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Preventing Greek Tragedy From Becoming a Eurozone Disaster

Lessons from IMF Crisis Lending – and the Challenges Ahead

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'Time as he grows old teaches all things.'
Aeschylus

The Greek crisis has been so severely mishandled by European policymakers that markets legitimately fear that matters are now beyond repair.[1] A debt restructuring – and probably a disorderly one at that – is now generally seen as the most likely scenario, with contagion spreading from Greece to other European peripheral countries. The Greek debacle, if unchecked, could metamorphose into a eurozone disaster.

While there are no easy solutions to the difficulties at hand, responsible policymakers could still avert the worst – and it is in any event their responsibility to strive to do so. A genuine endeavour to correct for the blunders made to date and to put in place a credible, rapid response to calm market fears stoking contagion should be the priority and should be well underway. Lamentably, it is still far from sight.

Yet, the international community has at its disposal a rich experience in dealing with such crises, even when due allowance is made for the limited policy flexibility of members of a currency area. The repository of that experience is the International Monetary Fund (IMF), and the arsenal developed over 60 years to deal with crises. The arms in this arsenal include a range of instruments and approaches: precautionary (i.e., non-disbursing) arrangements, prior actions and conditionality, programme reviews, waivers, and phased disbursements, and confidential decision-making capable of delivering rapid responses and providing clear market signals.

1. The author would like to thank Paul Hofheinz and Ann Mettler for their kind assistance and editorial encouragement in the preparation of this e-brief. As always, any errors of fact or judgment are the sole responsibility of the author.

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The European institutions lack most of the above. While there is no disputing the euro area would do well in developing further its instruments and institutions, time is now running out. Indeed, much time has already been squandered since Greece's announcement of a much larger-than-reported deficit a half-year ago. So, what can be done to regain the initiative and earn much-needed breathing space?

Resolve the Implementation Questions – Now

In this e-brief, we will focus on the institutional mechanics of the approach – applicable to Greece and to other crisis-prone euro area members – leaving the specifics of the policy measures to the ongoing negotiations. The procedural mechanics of the loans need to be agreed and announced clearly, in order to address the rampant market uncertainty about how the support package will in practice be implemented. How will the coordination problems between the European Commission, the European Central Bank (ECB), the European Council, and the IMF be resolved? How will conditionality be defined and its observance assessed? How will the loan(s) be disbursed? How will public communication be handled?

These questions may appear daunting, but in reality they were resolved without too much ado in late 2008, in the case of joint IMF-European Union (EU)

In a World of Fast-Moving Capital, Rapid Responses are Key

With this thought in mind, the IMF in 1995 developed emergency procedures to help provide financing at short notice. These procedures (known as the Emergency Financing Mechanism) were used in 1997 in the Asian crisis; in 2001 for Turkey; and in 2008-09 for Armenia, Georgia, Hungary, Iceland, Latvia, Pakistan and Ukraine.

When can the Emergency Financing Mechanism be used?
When a member country faces an exceptional situation that threatens its financial stability and a rapid response is needed to contain the damage to the country or the international monetary system.

How does it work?
(i) The IMF Executive Board is informed about a member's request for assistance; (ii) a staff team is quickly deployed to the country; (iii) as soon as staff reaches an understanding with the government, the Board considers the request to support a program within 48 to 72 hours.

Source: IMF Crisis Lending

‘Fast-track procedures are plainly needed in the case of Greece, and should have been activated much earlier.’

loans to two EU members, Hungary and Latvia. There, too, there initially seemed to be an insurmountable obstacle in the form of the Treaty of the European Union’s requirement that member states should first turn to the EU for balance of payments support.[2] But the need for a rapid response helped to surmount that obstacle quickly, laying the ground for a coordinated approach to those countries’ financing needs – in a form and with joint public communications that helped soothe markets. In practice, given its expertise and capacity to rapidly field teams, the Fund took much of the lead in negotiating conditionality, while mindful of the country’s Stability Programme and other EU commitments, and disbursements were – albeit not without some behind-the-scenes wrangling – coordinated. These cases bear witness that setting aside a misplaced sense of *amour-propre* can lead to rationally constructive solutions for the common benefit.

2. See Article 2 of Council Regulation (EC) No 332/2002 of 18 February 2002 establishing a facility providing medium-term financial assistance for Member States’ balances of payments: “Where a Member State which has not adopted the euro proposes to call upon sources of financing outside the Community which are subject to economic policy conditions, it shall first consult the Commission and the other Member States.”

3. IMF Survey, “Amid Crisis, IMF Emphasizes Readiness to Lend Quickly, ” IMF Survey Magazine, 09 October 2008; See also IMF, Summing Up by the Chairman – Emergency Financing Mechanism, September 1995.

Apply Basic Lessons of Conditional Lending and Crisis Resolution

So what should happen now procedurally for Greece and others on the sidelines? To provide the needed implementation assurances, there should be a clear, public understanding (or concordat) between the IMF and the European lenders – possibly in the form of some sort of Memorandum of Understanding. This agreement could usefully draw on the IMF’s multi-year experience in conditional financial support and on its lessons.

These lessons are in essence as follows:

- **Rapid Mobilisation of Financial Support is Vital**
  Procrastination can be fatally toxic for countries hit by financial turbulence; the harm wreaked by delays in the Greek case is all-too-manifest. Accordingly, in 1995, the IMF developed fast-track financing procedures known as the Emergency Financing Mechanism (see the box on Rapid Response Mechanisms on page 2 for more)[3], which it has activated in several cases to swiftly mobilise financial support for crisis countries. In particular, in late 2008, arrangements were approved within three and a half to six weeks of the initial indication of interest by the authorities in Hungary, Iceland, Latvia, Pakistan and Ukraine, tackling the challenging task of reaching understandings on difficult policy measures in such a short period of time. These fast-track procedures are plainly needed in the case of Greece, and should have been activated much earlier – a lesson for other crisis-prone countries not to unduly postpone requests for support and for the EU itself not to dawdle. Still, the promised euro area bilateral loans for Greece will in several cases require possibly lengthy domestic legislative approval. Such excruciating further delay needs to be forestalled by a rapid provision of bridge financing. Looking forward, quick-disbursement procedures need to be developed now as part of contingency planning for other

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euro area peripherals – indeed, their development could serve as a key crisis prevention step.

- **Stabilisation Needs to be Based on an Appropriate Mix of Adjustment and Financing**
When the needed adjustment is as large as in the case of Greece, it makes sense to alleviate the burden by a mix of adjustment and financing. In the current European approach, however, all the emphasis is being put on a huge upfront adjustment – dubbed “the mother of all adjustments” – likely to be a politically unsustainable effort. In this approach, official financing has been left as a last resort – an *ultima ratio.*[4] This is largely the result of wanting to make an example of Greece. As one observer has put it, the Europeans are treating Greece like “a stepchild who has misbehaved and are making an example of him for other children.”[5] Mindless however of another key lesson of past crises: the need to avoid that excessive frontloading of measures exacerbate the economic downturn, and aiming rather to secure confidence via a medium-term fiscal consolidation plan backed by structural reforms. In an extension of the previous point, the lack of timeliness of official financing forces ever more painful and disorderly demand contractions.

- **Adjustment is a Multi-Year Endeavour, and Financial Support Needs to be Tailored Accordingly**
In the case of Greece, the IMF has pledged its readiness to provide support through “a *multi-year* stand-by arrangement,” whose amount will, as customary, be fully specified upon agreement. For their part, euro area governments have similarly stated that the “programme will cover a three-year period,” with however the financial commitment quantified only for the first year (in an amount of €30 billion). The statement adds that “financial support for the following years will be decided upon the agreement of the joint programme.” With questions and doubts swirling wildly over Germany’s commitment to financing – even for 2010 – any evasion or hedging on the financing for 2011-12 will sink the whole exercise.

- **Involve the Private Sector to Avoid a ‘Rush for the Exits’**
Mechanisms are required to ensure that official financing does not immediately flow out, allowing the private sector to withdraw from the country with related moral hazard issues. This is a complex matter that has long preoccupied the IMF, particularly since the Asian crisis. Steps have included agreements for the maintenance of exposure on short-term bank credit (both voluntarily and through the application of moral suasion) and the restructuring of international sovereign bonds through debt exchanges, but efforts to develop a full-fledged *ex ante* framework for Private Sector

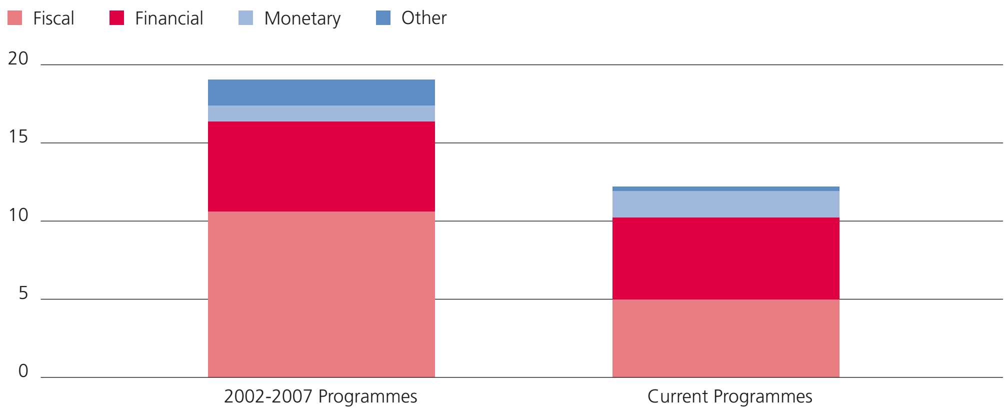
4. Statement by the Heads of State and Government of the Euro Area, published on 25 March 2010: “This mechanism… has to be considered ultima ratio, meaning in particular that market financing is insufficient.” See also Wolfgang Schäuble, “Why Europe’s Monetary Union Faces its Biggest Crisis,” *Financial Times*, 11 March 2010. In setting out his proposal for a European Monetary Fund, the German Finance Minister makes a similar case, arguing “aid must be a last resort” and – equally self-defeating – carry a “prohibitive price tag.”

5. Bob Davis and Marcus Walker, “IMF Role in Crisis Is Restrained,” *The Wall Street Journal*, 01 March 2010.

'The cacophony coming out of European capitals – and even within individual governments – has been destructive of market confidence.'

Involvement (PSI) have foundered. More recently, in the present crisis, private sector involvement has been sought for a number of Central and Eastern European (CEE) programmes both informally and through the so-called Bank Coordination Initiative.[6] The latter is a process whereby parent banks commit to preserve exposure in host countries and maintain adequate capital and liquidity in subsidiaries. Such commitments do not have legal standing and are intrinsically difficult to monitor, and are not as relevant for Greece and other peripheral euro area countries as for the CEE. Nonetheless, there too – especially with restructuring looming – the issue of concerted private sector involvement to overcome the collective action problem and secure an orderly resolution is paramount.[7]

Chart 1: Average Number of Structural Conditions per Programme Year



Source: IMF, Review of Recent Crisis Programmes.

• Conditionality Has to Cover All (and Only) Macro-Relevant Aspects

In the approach to date for Greece, the adjustment programme has focused heavily – indeed, almost solely – on fiscal policy. Given the public finance imbalances, this is understandable, and is also a reflection of EU surveillance, which is highly centred on the Stability and Growth Pact (SGP) and its requirements in the fiscal area. But the scant attention being paid to the financial sector is highly problematic. The IMF learned the hard way – notably in the Asian crisis – of the negative consequences of neglecting macro- and financial linkages, and has over time made the integration of macroeconomic and financial sector issues one of its overarching operational priorities.[8] This needs to be the case in Greece today as well, as financing strains on Greek banks come to the fore. At the same time, it is useful to bear in mind another lesson from many years of conditional lending, namely that conditionality on structural issues needs to meet the test of macro-relevance, and that structural policies are best monitored in a holistic fashion, rather than

6. IMF, *Review of Recent Crisis Programs*, (IMF: Washington DC, 2009). See also European Bank Coordination Initiative, *Statement of European Bank Coordination Initiative – Full Forum Meeting*, Athens, 18-19 March 2010.

7. A "collective action problem" is a situation in which everyone (in a given group) has a choice between two alternatives and where, if everyone involved chooses the act that is Individualistically Rational (IR), the outcome will be worse for everyone involved, in their own estimation, than it would be if they were all to choose the other alternative (i.e., than it would be if they were all to choose the alternative that is not IR). See Mancur Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups*, (Cambridge: Harvard University Press, 1971).

8. For a recent review of the IMF's experience with financial sector surveillance, see IMF, *Financial Sector Surveillance and the Mandate of the Fund*, (Washington DC: IMF, 2010).

'The time of muddling through must end.'

via adherence to specific performance criteria. This aims to render programmes less intrusive and burdensome. [A recent IMF review] shows both a reduction in the total number of conditions and a greater focus on core areas essential to the success of the programmes – notably the financial sector – than in the past (See Chart 1 on previous page for more information).

- **Communication to Markets Needs to be Clear and with 'One-Voice'**
  The cacophony coming out of European capitals – and even within individual governments – has been destructive of market confidence, and likely a major factor in keeping spreads high. In addition, the political fall-out of some of these "blame game" exchanges is potentially disastrous, poisoning intra-European relations and turning popular sentiment against closer integration. There is no easy solution to this incapacity to present an external show of unity, but it needs to be addressed – much as the initial undisciplined declarations of members of the ECB Governing Council were eventually reined in. Possible avenues could include delegating more of the relevant work to a technical organ such as the Economic and Financial Committee (EFC) or, as appropriate, its relevant sub-committee, the Eurogroup Working Group (EWG). In addition, all communications following Eurogroup meetings should be left solely to its President – discontinuing the practice of various ministers' individual press conferences for their national audiences. This will not be easy to implement, but agreement should be sought to at least avoid individual comments on crisis lending operations. The same should apply to conferences following European Council meetings, with of course heightened implementation difficulties.

Further Development of EU Instruments and Institutions Will Be Needed in Time, but This Should Not Distract from Urgent Tasks at Hand

In this e-brief, we have focused on some of the key lessons that emerge from the international community's (notably that of the IMF) experience in conditional crisis lending over many years, and that could be applicable to the case of Greece and other vulnerable euro area countries today. Though politically not always straightforward, these are lessons generally applicable without major institutional changes – though a clear modus operandi between the IMF and the EU (or euro area) institutions will need to be reached and made public. The time of muddling through must end.

Beyond the immediate crisis, there is of course a need both to strengthen and integrate EU policy frameworks and to equip EMU with appropriate crisis resolution instruments. One of these undoubtedly is a European framework for crisis prevention, management and resolution in the financial system. More broadly, the idea of a European Monetary Fund (EMF) has re-emerged.

'May our leaders rise to this immediate challenge – or risk the demise of European integration ambitions.'

The proposal remains largely undefined.[9] That said, a European Monetary Fund may well need to be a necessary component of EMU, but it is inevitably a longer-term proposition. It certainly induces an impression of *déjà vu*, harking back to the Bremen EU Council of July 1978, when the heads of state and government declared that they "remain firmly resolved" to create an EMF "no later than two years" after the creation of the EMS. But the plan foundered on a host of legal, political and economic obstacles – none of which have diminished in the intervening 30 years – on the contrary. German Chancellor Helmut Schmidt and French President Valéry Giscard d'Estaing had, in the late 1970s, a unique meeting of minds on Europe, which is far from the case among the major EU leaders today. Accordingly, as French Finance Minister Christine Lagarde has said, one is looking at "an adventure that could take us another three, four, five years" and even that is likely optimistic. In the meantime, there are other highly urgent tasks at hand – several of them enumerated above – that require undivided attention. May our leaders rise to this immediate challenge, or risk the demise of European integration ambitions – including possibly that of monetary union itself.

9. The most comprehensive proposal – with however no official standing – is Daniel Gros and Thomas Mayer, *Towards a Euro(pean) Monetary Fund*, (Brussels: CEPS, 2010).

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