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Loan Agreement between Australia and the International Monetary Fund (not yet signed) [2012]

Introduction

3.1 On 30 October 2012, the *Loan Agreement between Australia and the International Monetary Fund (not yet signed) [2012]* was tabled in the Commonwealth Parliament.

Background

3.2 The International Monetary Fund (IMF) was conceived at the United Nations' Bretton Woods conference held in July 1944, where representatives of 45 countries agreed to establish institutions to govern international economic relations in the aftermath of the Second World War. The IMF came into formal existence in December 1945, when 29 members ratified its Articles of Agreement.[1]

3.3 The IMF was established to promote growth and prosperity. The IMF's purpose (set out in Article I of its Articles of Agreement) is to promote international monetary cooperation; facilitate the expansion of trade contributing to employment growth; promote exchange rate stability to avoid competitive devaluation; assist in the establishment of a multilateral

1 'Section 2: Australia's interactions with the International Monetary Fund', http://www.treasury.gov.au/PublicationsAndMedia/Publications/2011/Australia-and-the-International-Financial-Institutions-2008-2009/Australia-and-the-International-Financial-Institutions-20082009-Annual-Report/Section-2-Australias-interactions-with-the-International-Monetary-Fund>, accessed 9 November 2012.

system of payments; and make resources available to members to reduce the costs of balance of payments adjustments.[2]

3.4 Australia became a member of the IMF in 1947. The *International Monetary Agreements Act 1947*[3] formalised Australia's IMF membership. The Act contains provisions, which have been updated through time, to enable Australia to meet any obligations that may arise by virtue of its IMF membership.[4]

Overview and national interest summary

3.5 The Agreement's purpose is to enhance the IMF's available resources for crisis prevention, with Australia to lend up to the equivalent of Special Drawing Rights (SDR) 4.61 billion (around A$6.8 billion). Drawings from Australia by the IMF under the Agreement would be repayable in full and with interest. Australia has an interest in ensuring that the IMF is adequately resourced to play its global role in promoting economic growth and financial stability.[5]

3.6 The loan agreement is a temporary, voluntary credit arrangement allowing the IMF to borrow from Australia. This is the first such bilateral arrangement between Australia and the IMF which is separate to other types of lending Australia engages in with the Fund, and is not covered by other treaties.[6] It is in addition to Australia's existing commitments to the IMF under its quota, which itself is currently being reviewed. It will be determined whether a further permanent increase in IMF quotas is required in 2013.[7]

3.7 Australia does not need to go through a new treaty process every time additional funds are provided to the IMF. For example, any increase in Australia's quota subscription does not require a treaty process. Quota increases are covered by the IMF Articles of Agreement, a treaty to which

2 'Section 2: Australia's interactions with the International Monetary Fund', as above.

3 *International Monetary Agreements Act 1947*, <http://www.austlii.edu.au/au/legis/cth/consol_act/imaa1947360/>, accessed 9 November 2012.

4 'Section 2: Australia's interactions with the International Monetary Fund', as above.

5 National Interest Analysis [2012] ATNIA 19 with attachment on consultation *Loan Agreement between Australia and the International Monetary Fund (Tokyo, 13 October 2012)*, [2012] ATNIF 22, (Hereafter referred to as 'NIA'), paras 4-5.

6 Department of the Treasury, *Submission 2*, p. 1.

7 Mr Jyoti Rahman, Manager, International Monetary System Unit, International Finance and Development Division, Macroeconomic Group, Department of the Treasury, *Committee Hansard*, 26 November 2012, p. 11.

Australia is already a party. However, under the envisaged amendment to the *International Monetary Agreements Act 1947* required to give effect to this loan agreement, a treaty process would be required if Australia were to participate in any future bilateral loan agreements with the IMF.[8]

Reasons for Australia to take the proposed treaty action

3.8 The following summary of the proposed treaty action and its claimed benefits is taken from the National Interest Analysis (NIA).

3.9 The IMF achieves its mandate and advances Australia's interests by supporting stability in the global economy through: conducting surveillance over the economic policies of members, and providing policy advice to assist members in achieving key domestic objectives; providing technical assistance and training to members, enabling them to build the expertise required to implement sound economic policies; promoting international monetary cooperation, exchange stability, and orderly exchange arrangements; fostering economic growth and employment; and providing temporary financial assistance to members, thereby helping to ease balance of payments adjustment.[9]

3.10 Australia, as a small, open economy, benefits from an effective IMF that has the resources available to fulfil its mandate for global economic and financial stability. Reforms have been made in recent years to enhance the IMF's effectiveness, including: substantial permanent increases in the IMF's resources; enhancement of the IMF's lending instruments; strengthened surveillance; realigning the quota and voting shares of IMF members to better reflect changing weights in the global economy; and institutional governance reform.[10]

3.11 The Global Financial Crisis of 2008-2009 and the ongoing crisis in the Euro area highlight the importance of ensuring that the IMF is adequately resourced to fulfil its mandate.[11] The Treasury provided an assessment of potential future risks:

> The list of risks currently facing the global economy is extensive. The banking and sovereign debt crisis in the euro area and the still unresolved fiscal cliff in the United States are well known. The

8 Department of the Treasury, *Submission 2*, p. 1.

9 NIA, para 6. See also 'Section 2: Australia's interactions with the International Monetary Fund', as above.

10 NIA, para 7.

11 NIA, para 7.

> prospect of significant slow-down in China and other major emerging economies, the difficult transitions taking place through the Arab Spring and other geo-political tensions in the Middle East all build further uncertainty into the global economic outlook. In this environment, any combination of events could combine to trigger another Lehman-like event. Should this occur, the demand for IMF financial assistance to shield members from the crisis would rise to new highs.[12]

3.12 While the IMF's current resource base is sufficient to meet expected needs, in the event of a renewed global financial crisis, potential demands for IMF lending could exceed the IMF's existing lending capacity.[13] Increasing the IMF's available resources is thus essential for ensuring confidence that the IMF is fully equipped for its crisis prevention and resolution role. The Agreement is Australia's contribution towards a broad round of global commitments, announced at the June 2012 G20 Leaders Summit in Los Cabos, Mexico, to temporarily increase the IMF's resources by more than US$450 billion during a period of heightened global financial risks. Other countries who have pledged commitments to date include the United Kingdom, China, France, Germany, Japan, Russia and Indonesia.[14]

3.13 The IMF has always repaid its members in full and with interest.[15] The Treasury explained:

> … interest rates (are) paid in what they call special drawing rights interest rates, which is a weighted average of various government securities (which) would be fairly low compared with market interest rates.[16]

3.14 For example in mid-November 2012 the interest rate was 0.06 per cent per annum.[17]

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12 Mr Jyoti Rahman, Manager, International Monetary System Unit, International Finance and Development Division, Macroeconomic Group, Department of the Treasury, *Committee Hansard*, 26 November 2012, p. 11.

13 Further information on IMF lending can be found at 'Fact Sheet: IMF Lending' <http://www.imf.org/external/np/exr/facts/howlend.htm>, accessed 14 November 2012.

14 NIA, paras 8-9.

15 Mr Jyoti Rahman, Manager, International Monetary System Unit, International Finance and Development Division, Macroeconomic Group, Department of the Treasury, *Committee Hansard*, 26 November 2012, p. 12, and Department of the Treasury, *Submission 2*, p. 2.

16 Mr Jyoti Rahman, Manager, International Monetary System Unit, International Finance and Development Division, Macroeconomic Group, Department of the Treasury, *Committee Hansard*, 26 November 2012, p. 13.

17 Mr Jyoti Rahman, Manager, International Monetary System Unit, International Finance and Development Division, Macroeconomic Group, Department of the Treasury, *Committee Hansard*, 26 November 2012, p. 13.

Australia's role in IMF 'conditionality'

3.15 The IMF financing is typically provided under an 'arrangement', which stipulates specific policies and measures (known as conditionality) that are intended to resolve a borrowing country's balance of payments difficulties. Disbursements of IMF loans to a country are generally dependent on the progress made by that country in implementing the agreed measures.[18] The Treasury explained Australia's input into this process:

> Australia participates in the approval and monitoring of IMF program conditionality, and in reviews and revision of the Fund's Conditionality Guidelines, through participation at the IMF Executive Board… Treasury and the RBA provide advice directly to the [Asia-Pacific] constituency office [of which Australia is a part] on these matters as they arise.
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> The design of stipulated economic policies attached to IMF lending programs, that is, policy conditionality, is undertaken by IMF staff in consultation with the borrowing country, operating under guidelines provided by the IMF Executive Board. The Conditionality Guidelines, revised by the Executive Board in 2002, require that program related conditions be either '(i) of critical importance [in] achieving the goals of the member's program or for monitoring the implementation of the program, or (ii) necessary for the implementation of specific provisions of the Articles [of Agreement] or policies adopted under them.'
>
> Compliance with program conditionality is also assured by periodic program reviews. Staged disbursements under IMF programs can only take place upon the completion of reviews by the Executive Board. This mechanism enables the Executive Board to assess whether a program is on track and whether modifications are necessary for achieving the program's objectives.[19]

Obligations

3.16 The Agreement provides for Australia to lend to the IMF up to the equivalent of SDR4.61 billion. The Agreement shall have a term of two

18 'Recent Changes in IMF Lending' Reserve Bank of Australia, Bulletin, December Quarter 2011, <http://www.rba.gov.au/publications/bulletin/2011/dec/pdf/bu-1211-8.pdf> accessed 14 November 2012.

19 Department of the Treasury, *Submission 2*, p. 1.

years, extendable by the IMF for up to two additional one-year periods, for a maximum term of four years.[20]

3.17 The IMF will provide estimates of the amounts it expects to draw under the Agreement for every three-month period. Drawings under the Agreement will have a repayment maturity of three months from the drawing date, extendable at the discretion of the IMF in three-month increments up to a maximum of ten years. In exceptional circumstances the IMF, with Australia's agreement, may extend the maximum maturity of drawings by up to a further five years. The rate of interest on drawings under the proposed Agreement will be the SDR interest rate.[21]

3.18 Australia's commitment to meet drawings under the Agreement shall be terminated if Australia's balance of payments and reserve position does not justify further drawings. Australia may also obtain early repayment of all or a portion of the drawings outstanding under the Agreement if there is a need for early repayment in light of Australia's balance of payments and reserve position. Australia shall have the right to transfer all or part of any claim on the IMF resulting from outstanding drawings under the Agreement to any member of the IMF, subject to limitations set out in the Agreement.[22]

3.19 The Agreement will not affect Australia's existing rights and obligations under international law in relation to the IMF.[23]

Likelihood of funds being drawn upon

3.20 Despite the risks to the global economy outlined above, the Treasury assessed that the likelihood of this extra external funding being drawn upon is not very high and the additional funds will only be accessed after all other resources have been exhausted.[24] Treasury explained:

> …the temporary loan agreements and note purchases, including Australia's loan agreement, will act as a second line of defence behind the existing quota and NAB [new arrangements to borrow] arrangement. They will not be drawn upon until it is clear that the

20 NIA, para 10.

21 NIA, para 11. The SDR interest rate is determined weekly, based on a weighted average of representative short-term money market interest rates (currently the US dollar, Euro, Pound Sterling and Yen rates). This is in accordance with Article XX of the IMF's founding multilateral treaty, the *Articles of Agreement of the International Monetary Fund (1947).*

22 NIA, paras 12-13.

23 NIA, para 14.

24 Mr Jyoti Rahman, Manager, International Monetary System Unit, International Finance and Development Division, Macroeconomic Group, Department of the Treasury, *Committee Hansard*, 26 November 2012, p. 12.

> IMF's lending commitments will exceed the available quota and NAB resources. This is considered unlikely to occur over the period of the loan agreement. Finally, these resources are provided to the IMF's General Resources Account, which means that any drawings by the IMF on the loan agreement are backed by the fund's full balance sheet.[25]

Implementation

3.21 Amendment will be required to the *International Monetary Agreements Act 1947* to provide the authority for the Australian Government to enter into a bilateral lending agreement with the IMF. No action is required by the States or Territories to implement the Agreement.[26]

Costs

3.22 The Agreement was included in the 2012-13 Budget as a Quantifiable Contingent Liability. The maximum amount available to be drawn under the proposed Agreement is the equivalent of SDR 4.61 billion (around A$6.8 billion). The IMF would make drawings under the Agreement only if needed to support its lending to borrowing member countries. The Agreement is not expected to be drawn upon over the forward estimates period as the IMF's currently available resources are sufficient to cover its projected lending activities.[27]

Effect of loans on the Australian Government's financial position

3.23 Any drawings would be financing transactions with no direct impact on the Australian Government's underlying cash balance or fiscal balance. They would have no impact on the Australian Government's net debt but would add to its borrowing requirement.[28]

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25 Mr Jyoti Rahman, Manager, International Monetary System Unit, International Finance and Development Division, Macroeconomic Group, Department of the Treasury, *Committee Hansard*, 26 November 2012, p. 12.

26 NIA, paras 15-16.

27 NIA, para 17.

28 NIA, para 18.

3.24 These indicative costs (of no impact on budget balance or net debt) for the loan proposal have been prepared by Treasury and agreed with the Department of Finance and Deregulation.[29]

3.25 The loans would have no direct impact on the Australian Government's underlying cash balance or fiscal balance because, under the accounting standards used by the Australian Government, the *Australian Accounting Standard 31: Financial Reporting by Government* issued by the Australian Accounting Standards Board, loans are classified as assets. In other words, if the IMF draws on the funds, the funds remain on the assets side of the balance sheet as a loan and consequently will have no effect on net debt.[30]

3.26 Until any drawings by the IMF have been repaid, they will have an impact on Australia's borrowing requirements as those funds will not be available to the Australian Government to meet its financial obligations. If a loan drawn by the IMF under this Agreement results in a deficit of funds available to the Australian Government, the shortfall will have to be borrowed.[31]

3.27 To prevent funds drawn under the Agreement from becoming a burden on Australia's borrowing requirements, the terms of the Agreement permit Australia to terminate the Agreement where Australia's balance of payments and reserve position does not justify further drawings. Australia can also obtain early repayment of all or a portion of the drawings outstanding under the proposed Agreement if there is a need for early repayment in light of Australia's balance of payments and reserve position.[32]

3.28 As previously discussed, the interest rate that will apply to loans under the Agreement is a weighted average of various government securities. In mid-November 2012 that interest rate was 0.06 per cent. Ninety five per cent of Australian Government debt is made up of Commonwealth Government Securities.[33] The indexed rate of return on Australian Government Securities at the time of writing was 1.06 per cent.[34]

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29 NIA, para 19.

30 Australian Accounting Standards Board, 2005, *Australian Accounting Standard 31: Financial Reporting by Government*, p 187.

31 NIA, para 18.

32 NIA, para 12.

33 The Treasury, *Debt, the Budget and the Balance Sheet*, <http://www.treasury.gov.au/PublicationsAndMedia/Publications/2011/Economic-Roundup-Issue-4/Report/Debt-the-Budget-and-the-balance-sheet>, Accessed 7 March 2013.

34 Reserve Bank of Australia, Statistical Tables, Capital Market Yields – Government Bonds, <http://www.rba.gov.au/statistics/tables/index.html#interest_rates>, Accessed 7 March 2013.

3.29 Consequently, the Australian Government may be paying more interest on Australian Government Securities sold as a result of funds drawn by the IMF under the Agreement than the IMF will be paying on the loaned funds.

3.30 Funds drawn by the IMF under the Agreement are unlikely to affect Australia's credit rating. Credit ratings are determined by taking into account political risk, regulatory risk and other unique factors to determine the likelihood of a default.[35] As has been stated earlier, the IMF has an excellent repayment record. Funds loaned to the IMF are unlikely to increase the risk of the Australia Government defaulting on its debt.

The IMF, its failings and its reform

3.31 The Committee noted the IMF's patchy record over recent years. The IMF has, by its own admission, failed to either properly assess or properly respond to:

- the Asian Economic Crisis of 1997-98

> The main reason for the breakdown in the relationship was Asian countries' unhappiness with the macroeconomic and structural conditionality associated with the IMF's programs that were negotiated with Thailand (August 1997), Indonesia (November 1997, August 1998), and Korea (December 1997). The conditionality contained in these programs was seen as overly harsh and intrusive and this soured the relationship. Asian countries were convinced that the IMF had misdiagnosed the problems they were facing and had imposed excessive and inappropriate conditionality on the financing it was providing. **It is noteworthy that the IMF later acknowledged the mistakes it made**… [Emphasis added][36]

- the Argentinian Crisis of 2001

> The International Monetary Fund has owned up to making mistakes in dealing with Argentina's 2001 debt crisis. In a discussion paper, the IMF said its surveillance had missed

35 International Investing, *What are sovereign Ratings*, <http://internationalinvest.about.com/od/researchingglobalstocks/a/What-Are-Sovereign-Ratings.htm>, Accessed 7 March 2013.

36 Op-eds "Asia: Stepping Up from Regional Influence to a Global Role", *Peterson Institute for International Economics*, <http://www.iie.com/publications/opeds/print.cfm?ResearchId=1956&doc=pub> accessed 14 November 2012.

warning signs and had over-estimated growth and the success of economic reforms.[37]

- and the Global Financial Crisis of 2008-2009

  Warning member countries about risks to the global economy and the build-up of vulnerabilities in their own economies is arguably the most important purpose of IMF surveillance. This Independent Evaluation Office (IEO) evaluation found that the IMF fell short in delivering on this key objective in the run-up to the financial and economic crisis that began to manifest in mid-2007 and that reached systemic proportions in September 2008…

  The IEO found that the IMF's ability to identify the mounting risks was hindered by a number of factors, including a high degree of groupthink; intellectual capture; and a general mindset that a major financial crisis in large advanced economies was unlikely. Governance impediments and an institutional culture that discourages contrarian views also played important roles.[38]

3.32 Given the further funds that the Australian Government was committing under this treaty, the Committee sought further information about what had been learned by the IMF and what reform initiatives were in place to improve the organisation's performance. The Treasury responded:

> Firstly, since the beginning of the [Global Financial] crisis not only have the resources of the IMF been increased and reviewed but also general working of the IMF, including its surveillance products, is being reviewed… Yes, it is a fair criticism that IMF in the lead-up to the [Global Financial] crisis perhaps did not highlight the risks as much as they should or could have, but their services and products are being reviewed...[39]
>
> There was a set of reviews that were done immediately after the [Global Financial] crisis, and there was a review of the quarter formula that was agreed upon by 2010. That is still to be implemented because not every country has ratified it. The next

37 "IMF owns up to Argentina errors". <http://news.bbc.co.uk/2/hi/business/3566699.stm> accessed 14 November 2012. See also "We made many mistakes with Argentina in the 90s,' says ex-IMF chief", <http://www.buenosairesherald.com/article/70966/we-made-many-mistakes-with-argentina-in-the-90s-says-eximf-chief> accessed 14 November 2012.

38 Independent Evaluation Office of the IMF "IMF Performance in the Run-Up to the Financial and Economic Crisis IMF Surveillance in 2004–07", <http://www.ieo-imf.org/ieo/files/completedevaluations/crisis-%20main%20report%20(without%20moises%20signature).pdf> accessed 14 November 2012.

39 Mr Jyoti Rahman, Manager, International Monetary System Unit, International Finance and Development Division, Macroeconomic Group, Department of the Treasury, *Committee Hansard*, 26 November 2012, p. 12.

> one began immediately thereafter. These reviews usually happen once every three years as per course. Since the beginning of the crisis they have become a lot more urgent.[40]

3.33 Further, the Treasury advised that Australia was playing a significant role in this process:

> Australia is playing an active role in that through our representatives on the IMF board. We have a constituency office that we share with Korea and a few other countries. Since the beginning of November we have for a two-year period an alternative executive director. Up until this year we had an executive director. They play an active role in these review processes.[41]
>
> The most important thing that Australia could do and is trying to do is reform the governance structure of the IMF such that the emerging countries and dynamic countries of our region, including ourselves, will have stronger voting rights in the way the institution is run. That would allow our representatives and representatives of other countries that have hitherto been relatively less represented than their economic might would suggest to play a stronger role in approving or influencing the fund's programs and activities.[42]

3.34 Treasury further advised the Committee of reforms being put in place which are designed to improve the IMF's lending programs, its dealing with country authorities and governance arrangements that are essential for the ongoing legitimacy, effectiveness and relevance of the IMF.[43]

3.35 These reforms[44] include:

- the IMF Board of Governors approval of a package of 'far-reaching reforms of the Fund's quotas and governance', including:

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40 Mr Jyoti Rahman, Manager, International Monetary System Unit, International Finance and Development Division, Macroeconomic Group, Department of the Treasury, *Committee Hansard*, 26 November 2012, p. 13.

41 Mr Jyoti Rahman, Manager, International Monetary System Unit, International Finance and Development Division, Macroeconomic Group, Department of the Treasury, *Committee Hansard*, 26 November 2012, p. 12.

42 Mr Jyoti Rahman, Manager, International Monetary System Unit, International Finance and Development Division, Macroeconomic Group, Department of the Treasury, *Committee Hansard*, 26 November 2012, p. 13.

43 Department of the Treasury, *Submission 2.1*, p. 1

44 These reforms are still currently in the implementation phase with the delay largely stemming from the US elections precluding the introduction of legislation to the US Congress. Department of the Treasury, *Submission 2.1*, p. 1

- ⇒ shifts in quota shares and comprehensive review of the quotas;
- ⇒ greater representation for emerging market and developing countries at the Executive Board; and
- ⇒ moving towards an all-elected Board, along with a commitment to maintain the Board size at 24 chairs, and a review of the Boards composition every eight years.

- the IMF Executive Board agreement to:
  - ⇒ consider increases in Fund's precautionary balances in the medium term from SDR 15 billion to SDR 20 billion;
  - ⇒ improve data provision for surveillance purposes by improving collaboration with international agencies to fill data gaps while minimizing the reporting burden for countries; and
  - ⇒ changes in conditionality, design, and effects of IMF-supported programs.[45]

3.36 In particular, the Governance reforms aim to increase the voice and representation of the emerging market and developing countries to closer match economic realities while protecting the voice of smaller nations.[46]

Conclusion

3.37 The Committee acknowledges the risks currently facing the global economy. The sovereign debt issues in the Euro zone and in the United States are well known. The economies of China and other major emerging economies have slowed, and the geo-political tensions in the Middle East are all contributing to uncertainty in the global economy.

3.38 Providing more resources to one of the key institutions capable of responding effectively should the global economy deteriorate further is both logical and practical. In that context, the Committee supports the agreement and recommends that binding treaty action be taken.

3.39 Nonetheless, the Committee expresses its disappointment with the IMF's previous failings and anticipates seeing positive reforms to its structures, programs and activities. Furthermore, the Committee requests that the Treasury continually monitor effectiveness and implementation of reforms with regular feedback to the Committee.

45 Department of the Treasury, *Submission 2.1*, p. 1.

46 Department of the Treasury, *Submission 2.1*, p. 2.

Recommendation 3

The Committee supports the *Loan Agreement between Australia and the International Monetary Fund (not yet signed) [2012]* and recommends that binding treaty action be taken.