T20 Policy Brief

Task Force 03
REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE

Reforming the IMF Surcharge Rate Policy to Avoid Procyclical Lending

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Abstract

The International Monetary Fund (IMF) levies ‘surcharges’ or extra fees on member countries that either draw “substantial” amounts of IMF credit to mitigate balance of payments constraints, or that maintain their credit exposure with the institution for sufficiently long periods of time. Reportedly designed to discourage the overuse of Fund resources and to ensure the financial soundness of the IMF, in recent years, surcharges have come under scrutiny for two reasons. First, such surcharges are inherently pro-cyclical as they increase the burden of debt payments at exactly the time when a member country is in need of counter-cyclical and low-cost financing, contravening the very rationale of the IMF. Ten countries were paying surcharges in 2020. Now, 22 countries are subject to IMF surcharges, and revenues from surcharges between 2020 and 2023 have reached about $6.4 billion, just as countries are struggling to recover from their balance of payments issues amidst multiple shocks, such as COVID-19, climate change, war, and advanced economy interest rate changes. The five countries paying the highest surcharges are Ukraine, Egypt, Argentina, Ecuador, and Pakistan. Second, IMF surcharges have now become among the largest sources of revenue for the IMF, creating a perverse situation whereby the most economically disadvantaged member countries are a major source of income for Fund operations. This policy brief will review the rationale for IMF surcharges and evaluate their impacts on member country economies, and on the IMF business model. In conclusion, the authors will evaluate various proposals for IMF surcharge reform and advance a set of concrete steps that can be made by the G20 and the IMF itself.

Introduction

IMF surcharges, levied on countries that have large and longstanding borrowings from the IMF, are inherently pro-cyclical as they increase the burden of debt payments at exactly the time when a member country is in need of counter-cyclical and low-cost financing, contravening the very rationale of the IMF. Surcharges are pro-cyclical and disproportionately affect middle-income countries (MICs) that need both extensive IMF financing and longer repayment periods to recover from crises and that borrow from the IMF General Resources Account (GRA)[1] on non-concessional terms—unlike low-income countries that borrow from the Poverty Reduction and Growth Trust (PRGT) at concessional rates (currently at zero interest rates). The top 5 surcharge-paying countries are large MICs, and they account for more than 90 percent of total surcharge revenues.

This paper describes who are now paying these surcharges and their consequences. We review the original rationale for the surcharges, showing that especially in the current circumstances, the objectives are not being served—indeed, they are counterproductive. The final section describes alternative reform proposals.

[1] Surcharges apply to borrowers from the IMF's GRA.

Diagnosis: The Problem of Surcharges

IMF surcharges are additional fees levied by the IMF atop regular interest payments and service fees. If a member country's debt exceeds 187.5 percent of its IMF quota, the country is subjected to an additional 200 basis point (bp) surcharge. When debt exceeds 187.5 percent for 36 or 51 months for Stand-by Arrangements or Extended Fund Facility, respectively, a time-levied surcharge of 100 bp is added.

The surcharges have become particularly problematic with the recent large increases in the basic rates charges. The result is that some borrowers pay 8% interest rates on outstanding balances subject to surcharges.

The current IMF lending rate on its GRA is given by

$$l = 0.01 + SDRi + s$$

where $SDRi$ is the SDR rate, determined weekly, based on a weighted average of interest rates on three-month debt in the money markets of the SDR basket currencies (USD, Euro, Pound Sterling, Japanese Yen, and Chinese Renminbi), and s is the effective surcharge rate. A concern that adds to the problem of the surcharge policy is the increase in $SDRi$ following the contractionary monetary policy stance that central banks that issue reserve currencies have pursued since 2022 (see Figure 1).

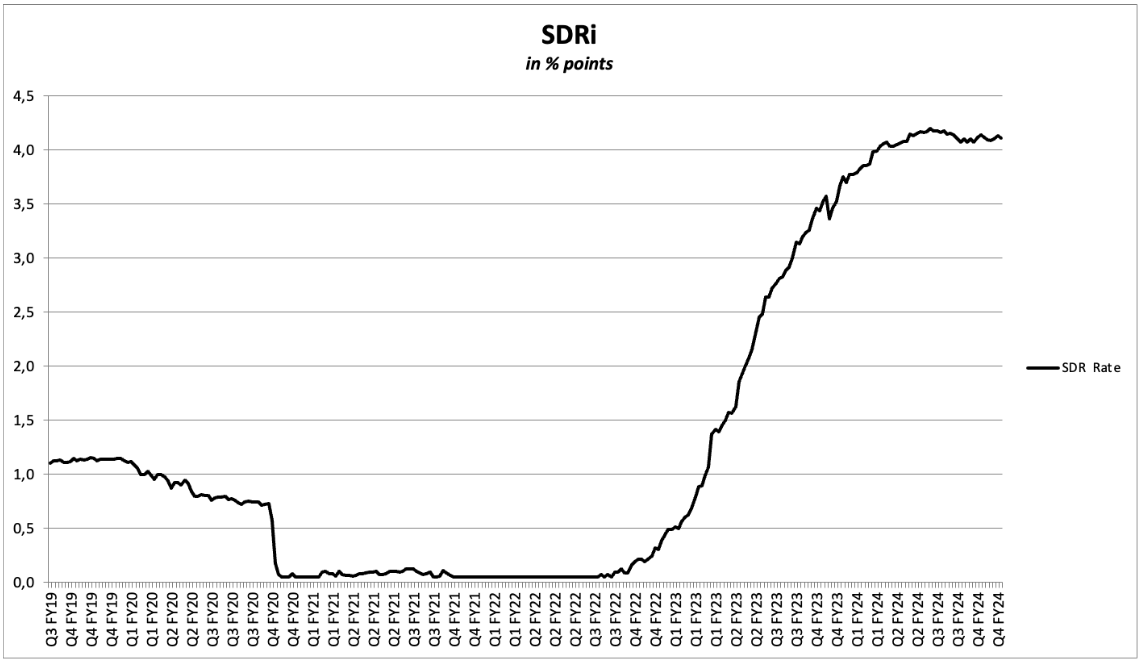

FIGURE 1.

Compounding an already bad situation

The current situation, where Covid 19 and the war in Ukraine have simultaneously led to marked increases in indebtedness, in interest rates confronting all countries in private markets, but especially those in emerging markets and developing economies (EMDEs), and to large increases in rates charged by the IMF, has brought the issue of surcharges to the fore.

Ten countries were paying IMF surcharges in 2020. Now, 22 countries are subject to surcharges, and cumulative revenues from surcharges between 2020 and 2023 have reached about USD6.4 billion (in constant 2022 USD), as countries struggle to recover from their balance of payments issues amidst multiple shocks. The IMF (2022) predicts that the number of countries paying surcharges could range from 18 to 49 depending on various scenarios of further turbulence globally by 2025.

This is also occurring amidst a time when the G20, and others are calling for a major 'big push' of $3 trillion annually in investments in EMDEs outside China to meet climate and development goals (G20 IEG, 2023; IHLEG, 2022). Surcharges make that difficult, if not impossible, in the affected countries.

TABLE 1.

Implications of IMF Surcharges for Selected Countries

Country	Surcharges (2020-2023) 2022 USD	% of 2022 Exports	% of 2022 Reserves	% of 2022 Health Expenditure	% of 2022 Education	Surcharges (2020-2023) current USD
Angola	120.3	0.3	0.8	9.4	4.2	121.2
Argentina	3,693.6	3.6	8.2	12.4	12.6	3,626.2
Armenia	9.3	0.1	0.2	3.1	1.9	9.2
Barbados	10.7	0.5	0.7	5.0	4.2	10.8
Costa Rica	10.3	0.0	0.1	0.3	0.2	10.8
Ecuador	318.9	1.0	3.8	5.7	7.6	319.8
Egypt	1,253.1	1.7	3.9	16.9	n.a	1,236.3
Gabon	25.5	0.2	1.8	7.9	5.5	25.5
Georgia	5.7	0.0	0.1	0.7	0.6	5.7
Jordan	35.3	0.2	n.a	3.0	2.3	36.3
Mongolia	9.6	0.1	0.3	1.4	1.3	9.4
Pakistan	256.1	0.6	2.6	8.8	3.5	251.9
Seychelles	2.3	0.1	0.4	4.0	2.5	2.4
Tunisia	89.5	0.4	1.1	4.6	n.a	86.9
Ukraine	630.6	1.1	2.2	7.7	6.8	618.1
Total	6,470.7					6,370.5

Source: Authors calculations based on IMF, 2024, World Bank, 2024

Table 1 shows that surcharges paid since the COVID-19 crisis amount to a significant percentage of exports and reserves for some countries. (These are in addition to the substantial amounts these countries have to pay in interest, fees, and other obligations.) Moreover, surcharges have played a role in crowding out investment in human and physical capital that not only accentuate balance of payments problems today, but erode the potential for long run economic growth. Between 2020 and 2023, surcharges in Egypt are equivalent to 16.9 percent of a year's health expenditures. For Ukraine, surcharges are analogous to 7.72 percent of a year's health spending (IMF 2024; United Nations, 2023).

It is inevitable that these surcharges crowd out other necessary expenditures for these countries already under stress, delaying the time at which they will be able to stand on their own feet, accessing global capital markets, one of the key objectives associated with the original imposition of the surcharges.

The Original Rationale and why today surcharges are counterproductive

Two main arguments were put forward for the surcharges: An incentive-based argument that they would encourage countries to turn to capital markets rather than rely on the IMF, an argument particularly resonant in the era of neoliberalism, where there was a presumption in favor of private markets; and that they were necessary and desirable as part of responsible risk management by the IMF; it was important to have adequate precautionary balances.

Rationale 1: Moral Hazard

The IMF's primary rationale for surcharges has been to limit the demand for IMF programs, and to encourage borrowers to pay back their debts ahead of schedule, either by restructuring their economy so it is not so dependent on foreign funds or by accessing private capital markets. The current structure of surcharges was implemented in 2009 when market liquidity was increasing, and it was assumed that countries that borrowed from the IMF when they lost access to private credit markets would recover it after a brief period if they implemented the "right" policies.

Applying surcharges after the third year of IMF's support, for example, narrows the gap between the cost of borrowing from the Fund and market sources, and it was assumed that this would induce early repayments of outstanding credit to the IMF and a return to market financing (IMF 2008).

Surcharges undermine IMF's objectives

The moral hazard concerns quoted in the defense of the policy are unfounded. Countries cannot borrow from the IMF without the approval of the IMF Executive Board. Therefore, if there was moral hazard behavior on the debtor side – meaning that the debtor would have incentives to borrow large amounts for long periods from the IMF in the absence of deterrent surcharges – the IMF Executive Board would have the authority to restrict that behavior. Besides, much of the "exceptional" borrowing that is associated with surcharges is explained by external shocks, which are unrelated to borrowers' behaviors.

There is one subtle point of incoherence between the moral hazard concern and the structure of borrowing fees: an IMF-supported program defines the limit for the amount that the country can borrow under the program. But rather than discouraging borrowing, the IMF encourages it, as it charges a *commitment fee* on the undisbursed portion of an approved loan equal to 15 bp for committed amounts up to 115 percent of quota; 30 bp above 115 percent and up to 575 percent of quota; and 60 bp on amounts exceeding 575 percent of quota.

On the contrary, surcharge payments make it more difficult for countries suffering balance of payment distress to accumulate foreign exchange reserves, as foreign exchange is used to pay surcharges first. This plays against the ability of the distressed country to regain access to international credit markets and helps to perpetuate dependence on the IMF—exactly the opposite of the purported intent of the surcharges.

Surcharges require borrowing members to pay more at exactly the moment when they are most squeezed from market access--crowding out private financing due to IMF's preferred creditor status[2]: As the IMF supplies liquidity, aimed at helping countries meet their basic and balance of payments needs and restore growth, it takes away needed foreign exchange through surcharges. Thus, surcharges decrease the perceived probability that a country will repay its debts with the private sector, given that countries have to pay the IMF's debt first.

By taking away foreign exchange from countries in dire need, this policy makes already complex debt restructurings even more complicated as the size of relief required from other creditors to restore debt sustainability with high probability has to be high enough in order to ensure the payment of surcharges.

Politically, by both claiming preferred creditor status and demanding a spurious "risk compensation" as if it does not have preferred creditor status, the IMF puts itself even more in the crosshairs of other creditors, who increasingly argue during debt negotiations that it should not have preferred creditor status.

Besides, given the IMF preferred creditor status, the moral hazard problem could be placed on the IMF side: knowing that it will be first in line to get repaid, surcharges could

[2] Krahnke (2023) finds that sufficiently large loans create the opposite of a positive "catalytic effect" on other sources of financing, a fact that is consistent with the notion that a large exposure to a creditor with preferred creditor status increases the perceived risk of repayment by junior creditors.

act as an incentive for the institution to provide large loans that yield surcharges, resulting in higher lending income.

Even if the moral hazard argument was correct at the time the existing structure of surcharges was imposed in 2009, changes in the global economy imply that they are not today. Global financial markets have changed. Multiple crises have increased financing needs, while much tighter financial markets have reduced net financial flows to developing countries[3]. These worsen and prolong balance of payments difficulties in many borrowing countries, rendering the assumptions that seemingly motivated the IMF surcharge policy no longer relevant, if they ever were.

Rationale II. Precautionary Balances

Surcharges are also argued for as necessary for the Fund's policy of "accumulation of precautionary balances to protect it against credit risk". They are the Fund's largest source of revenue, reaching more than $1.8 billion in 2023, amounting to 50 percent of total revenue that year (IMF, 2023). Surcharge revenue is likely to increase in the next few years, and could more than double under an adverse scenario (IMF 2022).

It can be argued that the Fund's stance on precautionary balances never made sense, given the low level of defaults and the underlying commitments of the member countries, implying a de facto capitalization well beyond the paid-in capital. The low level of defaults, in turn, is partially attributable to its preferred creditor status, and as we noted above, the claim that it was necessary to have large precautionary balances goes against its claim to have preferred creditor status. Finally, thinking of the Fund as a cooperative institution among the countries of the world designed to promote global financial stability,

[3] See https://data.one.org/data-dives/net-finance-flows-to-developing-countries/

it makes little sense to require the countries *at the time of their need* to fund any required precautionary balances.

That said, even if there were an argument for surcharges to fund precautionary balances in earlier years, that argument has lost weight: The IMF expects its precautionary balances to reach the target level by end-2024 and to increase beyond what, according to the Fund itself, is reportedly needed to manage credit risks in the coming years (IMF 2024e). This presents an opportunity for the IMF to eliminate, or at least significantly reduce, surcharges and to move away from funding its precautionary balances with transfers from MICs experiencing economic difficulties. Funding the IMF's precautionary balances and operations with surcharges seems a poor way of funding an institution providing a global public good (the enhancement of global financial stability) to ask the countries at the time of their greater distress to provide such a large fraction of the costs of running the institution.

Recommendations

The policy brief proposes the elimination of surcharges as the appropriate solution to the problems we have outlined. Without consensus among IMF members, second-best options need to be considered. We discuss several reformed intended to dampen the procyclical impact of surcharges. These options, which are not mutually exclusive, include capping total interest and surcharges, aligning thresholds for exceptional access and level-based surcharges, and counting what the country would pay for surcharges as principal payments of IMF loans.

1. Elimination of surcharges

The most reasonable decision would be the elimination of surcharges. They undermine the IMF's role as a steward of global financial stability. The previous section has explained why all the arguments put forward for the surcharges are questionable at best—we have shown that, especially under current circumstances, the surcharges are counterproductive. For instance, while a central argument was that they would encourage countries to access international credit markets rather than rely on the IMF, they actually make it more difficult for kinds in distress to access international markets.

2. Capping total interest charges

To reduce the problem of the procyclical lending rates, a cap on the lending rate could be set, which would turn the surcharge formula into a variable rate—under such a new formula, the surcharge payments would vary with the SDRi: if the SDRi increases, then surcharges will go down, and vice versa, to ensure that the total lending rate does not exceed a value of x percent.

Thus, the lending rate l' under this alternative would be given by

$$l' = max\,\{0.01 + SDRi + s, x\}$$

Thus, the new effective surcharge rate s' would be equal to

$$s' = \begin{cases} s, & 0.01 + SDRi + s < x \\ \{x - SDRi - 0.01, 0\}, & 0.01 + SDRi + s \geq x \end{cases}$$

The rate x could be determined according to the principle of ensuring that the IMF can cover its operational costs of lending. [4]

3. Aligning the current thresholds for exceptional access and level-based surcharges

On March 6, 2023, the IMF Executive Board agreed to temporarily increase the limits on members' annual and cumulative access to Fund resources in the GRA. The annual limit was raised to 200 percent of quota from the previous 145 percent, and the cumulative limit was increased to 600 percent of quota from 435 percent. On March 4, 2024, this increase was extended until the end of 2024.

However, the threshold for the application of the level-based component of surcharges was not modified. Somehow, the size that is classified as an exceptional lending amount was deemed higher for the determination of access, but not for the determination of the

[4] It is, as we have argued, problematic that the operational cost of lending be imposed on those most in need of assistance.

surcharge formula. At the very least, the IMF Executive Board could align the thresholds for exceptional access and surcharges.

4. Counting what a country would pay for surcharges under the current formula as principal payments of IMF loans

If the purpose of surcharges is to encourage early repayments of IMF loans, that goal could be better achieved by changing the schedule of amortizations of IMF loans so that what the current formula counts as surcharge payments would be considered principal payments (in the IMF language, "repurchases"). This approach would still be suboptimal, as countries that borrow more than the surcharge level-based threshold would need to start amortizing the loan right after they hit that threshold, even if they are still under balance of payments distress. The funds allocated to pay the surcharges would not be available for paying other creditors, and so the surcharges would still delay the country accessing international credit markets and would make debt restructuring more difficult. However, the approach would be superior to the current one because while they result in a faster reduction of exposure to the IMF, they avoid the transfer of *more* resources from a country in distress to the IMF, as the current surcharge policy does.

Counting what today are surcharge payments as principal payments to the IMF, thereby decreasing the level of indebtedness in foreign exchange, should also improve the prospects for credit market access. The reduction in debt with the IMF – and therefore the improvement in the balance of payments situation of distressed surcharge-payers – could be sizable over time.

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