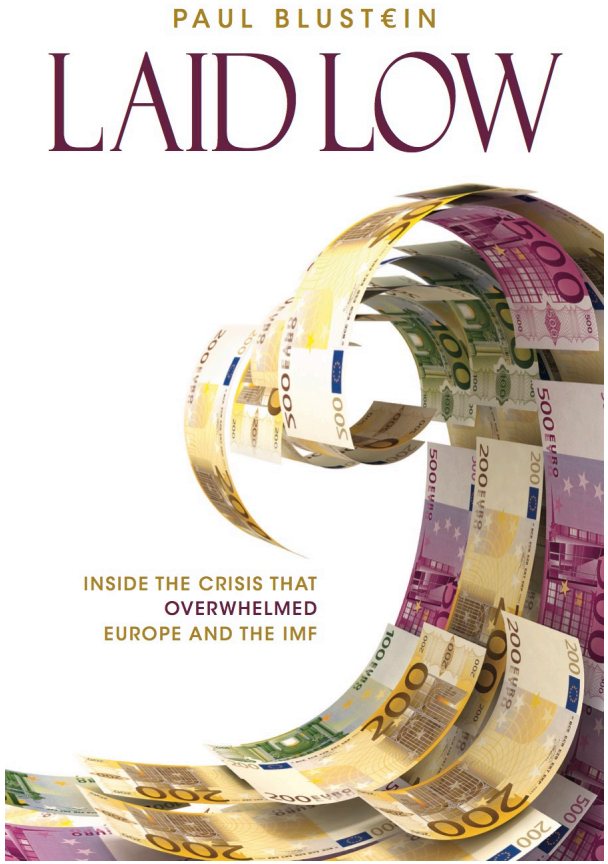

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CENTRE FOR FINANCE AND DEVELOPMENT

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A sordid episode

(Chapter 1)

But DSK's arrest was far from the only setback for the IMF in the EZ crisis

- Under European pressure, IMF joined rescues despite misgivings, and broke its own rules
- Some rescues worked out, but all too often piled debt atop debt, imposed excessively harsh conditions
- Approach taken based on fear of contagion
- But legitimate interests of crisis-stricken countries were sacrificed; crisis was more prolonged, painful, near-catastrophic than it ought to have been
- Although IMF economists saw flaws in bailouts, often yielded to Berlin, Frankfurt, Paris, Brussels

Result: the EZ crisis, in addition to laying Europe low, laid IMF low as well

- IMF was sapped of its most precious asset—its credibility as an independent, neutral arbiter
- Damage was inflicted on IMF's ability to serve as a crisis-fighter and fixer of economic problems
- This raises concerns about management of future crises

More glaringly than ever, EZ crisis showed globalization's treacherous side

- Intl bailouts were once thought necessary only in emerging markets (Mexico, Thailand, etc.)
- EZ crisis showed that advanced countries may need bailouts too
- Importance of a muscular IMF is thus greater than ever
- IMF = chief guardian of global financial stability, providing a "global public good"

A secret meeting in a Davos kitchen

- Greece has borrowed its way into deep trouble (€300b+ debt), without disclosing profligacy
- Deficit for 2009 much higher than reported
- Ratio of debt/GDP (115%) is on the rise
- Mounting worry about "exploding debt dynamics," Grexit
- Greece tries to cut deficit, but also have question: If necessary, will IMF provide emergency aid? (Europe was balking)
- DSK's answer, at secret meeting during WEF: 1) Greece would need more money than the IMF alone could provide
- 2) "As long as other EU countries did not want the IMF involved…they could block such a decision at the IMF board of directors."

A Faustian Bargain

- European opposition: "The IMF is not for Europe. It's for Africa—it's for Burkina Faso!"
- But IMF was eager to play a part in the crisis
- Pre-crisis, its relevance and raison d'être were in doubt

- The decider:

- IMF agreed to work with EC & ECB in "Troika," as junior partner (normally senior partner)
- DSK to EU officials:

"We have to be in, but you will be the leader."

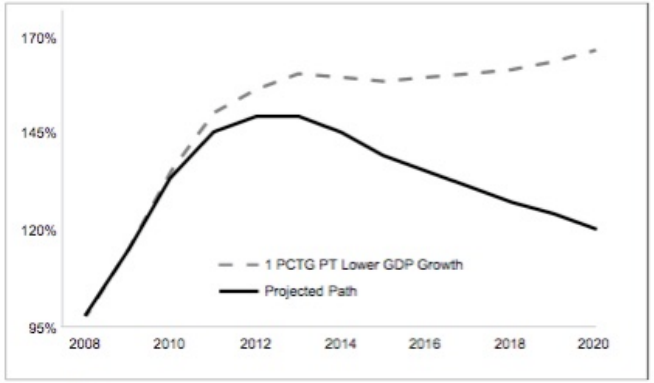
Greece, 2010, “Plan A”: Lend euros so default can be averted

Deadline looms: Greek govt obliged to pay €8.5b on May 19

- Big loan, with conditions
- Germany, others demand austerity
- Impact will be enormous; Combined hit from spending cuts and tax increases = 1/10 of GDP over 3 years; economy already in slump
- Need growth—but usual tools unavailable. Troika’s solution: Structural reforms (labor law changes, liberalization of professions, streamlining SOE’s
- Troika projects downturn of 2.6% in 2011, resumption of growth in 2012

AT THE IMF, DEEP SKEPTICISM THAT PLAN A WILL WORK

Greece: Debt-to-GDP Projections, May 2010



Source: IMF.

Office Memorandum

To: Mr. Thomsen

From: Olivier Blanchard

May 4, 2010

Subject: **Greece: Request for Stand-By Arrangement**

The report should recognize at the onset that the degree of adjustment envisaged in the **program is exceptional and entails severe risks.** International experience indicates that a 16 percent cumulative fiscal adjustment over such short period (and with this extent of frontloading) has never been achieved. The absence of other policy levers (interest rates, exchange rates) and far-from-favorable external circumstances (external demand) further complicate the picture.

The program could go fast off track (even with full policy compliance). In the absence of a strong export rebound, there is nothing that can support growth against the negative contribution of the public sector (about 8 percent and 4 percent in 2010 and 2011, respectively). Then, the recovery would likely be L-shaped, with a recession deeper and longer than projected, followed by a period of sluggish growth. This would mean fiscal shortfalls and more severe strain in the financial sector (more fiscal shortfalls).

We are concerned about likely policy slippages and internal inconsistencies in the program that may lead it off track even with perfect policy implementation. We are well aware of the constraints bearing on the design of the program. For that reason, we believe it is critical to reach a clear and confidential understanding with the authorities and the EU on how to proceed forward should such circumstances materialize (this may possibly involve a side letter).

One particular credulity-strainer: The long-term budget surplus

Table A. 1. Greece: Public Sector Debt Sustainability Framework, 2008-2020
(In percent of GDP, unless otherwise indicated)

	Actual		Projections											
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	D
Baseline: Public sector debt 1/	98	115	**133**	**145**	**149**	**149**	**145**	**139**	**135**	**131**	**127**	**124**	**120**	
Change in public sector debt	2.1	17.5	18.1	11.9	3.6	0.5	-4.7	-5.5	-3.9	-3.9	-3.9	-3.8	-4.1	
Identified debt-creating flows (4+7+12)	-0.5	16.3	18.2	11.9	3.6	0.6	-6.3	-5.5	-3.8	-3.8	-3.8	-3.7	-4.0	
Primary deficit	0.7	8.6	2.4	0.9	-1.0	-3.1	-5.9	-6.0	-6.0	-6.0	-6.0	-6.0	-6.0	

-5.9 -6.0 -6.0 -6.0 -6.0 -6.0 -6.0

2014 2015 2020

So behind the scenes, discussion of Plan B—a haircut

IMF is divided. Some believe Plan A can work. But there's a rule.

Debt must be sustainable "with high probability" (or must be restructured)

At DSK's direction, two IMF depts. (SPR and LEG) meet secretly with German and French officials

One reason for secrecy: opposition to haircut is powerful—and fierce

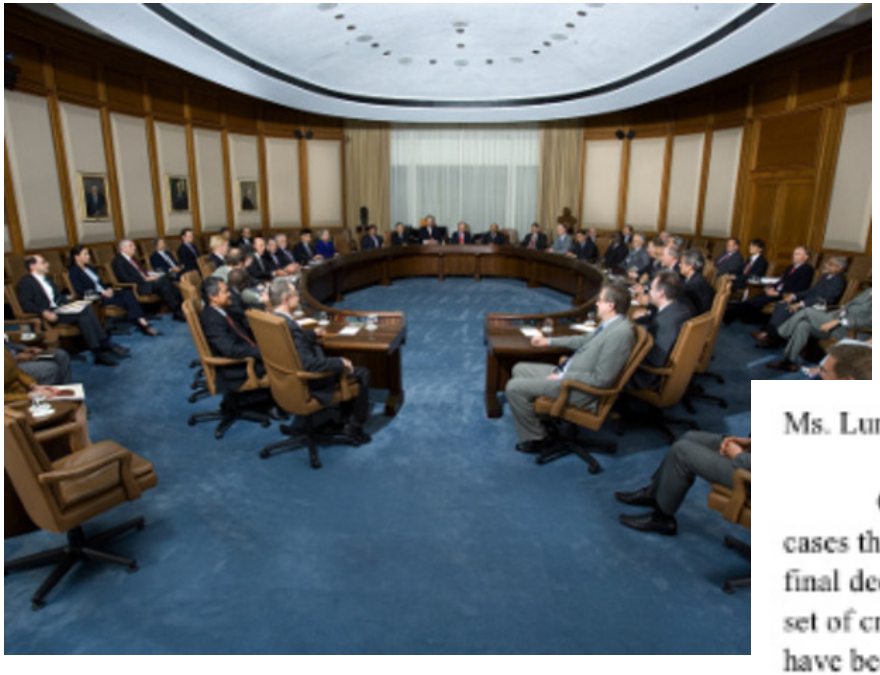
Trichet: "We are an economic and monetary union, and there must be no debt restructuring!"

- The big worry: Contagion
- Advocates of haircut respond: better orderly restructuring than disorderly default; countermeasures can be taken to limit contagion
- But: Back to Plan A (€110b in loans, €30b from IMF)

Board OKs—w/strong reservations, and despite unwelcome surprise

Transcript of May 9, 2010 meeting reveals…

Directors were kept in the dark about a key change in the rules



Ms. Lundsager made the following statement:

On this, I had the same sense as Mr. Kiekens that in every one of these cases the Board has always undertaken its responsibility, which is to make the final decision on whether we go ahead or not. It is very difficult to devise any set of criteria that will be exactly met every time, and time and time again we have been willing to act where we thought it was necessary for whatever reason.

I am fully prepared to support the staff proposal today, and I sense the whole Board is supportive as well. I did not realize we needed a policy amendment to do that, to be perfectly honest. I admit that I did not pick this up either in my quick read of the documents. Maybe we can come back to it. I

Plan A Goes Terribly Awry

- GDP in 2011: -7.1%, vs. -2.6% forecast
- Debt/GDP ratio: 170%, vs. 133% forecast

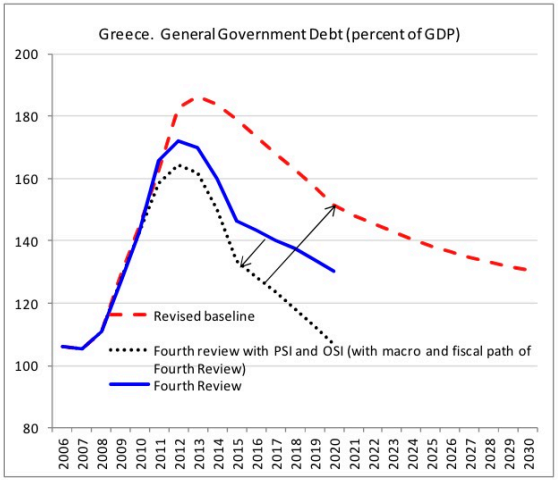
By 3Q 2011…

1 STRICTLY CONFIDENTIAL

Greece: Debt Sustainability Analysis
October 21, 2011

Since the fourth review, the situation in Greece has taken a turn for the worse, with the

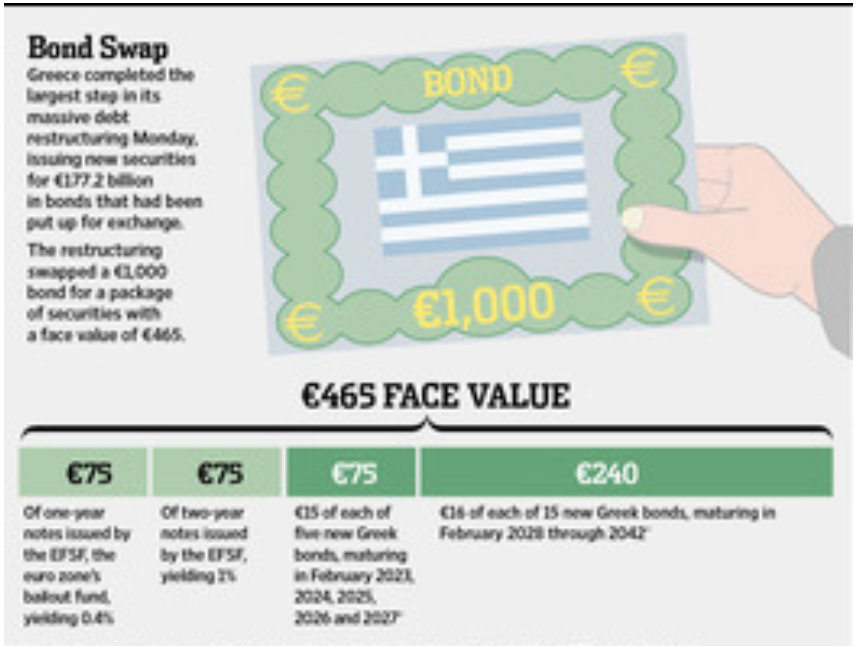
- **Deeper PSI**, which is now being contemplated, also has a vital role in establishing the sustainability of Greece's debt[1]. To assess the potential magnitude of



Greece's 2nd rescue, March 2012: This time, a haircut

Biggest debt relief in history, €206b in private debt at stake

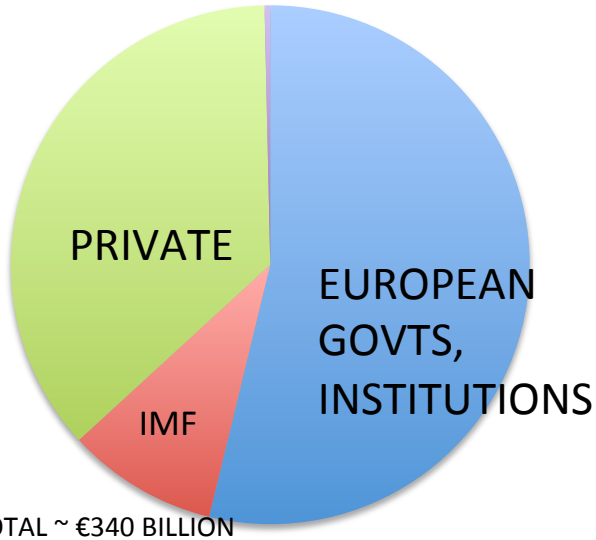
Fears of cataclysm prove to have been greatly exaggerated



- Ingenious scheme: CACs are inserted into most government bonds
- Thanks to CACs, 97% of bonds undergo haircuts
- Despite coercion of some bondholders, no market perturbations

But: Too little, too late

Official debt had replaced private debt



TOTAL ~ €340 BILLION

Two big problems with bailouts of over-indebted countries: 1) Moral hazard;
2) Official debt often harder to restructure than private

Greece was now in its 4th year of deep recession

Feb. 21, 2012, 5 a.m.:
"Don't celebrate, guys. In a couple of years, you're going to have to dig in your pockets again for Greece."

Plus: Another dose of austerity

To make its debt sustainable, Greece must still generate huge surpluses for years.

Table 9. Greece: Medium-Term Macroeconomic Framework, 2010–20

	2010	2011	2012	2013	2014	2015	2016	2020
			Projections					
Public finances (general government, percent of GDP)								
Total revenues	39.5	41.0	42.2	42.2	42.1	40.1	40.1	40.1
Total expenditures	50.1	50.3	49.5	46.8	44.2	41.7	42.0	41.3
Primary expenditures	44.6	43.4	43.2	40.4	37.6	35.6	35.6	35.8
Overall balance	-10.6	-9.3	-7.3	-4.6	-2.1	-1.6	-1.9	-1.2
Primary balance	-5.0	-2.4	-1.0	1.8	4.5	4.5	4.5	4.3

Modified, as of Nov. 2012

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2020	2025	2030
Baseline: public sector debt 1/	107.3	112.5	129.3	147.9	170.6	157.5	178.5	174.5	170.0	162.7	124.0	101.2	83.6
Of which: foreign-currency denominated	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Change in public sector debt	-0.2	5.2	16.8	18.6	22.7	-13.1	20.9	-3.9	-4.5	-7.2	-9.9	-3.5	-3.5
Identified debt-creating flows (4+7+12)	-0.2	5.5	16.5	16.5	19.9	57.8	13.6	1.1	-3.7	-6.8	-8.7	-4.1	-3.8
Primary deficit	2.0	4.8	10.4	4.8	2.3	1.5	0.0	-1.5	-3.0	-4.5	-4.3	-4.0	-4.0

To be sure, IMF deserves credit

Strong warnings on financial issues; tougher stance 2011→

- Aug 2011: Lagarde calls European banks undercapitalized
- Jan 2012: Lagarde makes case for banking union
- Oct 2012: Research challenging austerity
- Mar 2013: IMF view on Cyprus prevails (2nd choice)
- May 2013: "Mea culpa" on PSI for Greece

The 2015 drama in Greece: IMF played role of "honest broker"

Thomsen, @Riga, on OSI:

"I want to caution you, ministers… Very significant debt relief...will be necessary. Do not be surprised when this will come." (4/24/2015)

7/29/2015—board meeting re 3rd bailout

"The differences between the IMF's thinking about the debt issue and what the Europeans are currently discussing is very large."

But the IMF should have been tougher —and acted sooner

July 15, 2015:

Medium-term primary surplus target: Greece is expected to maintain primary surpluses for the next several decades of 3.5 percent of GDP. Few countries have managed to do so. The reversal of key public sector reforms already in place—

April 14, 2016

Ms. Lagarde - On my point about realism and sustainability in relation to Greece, 3.5 percent in the short term might be achievable by some heroic—and I really mean heroic—efforts on the part of Greece and the Greek people. It might be. We are skeptical about it, but we are open to seeing what additional measures the authorities are proposing.

What we find highly unrealistic, on the other hand, is the assumption that this primary surplus of 3.5 percent can be maintained over decades. That just will not happen. So, that is where I draw the line between the short-term objectives and the medium- to long-term similar objectives.

Why has the Fund only recently deemed Greece's surplus targets to be economically and socially unattainable? (Remember earlier, bigger targets.)
Answer: The Fund waited too long—both for Greece's sake, and its own—to muster sufficient pluck.

There's got to be a better way (1): No more junior partnerships!

- One word for it: Travesty
- The IMF should have had clearly understood power to set terms and conditions
- Indeed, should have had "super senior" status
- The IMF was coming to the rescue of the euro, not just the crisis-stricken countries
- Fund needs to take steps to regain its authority, credibility, independence—or future crises will be harder to manage

There's got to be a better way (2): Sovereign debt

- Two related problems: "Greece"
- and "Griesa"

- As IMF staff paper said: "Debt restructurings have often been too little and too late."
- Unfortunately, sensible staff proposal was watered down
- "Super CACs" will help, but more is needed, e.g. SDAF

Whatever policy actions are best…

- The lessons of the IMF's misadventures in the euro zone crisis must be fully taken on board
- Appropriate remedies must be adopted
- Only then will the Fund stand a decent chance of providing global public goods of the sort the world needs

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