Analysis: IMF mulls bonds, borrowing to pump up war chest

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By David Lawder

WASHINGTON (Reuters) - Facing the prospect of a deeper crisis in Europe, the International Monetary Fund is weighing whether it could expand its rescue lending capacity through debt issuance or bilateral borrowing.

The options are being considered as part of a review of the IMF's crisis-fighting resources mandated by the lender's managing director, Christine Lagarde.

The idea is to prepare for the worst.

Should a country the size of Italy or Spain need rescue, the IMF's funds could be severely strained.

Experts say IMF bonds could easily attract some of the liquidity now sloshing into safe-haven U.S. Treasury debt.

But the IMF's dominant shareholders, including the United States, Japan, Germany and China, would likely be wary of a new independent funding source that could dilute their influence.

An easier and more straightforward path -- especially if the IMF needs to raise rescue funds in a hurry -- may be to borrow bilaterally from these wealthy IMF member countries.

"It is an intriguing idea for the IMF to issue debt to shore up its financial base," said Eswar Prasad, a former IMF official who is now a professor of international trade policy at Cornell University, in Ithaca, New York.

"Emerging markets are likely to welcome this move as it would provide an alternative safe asset for them and reduce their reliance on increasingly risky sovereign debt of the reserve currency economies," Prasad said.

However, the United States, which would see increased competition for Treasuries in international capital markets, has shown little enthusiasm.

A U.S. Treasury official declined comment on the prospects for IMF debt issuance, saying only that Washington believes the IMF's current lending capacity of $400 billion "is more than adequate to meet currently anticipated needs."

INFLUENCE AND INDEPENDENCE

A new market-based source of funding could boost a sense of independence at the IMF, which gets its money from its member countries.

"The key members clearly aim to exercise political clout over the Fund's decisions," said Domenico Lombardi, a former IMF executive board member who is now a senior fellow at the Brookings Institution in Washington. "They fear that if IMF turned to the markets, the IMF would somehow lose that tie to the membership."

Debt issuance also could take some time because of internal policy approvals and the need for the IMF to acquire a credit rating and comply with securities disclosure laws.

But the IMF's sister institution, the World Bank, has been issuing debt since 1947 and has had a triple-A credit rating for more than 50 years. It has issued around $30 billion in debt this year to investors ranging from central banks to insurance companies, pension funds and asset managers.

Some worry that the IMF could become more conservative in its lending programs because it would have to protect its own credit rating if it were selling bonds.

THINKING OUTSIDE THE BOX

Lagarde and the IMF staff have said the Fund's existing resources could prove woefully inadequate if Europe's crisis gets worse.

A staff study obtained by Reuters suggested that the IMF may face demands for $840 billion in a "worst-case" scenario.

IMF officials are clearly thinking outside the box on how to deal with the crisis. IMF Europe chief Antonio Borges on Wednesday floated the idea of setting up a special-purpose vehicle to buy Spanish or Italian bonds alongside a euro-zone bailout fund, but he quickly backed away from the suggestion.

Such a move would require a change in the fund's legal structure -- and alternative funding sources -- and nothing has been discussed with members, Borges said. Still, the IMF has used special purpose vehicles in the past.

IMF officials have yet to focus on a specific target for expanded resources, but some simple math indicates that it would probably be well north of $1 trillion.

Full approval of previously agreed increases in quotas -- the contributions that determine IMF voting rights -- would boost the IMF's lending capacity to around $755 billion.

If the IMF were to permanently activate a separate $581 billion crisis lending fund -- the New Arrangements to Borrow -- this could boost resources to around $1.3 trillion.

But fewer than 20 of the IMF's 187 members have approved the quota increase.

"The quickest option is to activate bilateral lines of credit," Lombardi said. "That is the most immediate and fiscally feasible way for the IMF to increase its war chest."

BRAZIL, BRICs AND A BLUNT 'NYET'

Brazil, eager to increase the influence of emerging markets in the IMF, last month proposed that the BRICs group of countries offer new funds to the IMF to battle the European crisis.

But at a news conference just before the IMF's annual meeting late last month, however, fellow BRICs partners China and India gave a lukewarm response to the idea.

With $3.2 trillion in reserves, China is the most obvious source of ready financing. But any new funds would likely come with strings attached and would be widely viewed as a prelude to a demand for increased voting rights. Beijing may need to be able to trumpet more clout within the IMF to overcome domestic opposition to aiding wealthy democracies in fiscal trouble.

"The question is, 'What sort of bargain would have to be struck that would allow China to get enough of a benefit from providing funds to the IMF?'" Prasad said.

Russia's deputy finance minister Sergei Storchak called BRICs' joint aid for Europe "impossible."

There are still some other options available under the IMF's structure that could be considered, but these are similar to issuing debt and borrowing from members, and have never been tried. The IMF could borrow from private-sector lenders and it could issue notes to the central banks or other official arms of sovereign members.

(Reporting by David Lawder; Editing by Jan Paschal)