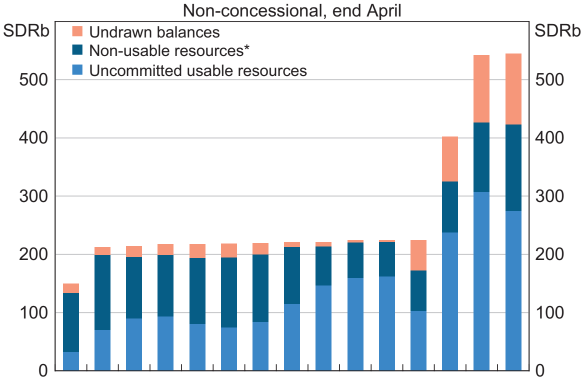
3 The other is the General Agreement to Borrow (GAB), which has been in place since 1962 and has a maximum capacity of SDR17 billion. The GAB was last activated in 1998. Australia does not participate in the GAB.

4 In September 2012, total activated IMF resources included: currencies (SDR266.6 billion), SDR holdings (SDR11.6 billion), gold holdings (SDR3.2 billion), other assets (SDR15.5 billion) and activated amounts under borrowing arrangements (SDR248.1 billion). Activated amounts under borrowing arrangements are less than total commitments as they do not include 20 per cent held as prudential balances and outstanding claims (among others).

subscriptions from countries judged to have weak external positions or with outstanding IMF programs.

As a 'second line of defence', by mid 2012, a number of countries had committed to provide additional bilateral loans to the IMF of US$456 billion, to be drawn upon in the event that a substantial amount of the resources available under the quota and NAB are used.[5] Australia has pledged SDR4.6 billion in additional resources, which would become available for the IMF to draw upon if the loan agreement is successfully signed into Australian legislation (expected to occur in 2013). These additional resources will be available for a two-year period, extendable for two further one-year periods.

Graph 2
IMF Financial Resources
Non-concessional, end April

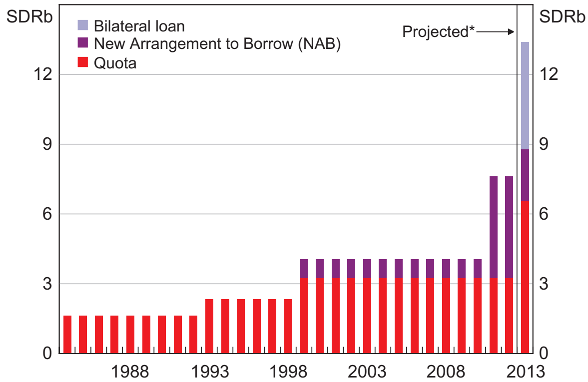


* Includes gold holdings and currencies of countries with IMF programs and/or and/or weak external positions
Source: IMF

Implications of the IMF's Lending Programs for Australia

Australia's maximum financial commitment to the IMF is currently SDR7.6 billion, consisting of the SDR3.2 billion quota subscription and SDR4.4 billion commitment under the NAB (Graph 3). Once the doubling of the quota that was agreed to in 2010 comes into effect, the NAB commitment will be reduced to SDR2.2 billion. The net result will be to increase Australia's financial commitment by

Graph 3
Australia's Financial Commitment to the IMF
End June



* Assumes the bilateral loan, quota doubling and associated NAB rollback are implemented in 2013
Source: IMF

SDR1.2 billion to SDR8.8 billion. When combined with a successful passing of legislation in 2013 to effect Australia's SDR4.6 billion bilateral loan agreement, Australia's financial commitment to the IMF would rise temporarily to a maximum of SDR13.4 billion. It is important to note that this is a maximum financial commitment and that borrowing arrangements are only drawn upon as required.

Under the IMF's Articles of Agreement, the rights and obligations associated with Australia's membership of the IMF are vested with the Australian Government. This means that unlike other reserve assets, any lending by Australia to the IMF (the 'Reserve Position at the IMF') resides on the Australian Government's balance sheet, rather than on the Reserve Bank's balance sheet. Under an agreement between the Bank and the Australian Treasury, the Bank essentially acts as the banker for IMF transactions and sells any foreign exchange to Treasury that it requires to conduct transactions with the IMF. These agreements mean that Australia's financial transactions with the IMF have implications for both the Australian Government and Reserve Bank balance sheets.

When the IMF calls on funding from Australia so that it can provide a loan it typically makes a request for foreign currency funding, usually US dollars. To fulfil this request, the Treasury generally draws the

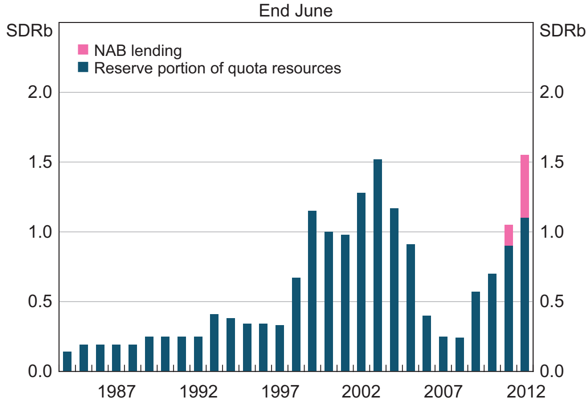
5 The total value of these bilateral loans has subsequently increased to around US$461 billion.

required funding from its Australian dollar accounts at the Reserve Bank. The Treasury then sells these Australian dollars to the Bank in exchange for foreign currency, in order to provide the requisite amount of foreign currency to the IMF. The Treasury then lends the foreign currency to the IMF and in return Australia receives an increase in its Reserve Position at the IMF. To provide the foreign currency to the Treasury, the Bank will typically draw on its foreign exchange reserves. Hence, the level of Australia's ORA, which includes both the Bank's foreign exchange reserves and Australia's Reserve Position at the IMF, does not change as a result of transactions with the IMF. However, the composition of Australia's ORA changes, with foreign exchange reserves falling and the Reserve Position at the IMF rising. When the loans are repaid by the IMF, these transactions are reversed.

Transactions with the IMF have typically had only a small effect on the Reserve Bank's stock of foreign exchange reserves and balance sheet more generally. In aggregate as at June 2012, Australia's Reserve Position at the IMF was only a little over SDR1.5 billion (equivalent to A$2.3 billion) – the bulk of which was reserve assets provided to the IMF as part of Australia's quota subscription, with more modest use of funding from Australia's NAB commitment – comprising less than 5 per cent of Australia's ORA (Graph 4). Given that this represents only a small portion of these reserves, the implications of transactions with the IMF for the risk and return on reserves are modest.

Like the Reserve Bank's foreign exchange reserves, which are claims on highly rated sovereigns and supranational institutions, Australia's lending to the IMF involves low credit risk. This is a result of the IMF's financial safeguards and is evidenced by a history of low arrears on its loans (discussed further below). While Australia's Reserve Position at the IMF is not as liquid as other reserve assets (because it cannot be sold in the market), Australia could make a call on the IMF to provide so-called 'freely usable currencies' (US dollar, euro, Japanese yen and British pound) up

Graph 4
Australia's Reserve Position at the IMF
End June

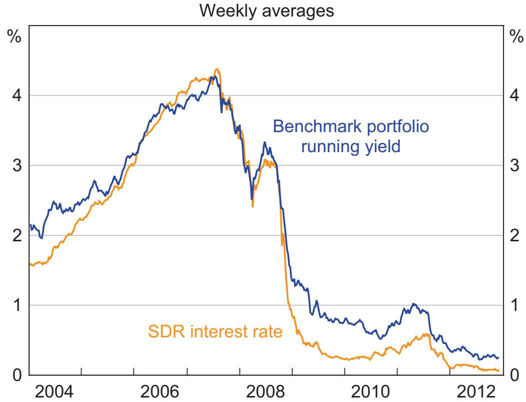


Source: IMF

to the value of the Reserve Position in the instance of a balances of payments need.

The implications for overall returns on Australia's ORA of increasing lending to the IMF (and hence reducing foreign exchange reserves) are usually slightly negative (Graph 5). The interest rate paid by the IMF is based on the composition of the SDR, which like the currency composition of Australia's foreign exchange portfolio, has a high weighting for the US dollar and the euro.[6] However, the foreign

Graph 5
Interest Rates
Weekly averages



Sources: IMF; RBA

6 The current currency composition of the Reserve Bank's benchmark portfolio is: US dollar (45 per cent); euro (45 per cent); Japanese yen (5 per cent); and Canadian dollar (5 per cent). See Vallence (2012) for more information on the management of Australia's foreign exchange reserves.

exchange portfolio is invested in longer-term securities, which typically earn higher returns due to higher term risk premiums, while the SDR interest rate is based on short-term (three-month) interest rates.

Credit and Liquidity Risks of Providing Finances to the IMF

The IMF's role as a lender to countries with a balance of payments need means that it cannot target particular levels of lending or avoid geographical concentration like a private bank might choose to do. Therefore, to ensure the safety of countries' reserve positions in the IMF, and in turn support the classification of these assets as official reserve assets, the IMF has a number of safeguards in place to reduce credit and liquidity risks.[7] Reflecting the strength of these safeguards, international convention is to treat lending to the IMF as a reserve asset, despite a number of cases in the past (particularly in the 1980s and early 1990s) where countries borrowing from the IMF went into arrears for a sustained period of time.

Restrictions on access to funds and conditionality are the two primary tools used by the IMF to minimise the likelihood of arrears on approved programs. Different types of IMF facilities have different restrictions on the maximum access a country has to funds. These maximum levels are expressed as a percentage of their quota. For example, Stand-by Arrangements (SBAs) have a normal access limit of 200 per cent of a member's quota for any 12-month period. The financial crisis has seen a number of countries with acute financing needs awarded exceptional access to funds. However, to counter the additional risk, these programs are subject to enhanced scrutiny by the IMF's Executive Board. IMF conditionality is designed to ensure that program countries adjust their economic policies so as to resolve their balance of payments problems and reduce their need for IMF funding. Regular reviews of progress are held and disbursements of funds are conditional on countries achieving pre-agreed quantitative performance criteria.

In the event that a government defaults on its debt, the IMF has historically been the first in line among creditors to be repaid due to its de facto preferred creditor status. This reduces the risk of loss for the IMF. Further, under its accounting rules, the IMF does not recognise a loss in principal on overdue debt unless the borrowing country exits the IMF or the IMF itself is liquidated. Instead, countries with obligations more than six months overdue go into 'protracted arrears' and the IMF recognises the lost interest income on the loan until payments resume. There are currently only three countries – Somalia, Sudan and Zimbabwe – with longstanding protracted arrears totalling SDR1.3 billion, or less than 1.5 per cent of IMF credit outstanding.

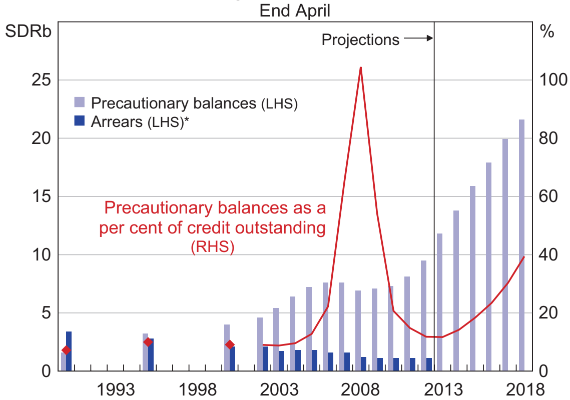
If a borrowing country goes into protracted arrears then the 'burden-sharing mechanism' and precautionary balances are designed to absorb the impact on the IMF's finances of the lost interest income. These safeguards were introduced in the late 1980s in response to a rapid build-up in protracted arrears, which reached a peak of SDR3.6 billion, or around 13 per cent of credit outstanding in 1992. The burden-sharing mechanism is designed to distribute the cost of protracted arrears equally among creditor and debtor countries by increasing the interest rate charged to countries on their outstanding borrowing from the IMF and reducing the interest rate received by countries on their contributions through the quota. However, the capacity of the burden-sharing mechanism to fund arrears is currently very low, given the unusually low SDR interest rate and the increased reliance on borrowed resources. Precautionary balances are retained earnings that are held to absorb financial losses, such as a shortfall in income due to a low level of credit outstanding or a country going into protracted arrears.

The IMF has taken steps recently to build up precautionary balances in response to the increase in credit outstanding and concentration of credit

7 See IMF (2004) for an evaluation of financial risk in the IMF and the policies that are designed to safeguard IMF resources.

risks. In 2010, the target for precautionary balances was changed to 20–30 per cent of a forward-looking measure of credit outstanding, with a floor of SDR10 billion.[8] In 2012, the medium-term target was increased to SDR20 billion from SDR15 billion (Graph 6). However, the floor (let alone the target) was yet to be reached as of April 2012, with precautionary balances at SDR9.5 billion. The IMF forecasts that precautionary balances will be SDR21.6 billion by April 2018, boosted by the higher levels of income the IMF is receiving on its burgeoning outstanding credit (IMF 2012). In the event that precautionary balances are insufficient to absorb income losses, the IMF has a range of options to fund the deficit, including gold or other asset sales and increased charges on borrowing.

Graph 6
Precautionary Balances and Arrears
End April



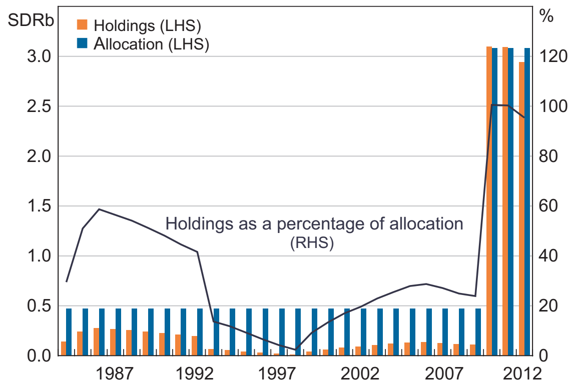
* The IMF does not provide projections for arrears
Source: IMF

Australia's SDR Allocation: A Separate IMF Liquidity Mechanism

SDRs are an international asset that were created by the IMF to supplement official reserve holdings. SDRs derive their value from the fact that countries are willing to hold them and accept them in exchange for actual currencies. As a response to the need to enhance global liquidity during the global financial crisis, the IMF increased SDR allocations by a total of SDR182.6 billion in 2009, bringing total SDR allocations to around SDR204 billion. By having a larger stock of SDR holdings, countries would have a greater ability to meet any balance of payments need by exchanging some or all of their holdings for freely usable currencies. In August 2009, Australia's SDR allocation increased to almost SDR3.1 billion from SDR0.5 billion, which provided a boost to Australia's ORA (Graph 7) (Doherty 2009).

8 The forward-looking measure of credit outstanding is calculated as the average of credit outstanding under non-precautionary arrangements in the past 12 months and projections for the next two years. See IMF (2010).

Graph 7
Australia's SDR Allocation and Holdings
End June



Source: IMF

In terms of the effect on the balance sheet and returns, the IMF allocation of SDRs involves receiving both an asset (SDR holdings) and liability (SDR allocation) of equal size. SDR holdings are part of Australia's ORA. Because the interest rate on this asset and liability are the same, there is a zero net return if Australia keeps SDR holdings equal to 100 per cent of the allocation. This has essentially been the case since 2009, with holdings in October 2012 equal to around 95 per cent of the allocation. However, historically Australia's holdings of SDRs were much less than the amount allocated, predominantly due to the use of SDRs to pay for some of the past increases in Australia's quota contributions, which resulted in (small) net interest payments in SDRs to the IMF.

The small decline in SDR holdings since 2009 has been due to demand for two-way SDR transactions from other countries. In these transactions, another country will typically buy SDRs from the Reserve Bank in exchange for US dollars. This results in a fall in the Reserve Bank's SDR holdings and an increase in its foreign exchange reserves. Countries can also sell SDRs to the Bank in exchange for US dollars or euros. In either case, these transactions change the composition but not the level of Australia's ORA. Therefore, as with lending to the IMF, the effect of these transactions on the risk and return of Australia's ORA is minimal. While the exchange of SDRs for actual currencies between countries is usually voluntary, the IMF also has the power to designate countries with strong external positions to purchase SDRs from countries with weak external positions if necessary. There are currently 32 countries, including Australia, with voluntary SDR trading arrangements.[9]

Conclusion

Australia's financial relationship with the IMF has implications for the composition of Australia's official reserve assets. However, the impact on returns on Australia's foreign reserves is typically small and the risk is low as the IMF has a number of safeguards in place to protect members' financial contributions.

9 Since 2009, Australia's agreement is subject to the restriction that SDR holdings are kept within 50–150 per cent of the SDR allocation and individual transactions shall not exceed SDR1 billion. The RBA or Treasury has the right to refuse to conduct a transaction under the voluntary arrangement.

References

Doherty E (2009), 'IMF Initiatives to Bolster Funding and Liquidity', RBA *Bulletin*, November, pp 7–10.

Edwards K and W Hsieh (2011), 'Recent Changes in IMF Lending', RBA *Bulletin*, December, pp 77–82.

IMF (International Monetary Fund) (2004), 'Financial Risk in the Fund and the Level of Precautionary Balances', Finance Department Report, February. Available at <http://www.imf.org/external/np/tre/risk/2004/020304.htm>.

IMF (2010), 'Review of the Adequacy of the Fund's Precautionary Balances', Finance Department Report, September. Available at <http://www.imf.org/external/np/tre/risk/2010/082410.htm>.

IMF (2012), 'The Consolidated Medium-term Income and Expenditure Framework', IMF Policy Paper, April. Available at <http://www.imf.org/external/np/pp/eng/2012/041212.pdf>.

Vallence C (2012), 'Foreign Exchange Reserves and the Reserve Bank's Balance Sheet', RBA *Bulletin*, December, pp 57–63.