New York University

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Emergency Financing at the IMF

Jean-Francois Seguin, New York University

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The American elections made 2008 an historic year. However, 2008 will also be remembered for the financial meltdown that has not only reshaped Wall Street and global finance at an astonishing pace, but has also considerably impacted the global economy. The IMF and leading economists warned of the severity of the current crisis: “the world economy is entering a major downturn in the face of the most dangerous financial shock in mature financial markets since the 1930s”\(^1\).

The “big freeze” in the credit markets and gloomy economic outlooks have led many

countries to face major economic problems. Emerging countries have also been hit very hard:

Until recently, emerging markets were one of the few bright spots left in a world economy hit by massive deleveraging, failing banks, and corporate profit warnings. But now, the crisis is spreading beyond the advanced economies where it originated, with emerging markets all over the world suffering from the squeeze in global financial markets.

As the Wall Street Journal points out, many developing countries facing balance of payments pressures, falling exports, currency devaluation and a potential collapse of their banking system have no alternative but knocking at IMF’s door. Recently, nations like Iceland, Hungary, Pakistan and Ukraine had to deal with domestic economic troubles and asked the IMF for help.

This article analyzes the case of Ukraine and the details of its rescue package from the IMF. We will briefly discuss Ukraine’s political situation, the impact of the credit crunch on its economy (especially on its currency, its imports and exports as well as on its banking system) and how did the IMF come to the rescue. We will then look at the purposes of the IMF and its role during a crisis. We will analyze how the IMF lends to countries with urgent needs and provides them with emergency financing. The conditionality of emergency loans will also be examined. Throughout the article, Ukraine will be used as the central example to illustrate IMF crisis lending.

We will conclude with a discussion on the future role of the IMF and how important this current financial turmoil is for the Fund. Many argue that the current credit crisis is bringing back the IMF to relevancy after several years of global criticism and questioning on its role and utility.

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1. Ukraine’s challenging situation

Ukraine is a former USSR republic that achieved independence in 1991 with the collapse of the Soviet Union. Until the recent downturn, its economy has steadily developed since 2000 despite a very unstable political environment. Ukrainian politics has been characterized by a permanent involvement of Russia in its domestic affairs, political tensions and rampant corruption.

In 2004, during pre-arranged Presidential elections, a peaceful popular revolt known as the “Orange Revolution” allowed Ukrainians to elect new leaders and overthrow the Russia-backed candidate. Victor Yushchenko, a reformer who led the Orange Revolution, became Ukraine’s third president after contesting the electoral results.

Yushchenko’s revolutionary campaign was marked by violence and threats. For instance, during the last three months before the elections, he has been poisoned by dioxin and cruelly disfigured. Yushchenko declared that he was convinced what happened to him was an act of political reprisal and an attempt to kill him.

a. Political instability after the Orange Revolution

Political tensions continued after the success of the Orange Revolution in 2004. The President is the head of State but the Constitution provides that he must share the power with the government, which is led by a Prime Minister. After Yushchenko’s election, Yulia Tymoshenko, a leader in Orange Revolution’s mass protests, was sworn in as Prime Minister, but only for a few months. The President who has legislative, executive and military authority has the right to dismiss the Prime Minister, revoke acts of the government and

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7 Id.
8 Id.
9 Id.
10 http://www.nytimes.com/2004/12/12/international/europe/12ukraine.html?_r=1
11 Id.
dissolve the *Verkhovna Rada*, the Ukrainian Parliament\(^{14}\). Yushchenko saw Tymoshenko rising in popularity at home and abroad and fired her in 2005. According to The Economist, Tymoshenko stepped down mainly because she did not have her own team and was constantly struggling with the President’s friends and allies\(^{15}\). This political move allowed the former presidential candidate (who had tried to rig the 2004 elections), Mr. Yanukovych, to win the parliamentary elections of August 2006 and become Prime Minister\(^{16}\). Again, political struggles and public pressure provoked an early legislative election in 2007 and Tymoshenko, leading a democratic coalition, returned as Prime Minister\(^{17}\).

Ms. Tymoshenko, known for her great communication skills and her ambition, clearly aspires to become President of Ukraine one day – and she probably will. President Yushchenko knows better than anybody else that Tymoshenko could challenge him in the next presidential elections. Because of personal ambitions and political infightings, the two leaders of the Orange Revolution don’t get along very well since 2005 and proved to be completely unable to work efficiently together. Both are openly and publicly blaming the other for all of Ukraine’s problems\(^{18}\).

Now, in the middle of the severe economic and financial crisis that hit Ukraine very hard, the President has again dissolved the *Verkhovna Rada* on October 8 after his party pulled out of the “Orange coalition” and he called for legislative elections on December 7 – the third parliamentary election in three years\(^{19}\). Tymoshenko contested the idea of having

\(^{14}\) See kmu.gov.ua, *supra* note 12.

\(^{15}\) See economist.com, *supra* note 13.

\(^{16}\) See cia.gov, *supra* note 6.

\(^{17}\) Id.


\(^{19}\) http://www.ft.com/cms/s/0/efd1d3e4-9665-11dd-9dce-000077b07658.html.
elections in this time of emergency and said the elections “would not take place”. Yushchenko has since postponed the elections, first to December 14, and then to 2009.

But the Parliament is not functional and many important laws must be passed and urgent measures must be taken to comply with IMF’s conditions and minimize the current economic and financial turmoil. A stable government is crucially needed in Ukraine in order to navigate in these turbulent economic waters. As The Economist put it, the President may feel justifiably threatened by Tymoshenko as a probable candidate in the presidential elections of 2009 but both will be judged on what has been achieved since the Orange Revolution. Tymoshenko should be less populist and more focused on the issues while the President should do everything he can to make this Parliament functional.

Reforming Ukraine and implementing macroeconomic policies commanded by the IMF will be particularly hard in this political environment. For example, the IMF had to hold separate meetings with the President and the Prime Minister to negotiate an emergency loan and its conditions. Doubtful of Kiev’s political ability to implement the IMF’s program and fix the economy, the credit rating agencies, Standard & Poor’s and Fitch, cut currency rating for Ukraine. Also, the President, whose approval rating has fallen under 10% this year and is now around 5.4%, lacks credibility and does not have the support needed to push the government in the good direction.

b. The credit crisis hit hard in Ukraine

Despite the political situation, Ukraine has experienced a sustained economic growth since 2000. For instance, its gross domestic product (“GDP”) has grown at an average annual

20 http://afp.google.com/article/ALeqM5iosNEc3C4oSuNSi_e1COuQQcw0bA.
22 See economist.com, supra note 13.
rate of 7% in the last eight years – a sharp contrast with the eight-year period that followed independence. This remarkable economic performance quickly lifted the living standards of millions of Ukrainians and stimulated consumption.

Although growth continued in 2007-2008 and was expected in 2009, a combination of internal and external factors considerably slowed Ukraine’s economic boom and reduced the government’s ability to balance public finance. Consequently, in the second quarter of 2008, Ukraine ran an important current account deficit and its balance of payments deteriorated. A current account deficit occurs “when a country's total imports of goods, services and transfers is greater than the country's total export of goods, services and transfers”.

In the Memorandum of Economic and Financial Policies attached to Ukraine’s Letter of Intent submitted to the IMF on October 31, the government identifies four main factors that have negatively affected the economy:

- high inflation;
- rising energy import prices combined to a sharp devaluation of the local currency;
- lower demand for Ukraine’s main export and declining commodity prices; and
- serious problems in the local banking system accelerated by the global credit crunch.

i) Inflation

The Ukrainian government recognizes that its economy was “overheating” by late 2007. While wages and consumption were rapidly increasing, inflation was also rising to new heights and the government failed to take efficient measures to control it. According to the IMF, by mid-2008, inflation exceeded 30% – a direct result of the spectacular growth in borrowing (over 70%) and wages (over 30%). With inflation that high, prices of services and

28 Id. and imf.org, supra note 27.
31 imf.org, supra note 27.
goods, from food to houses to energy, exploded and the purchasing power of Ukrainians decreased dramatically\(^{32}\). An escalating inflation rate also means a depreciation of the local currency and higher interest rates\(^ {33}\).

**ii) Currency & imports**

Ukraine’s currency, the hryvnia, has plummeted due to inflation, gloomy economic forecasts and speculation. The hryvnia fell to historic lows in November as foreign direct investments, exports and confidence continued to decrease\(^ {34}\).

Meanwhile, imports increased by 50 to 60\% annually in recent years\(^ {35}\). Ukraine’s principal importation is energy and the country remains largely dependent on Russia for gas supply (the country imports approximately three-fourths of its gas from Russia)\(^ {36}\). Even though oil and gas prices have declined lately, energy costs have steadily increased over the years and, with a depreciated currency, Ukraine now finds itself in a tough situation\(^ {37}\). Kiev currently owes 2.4 billion euros to Gazprom, Russia’s state-owned gas company, and the Russian President is threatening to cut off energy supply if the debt not quickly paid off\(^ {38}\). Ukraine simply can’t afford to pay Gazprom for the moment – it would drain crucial financial resources coming from the IMF. President Yushchenko’s headaches related to energy supply problems are far from over: Gazprom’s CEO told the Financial Times on Thursday, November 20\(^ {th}\), that his company will considerably increase gas prices for Ukraine in 2009 (passing from $179.5 per thousand cubic meters of gas to over $400)\(^ {39}\).

\(^{34}\) http://www.guardian.co.uk/business/feedarticle/8091663.
\(^{36}\) See cia.gov, supra note 6.
\(^{38}\) http://www.google.com/hostednews/afp/article/ALeqM5iTTnxBvDCEbIdawnOORdlGKgzwjQ.
\(^{39}\) http://www.ft.com/cms/s/0/a9c23648-b724-11dd-8e01-0000779fd18c.html.
iii) Exports

Beside high inflation, currency devaluation and rising import costs, exports have significantly slowed. Steel and metals production has been a major engine of growth for Ukraine and steel products are the principal export of the country\(^{40}\). The global financial crisis impacted the steel industry and the demand for Ukraine’s steel has fallen to its lowest point in a decade\(^{41}\). Following the generalized decline of demand, commodity prices have also plunged – aggravating even more Ukraine’s difficulty to maintain a decent balance of payments.

Steel production was down by 49% last month compared with the same period of time last year\(^{42}\). This means that many steelworkers have lost their job and have been, or will eventually be, unable to pay their short-term debt due to local banks. An increasing number of unemployed people also have negative repercussions on the government’s fiscal revenues and public expenses.

iv) Banking system

Like the United States, Europe and Iceland, Ukraine’s banking system became under pressure in the last months due to its exposure to international markets. Ukrainian banks and corporations financed their operations largely with short-term debt borrowed abroad in foreign currency\(^{43}\). Local banks also lent significantly in foreign currency to domestic borrowers\(^{44}\). According to Fitch, the credit rating agency, ‘‘the dollarisation of Ukraine's banking system, with 51% of lending denominated in foreign currency, exposes the country's domestic macroeconomic and financial stability to exchange-rate risk’’\(^{45}\). When the hryvnia started to depreciate and access to foreign money vanished due to the global credit freeze,

\(^{40}\) See cia.gov, supra note 6.
\(^{41}\) http://www.ft.com/cms/s/0/b3244a70-af75-11dd-a4bf-000077b07658.html.
\(^{42}\) Id.
\(^{43}\) Ukraine: Letter of Intent, supra note 28, at 2.
\(^{44}\) Id.
investors began to worry about the capacity of Ukrainian banks and corporations to pay their debts and find funding. Worries intensified with the demise of Prominvest Bank, Ukraine’s sixth largest bank, which lacked liquidity, suffered from hryvnia’s decline and couldn’t find financing anywhere⁴⁶. A run on the banks followed and the IMF estimates that the deposit outflow rose to US$3 billion in the first three weeks of October⁴⁷. The governments reacted quickly by providing liquidity to its banks and by imposing restrictions on deposit withdrawals⁴⁸. However, confidence in Ukraine’s economy, currency and banking system remains very low.

c. The Fund come to the rescue

To adequately calm economic turbulence, restore confidence and meet its balance of payments needs, Ukraine evaluated that it would need around US$16.5 billion after potential private capital inflow⁴⁹. Short of options, Ukraine formally requested a Stand-by agreement in an amount of SDR 11,000 million (equivalent to US$16.4 billion)⁵⁰. SDR stands for ‘‘Special Drawing Rights’’ and is the unit of account at the IMF⁵¹. On November 5, the IMF officially agreed to lend the requested sum⁵².

Mr. Strauss-Kahn, IMF’s managing director, have been very keen to lend to Ukraine, Hungary, Iceland and Pakistan. It is in fact a very important opportunity for the IMF to regain ‘‘relevance’’ and show the world that the organization has an important role to play. Claudio Loser, a scholar at the Inter-American Dialogue who was an executive at the IMF during the Argentine crisis, summarizes the significance of the global economic downturn for the IMF: ‘‘[The IMF] has been written off as increasingly irrelevant, but now we could see a

⁴⁷ See imf.org, supra note 37.
⁴⁹ Id. at 1-2.
⁵⁰ Id. at 1. See also imf.org, supra note 50.
⁵¹ SDR value is calculated with a basket of major currencies including the euro, the yen, the pound sterling and the U.S. dollar (www.imf.org/external/np/exr/facts/sdr.htm).
⁵² See imf.org, supra note 50.
renaissance at the Fund. Countries that had hoped never to need the Fund again may be forced to ask for help as the normal sources of finance dry up”\(^{53}\). NYU economist Nouriel Roubini also commented in RGE Monitor on how challenging is the global crisis for the IMF: “The IMF has been more and more challenged by its ability to contribute to solve the current global financial meltdown after years of low demand for IMF assistance as buoyant capital markets and rising commodity prices allowed many developing nations to raise funds on their own”\(^{54}\). In fact, lending took a clear drop at the IMF since the last major financial crisis in Asia in 1998 – passing from US$32 billion in outstanding loans in 1998 to less than US$2 billion in 2007\(^{55}\).

The current financial turmoil is a chance for the IMF to boost and improve its profile, especially among emerging economies. The outcomes of IMF’s assistance to countries in crisis will be extremely important for the future of the organization. In an article noting the embarrassing absence of the IMF in the first months of the crisis, it was argued that the organization “remains the institution most suited to dealing with such crises” and that the “IMF-led route is better for troubled countries than making ad hoc approaches to others”\(^{56}\).

2. **Purposes of the IMF and its role in a crisis context**

Adopted in 1944 in Bretton Woods, the Articles of Agreement of the IMF constitute the founding document of the international organization and remain the framework of IMF’s structure and operations. Article I states six general purposes that should guide “all policies and decisions” of the IMF\(^{57}\). Among these goals, two are pertinent with crisis lending:

- to give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments […]?
• [...] to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

The key word here is “safeguards” – the IMF will lend under “adequate safeguards”. This opens the way to conditionality and the major (and widely criticized) role the IMF played and is still playing in economic policy-making.

Aside from conditionality and the time it may take to reach an agreement on the policy program, the IMF can respond very quickly to a distressed member’s request for financial assistance. An “Emergency Financing Mechanism” has been developed in 2005 and has been employed in the midst of the Asian financial crisis in 1997, for Turkey in 2001 and for Georgia very recently58. IMF’s lending is in fact closely linked to financial crisis given that countries with alternatives would certainly not want to borrow from the Fund and be told what policies to implement.

3. The IMF as Ukraine’s white knight

The two-year Stand-by agreement approved in early November will allow Ukraine to borrow US$16.5 billion to the IMF. The agreement, however, comes with a program of policy reforms that need to be implemented by the government.

Before discussing the conditionality of the agreement, it is important to review the crisis lending process and structure.

a. Procedures and process

As said previously, the IMF has established an “Emergency Financing Mechanism” to respond more efficiently and rapidly to countries with urgent needs59. The emergency financing procedures are quite simple60:

58 See imf.org, supra note 1.
59 See imf.org, supra note 1.
• The country in distress requests the assistance of the IMF and announces its intention to proceed under the emergency financing mechanism;

• The Executive Board of the IMF is informed and the mechanism is activated;

• The IMF quickly sends a team to the country to evaluate the situation and the financial needs;

• The team, mainly composed of economists, prepares a relatively concise ‘‘program’’ (a set of short-term economic policies aiming to resolve the country’s problems);

• The government and the IMF’s staff negotiate the amount of the financing and the policies to be implemented;

• As soon as a staff-level agreement is reached, a report is circulated and the Executive Board meets within 72 hours to approve the request;

• The funds will almost always be provided by tranches as the country meets predetermined quantitative targets and following a schedule of measures to be taken.

The Executive Board’s authority to approve or disapprove a program is clearly stipulated in Section 3 of Article XII of the Articles of the Agreement.

Access to IMF’s resources is open to countries that are members in good-standing61. Although Ukraine was not a founding member, Article II of the Articles of Agreement provides that ‘‘membership shall be open to other countries at such times and in accordance with such terms as may be prescribed by the Board of Governors’’62. The Board approved Ukraine’s membership in 1992 and determined its quota to be SDR 665 million63. Ukraine increased its quota later in 1992 and again in 1999. Its current quota is SDR 1,372 million,

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61 With the exception provided at Section 3 of Article XVII of the Articles of Agreement, supra note 60.
62 Article II, Section 2, Articles of Agreement, IMF, supra note 60.
which meant approximately US$2.049 billion as of November 26, 2008\textsuperscript{64}. Special Drawing Rights’ value being based on the four major currencies, the real value of quotas fluctuates.

Quotas are governed by Article III of the Articles of Agreement and Section 2 of this article specifically details how quotas are adjusted\textsuperscript{65}. Quotas are mostly based on the economic size of the country\textsuperscript{66}. They represent the amount countries have to fully pay to the IMF for membership (quota subscription) and determine the voting rights of each member. Members receive 250 basic votes plus an additional vote for every SDR 100,000 of quota in the Fund\textsuperscript{67}.

Most importantly, the financing available to borrowing countries is largely depending on their quota. A member can normally borrow up to 100\% of its quota each year and no more than 300\% cumulatively\textsuperscript{68}. In exceptional circumstances, a country may request to borrow more than the 300\% generally allowed\textsuperscript{69}. Ukraine for example has now had access to funds representing more than 800\% of its quota\textsuperscript{70}.

One last point to be made is that according to Article V of the Articles of Agreement, governments must deal with the IMF through their Treasury department, their central bank or other similar agency like the Ministry of Finance\textsuperscript{71}.

\textbf{b. Structure of the financing}

Ukraine’s loan is representative of typical lending at the IMF. Iceland and Hungary for example have had similar rescue packages. First, the government has to agree with the IMF on the conditions of the loan and then will present the program to the Executive Board in a \textit{Letter of Intent} (‘‘LoI’’) to which will be attached a \textit{Memoranda of Economic and Financial

\textsuperscript{64} http://hwww.imf.org/external/data.htm (1 USD = 0.669288 SDR).
\textsuperscript{65} Article III, Articles of Agreement, IMF, supra note 60.
\textsuperscript{67} Id.
\textsuperscript{69} Id.
\textsuperscript{70} US$16.4 billion = SDR 11 billion; Ukraine’s quota = SDR 1.372 billion; (SDR11 billion x 100) / SDR 1,372 billion = 801.7\%. See Ukraine: Letter of Intent, supra note 28, at 1 and imf.org, supra note 37.
\textsuperscript{71} Article V, Section 1, Articles of Agreement, IMF, supra note 60.
Policies, and a Technical Memoranda of Understanding. The LoI is the official request to the IMF and contains the details of the policies the country will have to implement in order to have access to the funds. All LoI are made public on the IMF’s website.

The content of Memorandum of Economic and Financial Policies is probably the most important part of the financing. It is basically a binding action plan for the government. It defines the policies the IMF and the borrower have agreed on and contains detailed lists of performance criteria and targets to reach in definite timetable. It also includes details on the phasing of the loan. Finally, Technical Memorandum of Understanding, as provided in Ukraine’s Memoranda, “sets out the understandings between [the country] and IMF staff regarding reporting requirements and definitions of quantitative targets and structural measures for the economic program.”

Beside the LoI and the Memorandum, the financing documents will usually be comprised of three additional documents: the IMF staff report (generally not disclosed to public), the Executive Board decision (based on the staff report, the LoI and the Memorandum) and the loan agreement itself.

The loan will take the form of an arrangement. Generally, like for Ukraine, the financing will be made trough a “Stand-by Arrangement” – a type of short-to-medium-term credit line for countries with balance of payments problems. The IMF defines a stand-by arrangement as:

A decision of the IMF by which a member is assured that it will be able to make purchases (drawings) from the General Resources Account (GRA) up to a specified amount and during a specified period of time, usually one to two

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72 See ANDREAS LOWENFELD, INTERNATIONAL ECONOMIC LAW, 615 (Oxford University Press 2d ed. 2008).
76 LOWENFELD, supra note 76, 615.
years, provided that the member observes the terms set out in the supporting arrangement.\textsuperscript{77}

The first stand-by arrangement was concluded with Belgium in 1952\textsuperscript{78}. Although the initial Articles of Agreement, when concluded in Bretton Woods, did not have any mention of such an arrangement, it was included in the Amended Articles\textsuperscript{79}. Article XXX(b) defines the arrangement and article V(3) expressly refers to stand-by arrangements “\textit{to assist members to solve their balance of payments problems}”\textsuperscript{80}. Today, as Professor Lowenfeld wrote in his book on International Economic Transactions, stand-by arrangements are “\textit{the principal device through which the resources of the IMF are made available to member states}”\textsuperscript{81}. Sir Joseph Gold, a former General Counsel and consultant at the IMF, described these arrangements as being “\textit{the IMF’s most flexible device for combining the discipline which promotes balance-of-payments equilibrium with the assurance of support which permits a country to accomplish an orderly and gradual adjustment of its external accounts}”\textsuperscript{82}. In 1993, the Executive Board of the IMF approved a standard form and standard clauses on which all stand-by arrangements are now based\textsuperscript{83}.

Under a stand-by arrangement, the disbursement will usually be completed between 12 to 24 months and the timetable for the repayment ranges from two to four years\textsuperscript{84}. In Ukraine’s case, disbursements of funds are phased out over a period going from November 2008 to October 2010\textsuperscript{85}.

\textsuperscript{77} http://www.imf.org/external/np/exr/glossary/showTerm.asp#74. The official definition, however, is provided in the Articles of Agreement at Article XXX (b): “\textit{Stand-by arrangement means a decision of the Fund by which a member is assured that it will be able to make purchases from the General Resources Account in accordance with the terms of the decision during a specified period and up to a specified amount}”, supra note 60.

\textsuperscript{78} LOWENFELD, supra note 76, 615.

\textsuperscript{79} Id.

\textsuperscript{80} Articles of Agreement, IMF, supra note 60.

\textsuperscript{81} LOWENFELD, supra note 76, 615.

\textsuperscript{82} Edwards Jr., supra note 79, at 576.


\textsuperscript{84} See imf.org, supra note 72.

\textsuperscript{85} See Annex 1: Access and phasing, infra p.25.
Interestingly, the wording of the transaction bears significance. The IMF and its members call a stand-by an “arrangement”, not an “agreement”\textsuperscript{86}. Professor Lowenfeld explains that Sir Gold have maintained since the early 1960s that a stand-by “\textit{does not create obligations at law}”\textsuperscript{87}. Traditionally, a stand-by has not been considered by the IMF and its members as being an international agreement and thus, generally, no legislative ratification is needed and no contractual language is used\textsuperscript{88} – although the conditionality and the phasing of the disbursements give a powerful, contractual-type, effect to the arrangement\textsuperscript{89}.

Finally, it is worth noting that a stand-by with the IMF is normally perceived by private and sovereign creditors as being very positive. Many creditors will want the IMF to step in through a conditional stand-by and will consider the Executive Board’s decision to lend to the troubled country as a “‘seal of approval’”\textsuperscript{90}. Consequently, these arrangements not only provide fresh liquidity but can also play a big role in restoring confidence in a country’s creditworthiness and ability to stimulate its economy. Paul Blustein, a former journalist at the Washington Post and the author of two books on the IMF, tells the story of IMF staffers during the Russian economic crisis in the late 1990s who were receiving calls late at night from financiers and investors pushing for a “‘big package’” and reforms for Russia\textsuperscript{91}. An IMF bail-out of an emerging country will be followed very closely by the business and finance community, partly because the IMF has more legitimacy for “‘advocating’” a program of harsh policies than the banks or the bondholders.

\textsuperscript{86} LOWENFELD, supra note 76, 616.
\textsuperscript{87} Id.
\textsuperscript{89} See for instance the third paragraph of Ukraine’s LoI about consultation, monitoring, prior actions, performance criteria, etc.
\textsuperscript{90} Edwards Jr., supra note 79, at 574.
c. Conditionality

Conditionality is the heart of most IMF loans. The idea behind conditionality is to make sure the borrowing country takes the measures necessary to address its problems and be able to pay back the loan in time. According to the IMF, conditions are used as “a way for the IMF to monitor that its loan is being used effectively in resolving the borrower’s economic difficulties, so that the country will be able to repay promptly, and make the funds available to other members in need”.

The Executive Board of the IMF officially adopted the principle of conditionality in 1952. Since then, it became a central element of IMF lending, even in time of crisis. The Articles of Agreement specifically refers to it in Article V (3)(a):

The Fund shall adopt policies on the use of its general resources, including policies on stand-by or similar arrangements, and may adopt special policies for special balance of payments problems, that will assist members to solve their balance of payments problems in a manner consistent with the provisions of this Agreement and that will establish adequate safeguards for the temporary use of the general resources of the Fund.

The United States have played a pivotal role in promoting the idea of attaching a loan to conditions. Former Secretary of State, James Baker, at a meeting on international debt in 1985, proposed a three-point plan for debtor countries dealing with debt and balance of payments problems: (i) the debtor countries should adopt comprehensive macroeconomic and structural policies supported by international financial institutions; (ii) the IMF should play a continued central role in the resolution of the problems; and (iii) the debtor countries should also seek private loans. Baker made it clear that in order for a country to secure financing,

92 The IMF has launched the new Short-Term Liquidity Facility (SLF), a facility designed to lend to countries with strong track record facing short-term difficulties because of the global crisis. These loans will not be subject to conditionality. The new facility has been approved by the Executive Board on October 29, 2008. See http://www.imf.org/external/pubs/ft/survey/so/2008/POL102908A.htm.
95 Articles of Agreement, IMF, supra note 60.
96 Conrad, supra note 98, at 415.
its government will have to observe a policy program determined under the auspices of the IMF. The United States and European allies have always stuck to this principle\textsuperscript{97}.

i) Guidelines

Conditionality has been the subject of an extensive review in 2000 and resulted in a set of revised guidelines adopted in 2002\textsuperscript{98}. The Executive Board’s decision No. 12865-(02/102) sets important features for stand-by arrangements’ conditionality. These short guidelines are reproduces below:

1. Access to Fund resources in the credit tranches will normally be provided through a stand-by arrangement.
2. A representation of need by a member for a purchase requested under a stand-by arrangement will not be challenged by the Fund.
3. The normal period for a stand-by arrangement will range from 12 to 18 months. [...] .
4. Phasing and performance clauses will be omitted in stand-by arrangements within the first credit tranche. They will be included in all other stand-by arrangements but will apply only to purchases outside the first credit tranche. [...].\textsuperscript{99}

These guidelines provide important details on the timetable of stand-by arrangements and on “tranches”. A tranche is equal to 25% of the country’s quota\textsuperscript{100}. The first 25% represent the “reserve tranche” and borrowing within this tranche is unconditional\textsuperscript{101}. Some conditions are applied when funds are drawn within the following tranches and the last 25% tranche and over are called “upper credit tranches”\textsuperscript{102}. Drawings in the upper credit tranches are accessible only with a policy program\textsuperscript{103}. For example, in Ukraine’s LoI, it is written that the government will consult with the IMF on their economic policies while they have

\textsuperscript{97} Id.
\textsuperscript{98} See imf.org, supra note 97.
\textsuperscript{100} Conrad, supra note 98, at 411.
\textsuperscript{101} Id.
\textsuperscript{102} Id.
\textsuperscript{103} Id.
“outstanding purchases in the upper credit tranches” – even after the expiration of the stand-by.\textsuperscript{104}

The guidelines reproduced above should be read with the general Guidelines on Conditionality adopted by the Executive Board\textsuperscript{105}. The guidelines are very explicit and detail how the IMF should determine policy programs. The most important provisions are paragraphs 6 and 7 which specify the scope and the goals that should guide the IMF. Paragraph 6 provides that “\textit{Fund-supported programs should be directed primarily toward the following macroeconomic goals: (a) solving the member's balance of payments problem without recourse to measures destructive of national or international prosperity; and (b) achieving medium-term external viability while fostering sustainable economic growth}”\textsuperscript{106}. Paragraph 7 stipulates that all conditions should be “critical” and “necessary” to achieve the goals of the program\textsuperscript{107}. The Executive Board, based on an assessment report form the IMF’s Independent Evaluation Office, recently expressed the need to have more focused conditions that address directly the problems the borrower is having\textsuperscript{108}.

\textbf{ii) Ukraine’s program}

Conditions imposed by the IMF forms the program to which LoI refer. Memorandum will usually define more precisely the policies and the performance criteria. For Ukraine, the program has two main objectives: to stabilize the financial sector and to reduce inflation along with the impact of external economic and financial shocks\textsuperscript{109}. As many other countries this year, the priority was to provide liquidity to the banks and take appropriate measures to avoid the collapse of the whole banking system.

\textsuperscript{104} Ukraine: Letter of Intent, \textit{supra} note 28, at 1.
\textsuperscript{105} Ex. Bd. Dec. No. 12864-(02/102), \textit{supra} note 92.
\textsuperscript{106} Id.
\textsuperscript{107} Id.
\textsuperscript{108} See imf.org, \textit{supra} note 96.
\textsuperscript{109} Ukraine: Letter of Intent, \textit{supra} note 28, at 2.
As specified in paragraph 4 of the Memoranda of Economic and Financial Policies, the measures included in the program to address banks’ problems are: (i) appropriate liquidity support and expansion of deposit guarantees; (ii) a stronger bank resolution framework, including availability of public funds; and (iii) a stronger framework for resolution of household and enterprise sector debts. In order to provide a stronger resolution framework, the government had to adopt legislative amendments and pass a new law – what has been done as part of the prior action requirements. A “prior action” is an imperative measure that must be completed before the program can be presented to the Executive Board.

For inflation and macroeconomic troubles, the actions to be taken according to the program are the following: (i) a flexible exchange rate policy, supported by base money targets and an appropriate intervention strategy; (ii) planned transition to inflation targeting; (iii) bringing incomes policy in line with targeted inflation; (iv) maintain a prudent fiscal stance; and (v) bringing energy sector prices more in line with costs. The implementation of a flexible exchange rate regime was also part of the prior actions and it has been accomplished. However, the energy sector prices, in my opinion, are not a variable the government can control. As said earlier, Ukraine is totally dependent and Gazprom intent to rise prices in 2009. Reducing the prices of energy would probably have to imply governmental subsidies or a sharp reduction in the demand – which appears almost impossible to me in the current context. Nonetheless, this measure is not used as a performance criterion, a prior action or a structural benchmark. Performance criteria are defined by the IMF as “specific conditions that have to be met for the agreed amount of credit to be disbursed” and structural benchmarks as “measures that cannot be monitored objectively […] that would not
individually warrant an interruption of IMF financing but that are part of a reform that is critical for program success.”117.

One last thing worth to mention is the text found at paragraph 7 of the Memoranda of Economic and Financial Policies. In this provision, the government says that if the situation goes better than expected, they will consider repaying the IMF ahead of schedule.

iii) Criticism

The conditionality of IMF’s loans has been widely criticized in recent years. Concerns that conditionality may increase costs for the borrowing nation and may have an adverse impact on development have been raised118. The legitimacy of the IMF to impose a program has also been questioned119.

It has been said that conditionality handicaps the debtor nations to develop their own solutions to their economic problems120, that it is an erosion of borrowing countries’ economic and political sovereignty121, that it limits the range of policies at the debtors’ disposal and forces unwilling countries to undergo shock therapy122, etc. The following quotation illustrates well the general criticism of conditionality:

Global economic integration alone introduced new challenges to traditional notions of sovereignty; however, when coupled with the IMF and Bank’s conditionality, sovereignty is in a more precarious position than ever before.123

It is true that IMF staffers strongly influence the policies of the borrowing country. We can even say that polices are imposed and only superficially negotiated. The bargaining power between the first-class economists of the IMF and a distressed emerging country with no

117 See imf.org, supra note 96.
118 http://www.iilj.org/courses/FDSovereignDebtBackground.asp.
119 Id.
122 Tsai, supra note 124, at 1326.
123 Id. at 1329.
alternative is clearly not balanced\textsuperscript{124}. I disagree, however, with the proposition that policy programs threatens debtors’ sovereignty and that the troubled country could be better off without the intervention of the IMF. Crisis lending implies short-term solutions and facilities and appears to differ with mid-to-long-term financing under the Structural Adjustment Facility or other similar programs. Especially in the current crisis, the policies to be implemented by Ukraine and other nations like Hungary or Iceland are narrowly targeted and purely focused on the problems. As commanded by the Guidelines, all measures included in Ukraine’s program seem to be ‘‘critical’’ and ‘‘necessary’’.

Many speculated that the IMF would require Ukraine to postpone the elections and restructure its debts\textsuperscript{125}. None of this has been included in the LoI or the Memoranda of Economic and Financial Policies as a condition. The elections have been postponed to 2009\textsuperscript{126} but nothing could lead us to think that the IMF has formally required it (despite the fact that journalist Paul Blustein, in his book on the Argentine crisis, tells the story of secret pacts and hidden agreements between the IMF and the Argentine government)\textsuperscript{127}. Yet, even if such a political condition would have been included in Ukraine’s program, it would have been promoting stability and good governance\textsuperscript{128}.

Should the IMF reduce or eliminate the conditionality of its stand-by arrangements? Some have suggested that the policy programs are IMF’s collateral: ‘‘Just as private banks require collateral, conditionality serves as collateral for the IMF and the World Bank’’\textsuperscript{129}. And others have proposed that the IMF should lend without condition and take collateral such as oil

\textsuperscript{124} Id. at 1327.
\textsuperscript{125} See washingtonpost.com, supra note 23.
\textsuperscript{126} See forbes.com, supra note 21.
\textsuperscript{128} Although such a condition can be perceived as undermining national sovereignty and being anti-democratic, especially when the government has a very low approval-rating (as it is presently the case in Ukraine).
\textsuperscript{129} See Tsai, supra note 124, at 1328.
revenues or borrowers’ assets. My sense is that a policy program is sometimes as much needed as the financial package itself for emerging countries. Besides the fact that developing countries might not have collateral to offer, it would prevent the IMF to share its economic expertise with the government in need of support. Another idea put forward was to emphasize *ex ante* conditionality – meaning being more selective and lending only to ‘‘pre-qualified’’ countries having good policies already in place. I believe replacing *ex post* conditionality by *ex ante* conditions would deprive many members of the assistance the IMF can provide. It would also be unfair not to give a country in crisis a chance to readjust its policies and restore its economy. This is not to say, however, that a certain level of *ex ante* conditions should not be applied in order to limit moral hazards and to lend to countries having at least a potential of recovery and solvency. There is no perfect answer to the question posed above. Nonetheless, I think that, at least for crisis lending to emerging countries, conditionality conforming to the 2002 Guidelines may benefit borrowers a lot more than it may harm their economic situation.

4. Conclusion

In 1983, the International Financial Law Review published a comment entitled ‘‘The IMF: Firefighter or Policeman?’’ advocating conditionality and an active role of the IMF to prevent debt crisis. Should the IMF be a firefighter or a policeman now and in the future? It should probably be both.

The IMF is clearly a firefighter for its members and the international financial and economic system. The organization has reached the apex of its influence during times of

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130 See iilj.org, supra note 122.
131 Id.
crisis, notably because of the reduced bargaining power of countries in need\textsuperscript{135}. The Fund has an important role to play during crisis such as the one we are experiencing right now. As said earlier, The Economist argued that the IMF is the best institution to provide help during crises but also concluded that it “needs to move fast, to use the right tools, and to propose policies that are tailored to each country’s economic situation”\textsuperscript{136}. Being a good firefighter for the IMF will largely depend on two factors: (i) imposing only critical and necessary conditions while remaining flexible and very attentive to emerging countries’ needs and particular situations; and, (ii) a timely response to SOS calls for help. The Guidelines on Conditionality and the Emergency Financing Mechanism are two crucial steps forward in that direction.

The current turmoil has also shown, in my opinion, that global markets are now interlinked more than ever and that the IMF should increasingly play the role of a good policeman. I see the IMF as being a “vital requirement” for the stability and the sustainability of the global economy\textsuperscript{137}. Being a good policeman will mean being actively involved in public debates about the future of international financial regulation and cooperation but also pursuing its monitoring activities.

As for Ukraine, I’m doubtful that the IMF package will be enough to effectively rescue the Ukrainian economy. It will surely allow the banking system to avoid a disastrous collapse. But political tensions and dependence on Russian energy will continue to harm Ukraine’s economy at least until the next presidential elections. Everything seems to be in place for a hard and painful recovery after the economy will have hit the bottom\textsuperscript{138}. However, the program and the stand-by itself appear to be comprehensive, focused and timely. If the rescue fails, it will be hard to blame the IMF this time.

\textsuperscript{135} Davis, supra note 4.

\textsuperscript{136} See economist.com, supra note 59.


\textsuperscript{138} http://www.ft.com/cms/s/0/2938d282-c0a9-11dd-b0a8-000077b07658.html.
Annex 1: Access and phasing

Table 1. Ukraine: Access and Phasing Under a Proposed Stand-By Arrangement

<table>
<thead>
<tr>
<th>Date Available</th>
<th>In millions of SDRs</th>
<th>In percent of quota</th>
<th>Conditions include</th>
</tr>
</thead>
<tbody>
<tr>
<td>November 2008</td>
<td>3,000</td>
<td>218.7</td>
<td>Board approval of arrangement</td>
</tr>
<tr>
<td>15 February 2009</td>
<td>1,250</td>
<td>91.1</td>
<td>Observance of end-December performance criteria and completion of the first review</td>
</tr>
<tr>
<td>15 May 2009</td>
<td>2,500</td>
<td>182.2</td>
<td>Observance of end-March performance criteria and completion of the second review</td>
</tr>
<tr>
<td>15 August 2009</td>
<td>750</td>
<td>54.7</td>
<td>Observance of end-June performance criteria and completion of the third review</td>
</tr>
<tr>
<td>15 November 2009</td>
<td>2,000</td>
<td>145.8</td>
<td>Observance of end-September performance criteria and completion of the fourth review</td>
</tr>
<tr>
<td>15 February 2010</td>
<td>375</td>
<td>27.3</td>
<td>Observance of end-December performance criteria and completion of the fifth review</td>
</tr>
</tbody>
</table>

Quantitative and structural performance criteria for resuming scheduled purchases in 2010 are expected to be established at the time of the third review.

<table>
<thead>
<tr>
<th>Date</th>
<th>In millions of SDRs</th>
<th>In percent of quota</th>
<th>Conditions include</th>
</tr>
</thead>
<tbody>
<tr>
<td>15 May 2010</td>
<td>375</td>
<td>27.3</td>
<td>Observance of end-March performance criteria and completion of the sixth review</td>
</tr>
<tr>
<td>15 August 2010</td>
<td>375</td>
<td>27.3</td>
<td>Observance of end-June performance criteria and completion of the seventh review</td>
</tr>
<tr>
<td>15 October 2010</td>
<td>375</td>
<td>27.3</td>
<td>Observance of end-September performance criteria and completion of the eighth review</td>
</tr>
</tbody>
</table>

Total 11,000  802

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### Annex 2: Quantitative and Continuous Performance Criteria

#### Table 2. Ukraine: Quantitative and Continuous Performance Criteria 1

<table>
<thead>
<tr>
<th></th>
<th>Stock</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ceiling on the cash deficit of the general government (implies a surplus) 2/3/4/</td>
<td>-4,994</td>
<td>9,930</td>
<td>0</td>
</tr>
<tr>
<td>Floor on net international reserves of the NBU (in millions of U.S. dollars)</td>
<td>37,530</td>
<td>26,700</td>
<td>21,800</td>
</tr>
<tr>
<td>Ceiling on base money</td>
<td>170,815</td>
<td>190,000</td>
<td>192,000</td>
</tr>
</tbody>
</table>

#### II. Continuous performance criteria

- Prohibition on the imposition or intensification of restrictions on the making of payments and transfers for current international transactions
- Prohibition on the introduction or modification of multiple currency practices
- Prohibition on the conclusion of bilateral payments agreements that are inconsistent with Article VIII
- Prohibition on the imposition or intensification of import restrictions for balance of payments reasons

#### III. Adjuster:

<table>
<thead>
<tr>
<th></th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Project financing 2/</td>
<td>284</td>
<td>1,468</td>
<td>1,045</td>
</tr>
<tr>
<td>Cost of bank recapitalizations 3/</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

**Sources:** Ukrainian authorities; and Fund staff estimates and projections.

- Definitions are specified in the Technical Memorandum of Understanding (TMU). Targets for 2010 will be set at the time of the third review.
- The ceiling on the cash deficit of the general government will be adjusted downward by the amount that project financing falls short of the projections shown in Section II above. The quarterly ceilings are set taking into account the seasonality of the deficit.
- The floor on the cash balance of the general government will be adjusted downward by 100 percent of the fiscal cost of banks recapitalizations. This cost includes the upfront cost for the budget implied by the recapitalization as well as associated subsequent interest payments.
- Data are cumulative flows from January 1 of the corresponding year.

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### Annex 3: Prior Actions, Performance Criteria and Benchmarks

**Table 3: Prior Actions and Performance Criteria and Benchmarks Under the Stand-by Arrangement**

<table>
<thead>
<tr>
<th>Prior Actions</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>A1. Implement a flexible exchange rate regime. NBU Council to take and publicize a decision to abolish the exchange rate band, and NBU Board to define the official rate as the preceding day’s market exchange rate (with intra-day adjustments if necessary to keep it within 2 percent of the market rate) (MEFP §8).</td>
<td>Done</td>
</tr>
<tr>
<td>A2. Issue a Law or a Decree laying out the terms of financial support to banks (MEFP §13).</td>
<td></td>
</tr>
<tr>
<td>A3. Make the necessary legal amendments authorizing the NBU to undertake the necessary bank resolution process, including (i) purchase and assumption, (ii) sales of part or whole bank, and (iii) reduction in the value of the existing shareholders’ equity and voting rights to absorb the losses incurred in the resolution process (MEFP §13).</td>
<td></td>
</tr>
<tr>
<td>A4. Finalize the resolution of the Prominvest Bank (MEFP §12).</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Performance Criteria</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>B1. Complete a diagnostic study by December 15, 2008 covering NBU’s group 1 banks, coordinated by NBU and with participation of several reputable audit firms (MEFP §13).</td>
<td>Mid-December 2008</td>
</tr>
<tr>
<td>B2. Resolve all problem banks by end June 2009, so that viable banks meet the regulatory minimum capital and nonviable banks are liquidated (MEFP §13).</td>
<td>End-June 2009</td>
</tr>
<tr>
<td>B3. Pass a 2009 Budget consistent with our general government deficit target of a zero overall balance. Consistency will be monitored through the target for the state budget deficit and the budgets for the social funds (MEFP §14).</td>
<td>End-April 2009</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Structural Benchmarks</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>B4. Cancel the foreign exchange transactions tax (MEFP §9).</td>
<td>End-April 2009</td>
</tr>
<tr>
<td>B5. NBU to adopt framework for publication, on monthly and quarterly basis, of detailed bank-by-bank financial information in line with international best practices, to include among other items, detailed balance sheets and income statements, information on bank capitalization and asset quality, with separate information for domestic and foreign currency assets and liabilities (MEFP §12).</td>
<td>End-January 2009</td>
</tr>
<tr>
<td>B6. Strengthen NBU independence: reform the NBU council, transforming it into a narrower technical body in line with best practice; prolong the term of the governor; and provide more financial flexibility to the NBU (securitize government debt to the NBU, centralize all liquidity operations in the NBU, and bring profit transfer arrangements into line with best international practice) (MEFP §11).</td>
<td>End-June 2009</td>
</tr>
</tbody>
</table>

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