The IMF's immunity to loss is in jeopardy

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Argentina seems willing to pay a hefty price to shrug off foreign meddling in national policy. But, as the country floats plans to repay all its $15bn (€11.5bn) debt with the International Monetary Fund, the government's far-flung private creditors, who hold $81bn of defaulted bonds, are crying foul.

For the first time in the history of sovereign default, the implicit debt reduction that the official sector will absorb is far exceeded by the loss the private sector will be forced to swallow. If Argentina's restructuring, to be launched this week, goes according to plan, the score will be 20 per cent down for the IMF versus 75 per cent for the markets.

The IMF has always enjoyed a sacrosanct preferred-creditor status - to be paid first and in full before private investors get a penny. Payment is largely theoretical for, when problem loans become due, the IMF simply rolls over the financing without regard for risk or return. But, as creditors compete over a finite pot of money, the fund may be forced to accept write-downs. The IMF could find itself with a balance sheet as questionable as those of its developing-country borrowers and without the support of the rich nations that finance its high-profile rescues.

Official-sector loans are a gift to developing nations and their private lenders. The IMF regularly lends at subsidised interest rates 5 to 10 percentage points below what the private sector charges. When crisis threatens, the differential between IMF and market yields may exceed 50 percentage points.

This renewable stream of artificially cheap financing translates into debt reduction by the official sector. Benefits to the borrower add up quickly. The value of the subsidy in a 15-year loan, carrying an interest rate 6 percentage points below market, works out at 45 per cent of the loan's nominal amount, assuming a 10 per cent discount rate. To escape IMF control, Argentina will forgo savings of $3.7bn.

If the official sector "maintains its exposure" for another 15 years by rolling over existing debt stocks, the extension of the subsidy in effect reduces its claims by 45 per cent and its real capital is invisibly impaired. The longer the extension of the subsidy, the greater the reduction by the official sector.

There exists a silent compact among sovereign debtors, their investors and the IMF. When developing economies fail, it profits markets to tolerate the fund's priority status as long as official subsidies exceed the loss imposed on private lenders. When positions are reversed, the larger the differential and the larger the official share in total debt, the greater the incentive to challenge the fund's advantaged rank.

Self-interest also drives the sovereign debtor's view of IMF claims. Time was when the fund used to move in and shore up debt resolution deals. It set the conditions for the fiscal surplus that determines the cash for debt payments, divided the spoils and bailed out the process by rolling over old loans and providing new funds that found their way into the accounts of private creditors.

But today's more austere IMF will not supply extra financing to solve default. For many economies, the amount saved by rolling over old subsidised financing is not sufficient to settle debt that has escalated out of hand. When bondholders refuse restructuring offers and resolution is blocked, sovereign debtors will no longer be indifferent to how losses are allocated. The IMF's immunity will then be at risk.

After years of over-spending by countries and over-lending by capital markets, the international financial system faces serious adjustment. There is now $1,600bn in emerging market sovereign debt with $400bn of government bonds in investor portfolios. Debt levels of 80 per cent to 100 per cent of gross domestic product, which were endorsed by the IMF as recently as 2001, are now deemed unsustainable; the current prescription is 20 to 40 per cent. Politicians now feel an obligation towards a new "preferred creditor" -a"social debt" to provide a better quality of life for a restive electorate.

The IMF prides itself on the fact that there has never been a default on its books. But as over-borrowed nations become unable or unwilling to honour their promises to pay, a series of contentious restructurings - of which Argentina is only the first - risks putting the IMF's senior status and its balance sheet in jeopardy.

The Group of Seven industrialised nations must re-examine the element of risk in the high and untenable levels of fund largesse that they have been unwittingly underwriting. The alternative path would lead back to bail-outs, on to the sovereign bankruptcy court and to a tripling of IMF levies on G7 taxpayers. The IMF, which would be super-funded and highly protected, would hardly object to this interventionist outcome.

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