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Lessons from Three Years of Euro-Area Crisis Fighting

special briefing

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Getting It Right Next Time

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In the wake of the watershed August 2012 announcement by the European Central Bank (ECB) of its conditional willingness to undertake unlimited sovereign bond purchases, euro area crisis pressures have palpably receded.[1] Such relative calm, while clearly welcome, risks however being hazardously lulling for policymakers. The potential for *accidents de parcours* remains high, as vividly illustrated by the case of Cyprus in March 2013. To be sure, there has been considerable progress in the euro area's crisis management framework since the early days of 2010 – most notably with the creation of a permanent euro area crisis resolution mechanism in the form of the European Stability Mechanism (ESM). In October 2012, the ESM was formally inaugurated and various organisational steps were put in place. Subsequently, in December 2012, the ESM launched its first financial assistance operation, directed at the recapitalisation of the Spanish banking sector, followed by the assistance granted to Cyprus in May 2013.

These were the European Stability Mechanism's first steps, but the infant organisation faces further critical tests in the coming period. While the grander long-term projects – on banking and fiscal union – are vital to the overall design of Economic and Monetary Union (EMU), exit from the present crisis will depend on resolving several pressing issues in its day-to-day management, so as to avoid further Cyprus-type missteps.[2]

This interactive policy brief seeks to make knowledge more accessible through online circulation and interactive features, such as hotlinks to articles cited in the footnotes and a web-friendly format.

The opinions expressed in this policy brief are those of the author alone and do not necessarily reflect the views of the Lisbon Council or any of its associates.

1. The author would like to thank Paul Hofheinz and Ann Mettler of the Lisbon Council for their comments on an early draft of this paper. Any remaining errors of fact or judgment are the author's sole responsibility

2. This special briefing focuses on crisis management issues that are not part of the euro area's immediate work programme, but are nonetheless key to successful crisis fighting in 2013-14. It leaves aside the imperative of moving rapidly to direct recapitalisation of banks by the European Stability Mechanism. This is of course crucial to breaking the vicious link between bank and sovereign debt – an issue for almost all countries. The item is thus opportunely on the policymakers' agenda, including at the June 2013 European Council. Action will hopefully proceed, albeit likely not at the desirable pace (swift) and with the required scope (with no *a priori* exclusions).

'There has been considerable progress in the euro area's crisis management framework.'

In the current setup, such mishaps remain a clear and present danger, and risk not only prolonging the crisis but even dashing the longer-term projects themselves. Spinning things forward, the key country issues looming in the remainder of 2013 and 2014, and which will require dexterous crisis management, are:

- **For Italy, Spain, Ireland and Portugal (and possibly others):** Providing an appropriate pre-emptive buffer to guard against contingent risks arising from the uncertain outlook for Italy (including of a political nature) and Spain, and to smooth the process of eventual programme exit for Ireland – potentially the first "success story" of the crisis – and Portugal. This involves ensuring that the ESM's precautionary facilities are indeed employed as preventive tools (particularly insofar as they are a prerequisite for activation of the ECB's outright monetary transactions, or OMTs).

- **For Greece and (probably) Cyprus:** Taking additional steps to ensure debt sustainability, likely entailing in both cases further official debt restructuring (under the neologism of official sector involvement, or OSI), given the preponderance of debt to official creditors. For the future, this points to the need to set clearer official lending parameters, so as to avoid such periodic cases of "incapacity to repay" and related official debt work-outs.

- **For (possibly) Slovenia and other potential clients:**[3] Ensuring appropriate programme design, avoiding conditionality overload, and improving the workings of the European Commission-ECB-IMF negotiating troika. These workings have been problematic, and the related shortcomings need to be addressed, clarifying relative responsibilities of the participating institutions.

As these challenges loom, there remain critical gaps in the ESM's overall lending apparatus, potentially thwarting an effective response (see Table 1 on the next page for a summary). These gaps all fall in the "important-and-urgent" quadrant of the well-known decisional matrix, but are not receiving the required policy attention. The ESM's governing bodies should address these deficiencies early in the new institution's operational life.

This policy brief aims to provide Europe's well-demonstrated political will to preserve EMU with the required technical underpinnings, so that the currency area's crisis management framework will be well-placed to face the immediate challenges of 2013-14, while work on longer-term projects proceeds. The remainder of the brief will accordingly take up the difficulties encountered to date in euro area crisis lending and seek remedies from international experience. It will aim to establish some critical design and implementation guideposts, with a view to enhancing the celerity, transparency, predictability and effectiveness of the ESM's operations.

3 The reference to Slovenia is intended to be illustrative, reflecting market concerns, rather than predictive. The point here is that the ESM, as a permanent mechanism, needs to be well equipped for any future clients.

‘Cyprus-type mishaps remain a clear and present danger and risk prolonging the crisis.’

Key problems and potential remedies

The remedies to the main defects summarized in Table 1 below – regarding the timely use of facilities, capacity to repay, and programme implementation – overlap and cut across each other. They are best organised under three headings:

- Conditionality: The need for parsimony and calibration
- Lending parameters: The need for boundaries
- The governance framework: The need for efficiency and competency

Table 1: The what, why and how (to fix) of European lending programmes

What went wrong?	Why did it go wrong?	How can it be fixed?
1. Obstacles to using facilities in a timely manner (in particular precautionary lines and related outright monetary transactions [OMTs])	– Opaqueness re. conditionality – Blanket nature of conditionality (“strict and effective” mantra) – Prevalence of ex post conditions	– Enhance transparency – Calibrate conditionality – Develop ex ante conditions, pre-qualification criteria
2. Incapacity to repay: –Official sector over-exposure –Private sector involvement (PSI) delays –Official sector involvement (OSI) needed	– Absence of lending limits – Lack of financing assurances – No legal mechanism for sovereign debt restructurings	– Set country lending ceilings – Develop financing assurances policy – Revive consideration of a sovereign debt restructuring mechanism (SDRM); Europe takes global lead
3. Implementation difficulties and related programme slippages	– Unwieldy “troika” arrangements – Conditionality overreach – Flaws in debt sustainability analyses (DSAs)	– Greater reliance on lead agent – Focus on parsimony, criticality – Strengthen debt sustainability analyses (DSAs), based on IMF work

'Conditionality… was not even mentioned in the IMF's original Articles of Agreement.'

I. Conditionality

There are two main flaws in the conditionality framework exposed by euro area experience to date. The first concerns programmes approved since May 2010, largely characterised by conditionality overreach, i.e., an excess of conditions – at times seemingly "everything but the kitchen sink" – with insufficient prioritisation and attention to their macroeconomic criticality. And the second concerns facilities, notably those of a precautionary nature, which have not been activated because of the lack of clarity surrounding their degree of conditionality – a form, indeed, of "unconstructive ambiguity," with insufficient modulation of conditionality across the ESM's range of instruments.

The need for parsimony

The first issue – that of conditionality overreach – is one that dogged the IMF for many years, particularly at the time of the 1997 Asian crisis. It dented its reputation severely, and led to an in-depth review of the approach followed. IMF conditionality can be said to have come full circle in its evolution to date. It was not even mentioned in the IMF's original Articles of Agreement, and over 30 years lapsed before a first set of conditionality guidelines was elaborated in 1979.[4] These were restrained in scope, limiting conditions to macroeconomic variables only. There however followed, in the 1980-90s, a period of steady increase in structural reform conditionality (from less than one-fifth of programmes in the mid-1980s to almost all by the mid-1990s). This partly reflected the IMF's growing involvement in low-income and transition countries, where severe structural problems were seen to hamper economic stability, but was also driven by a process of institutional "mission creep."

The backlash from the Asian crisis finally provoked a process of "streamlining" as from the early 2000s. The exercise led to new conditionality guidelines in 2002, whose leading principles were "parsimony" and "macro-criticality." In brief, conditionality was to be used "parsimoniously," and should specifically 1) be limited to the minimum necessary to achieve the goals of the programme or monitor its implementation; 2) normally be related to the institution's core areas of responsibility; and 3) be critically important to achieving the programme's goals.[5] The IMF executive board again reviewed the guidelines in 2005 and 2012, concluding that there was still scope for greater focus, better consideration of macro-social issues, and the enhancement of programme ownership and transparency.[6]

Although these criteria, generated by years of trial-and-error, are generally recognised as being key to a programme's ownership and successful implementation, the euro area programmes to date have generally failed to observe them – particularly so in the case of Greece. This was, at least initially, attributable to the conviction of some participants (notably the ECB and some core countries) that crisis lending should be made "very unattractive," to be granted only "as a last resort" (the term used was

4 The absence of conditionality from the initial Articles of Agreement is thought to reflect a compromise between the United States, favouring some form of conditionality, and the European countries, who then saw themselves as likely borrowers, and were thus disinclined to submit to conditional lending.

5 International Monetary Fund, *Guidelines on Conditionality* (Washington DC: IMF, 2002).

6 International Monetary Fund, *Review of 2002 Conditionality Guidelines* (Washington DC: IMF, 2005) and International Monetary Fund, *Review of 2002 Conditionality Guidelines – Overview Paper* (Washington DC: IMF, 2012).

‘There remain critical gaps in the ESM’s overall lending apparatus, potentially thwarting an effective response.’

Nine Priority Steps

Conditionality: Get Focused

1. *Ensure that conditionality is parsimonious, focused and macro-critical.* Abandon the current “Christmas tree” approach. Establish guidelines with a clear burden of proof: If it is not critical, it should not be a condition.

2. *Replace “unconstructive ambiguity” of uniform conditionality with clarity and modulation.* Ensure that outright monetary transactions (OMTs) do not remain phantoms; allow easier activation. Replace the mantra of “strict and effective” conditionality for all ESM facilities with calibrated conditions per facility.

3. *Give teeth to the EU’s new surveillance procedures.* Link access to precautionary facilities to observance of country-specific recommendations.

Lending: Set Boundaries

4. *Share the burden equitably.* Set boundaries to official sector intervention, providing early guidance to any need for private sector debt restructuring.

5. *Define a common EU-IMF approach to financing assurances.* Avoid new cases of official sector involvement (OSI), inimical to the credibility and catalytic role of official lending.

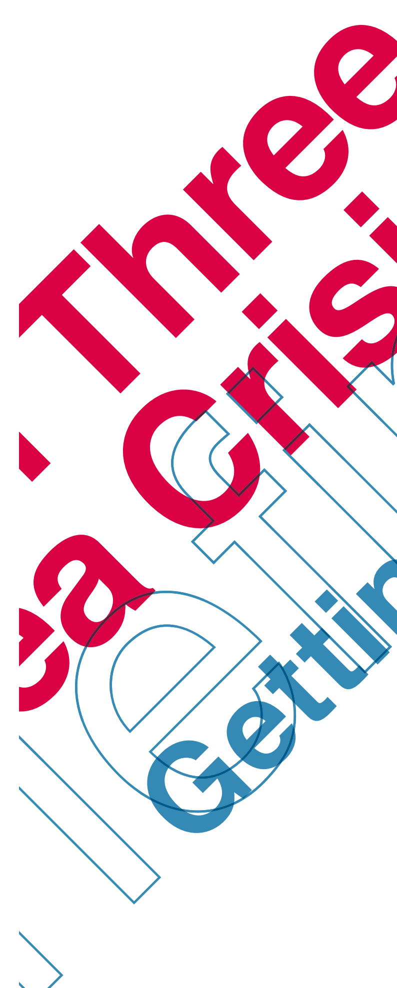
6. *Work toward a multilateral mechanism for sovereign debt restructurings.* If at first you don’t succeed, try and try again. Europe should take the lead.

Governance: Sort Out Troika

7. *Elaborate a European Commission-IMF “concordat” on workings of the troika.* Develop a “lead agent” framework, with clear-cut primary responsibilities per institution.

8. *Rely on a single forecaster and debt sustainability analyst.* Assign these tasks as the responsibility solely of the IMF, strengthening accountability.

9. *Ensure the troika’s operational independence.* All EU member states to undertake to respect the supranational character of the troika’s staff, and refrain from any attempt to influence them in the discharge of their duties.



‘The scope of European Commission structural conditionality has continued to increase over time.’

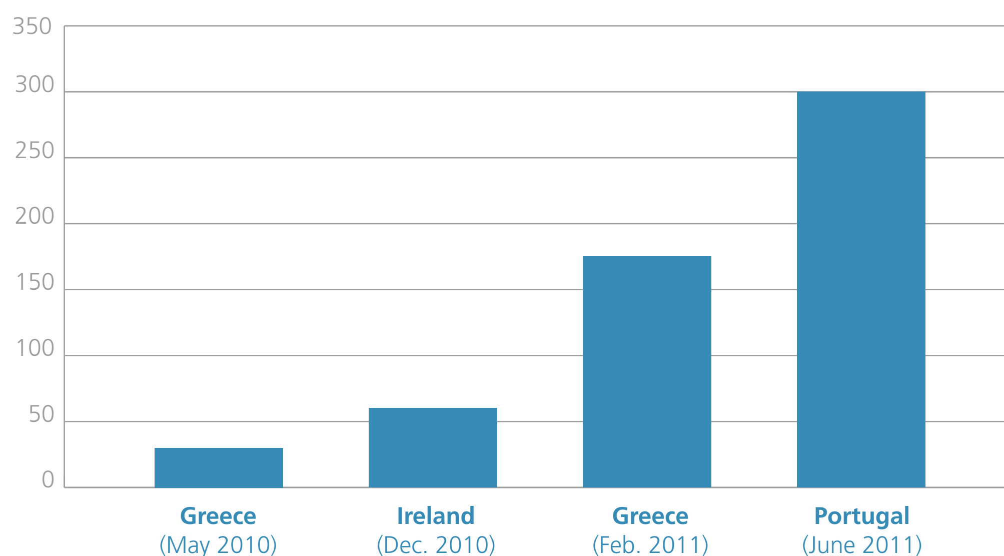
ultima ratio) and provided “at penalty rates” (initially, at a punitive 300 basis points above the euro interbank offered rate, inconsistent with the re-establishment of sustainability).[7] Though these notions have now fortunately been laid to rest, the scope of European Commission structural conditionality has nonetheless continued to increase over time, as illustrated in Chart 1 below.

7 All these notions can be found, *inter alia*, in the European Central Bank, “Reinforcing Economic Governance in the Euro Area,” *Task Force on Reinforcing Economic Governance in the Euro Area* (Frankfurt: ECB, 2010). For a critique of this approach, see Alessandro Leipold, *Good Governance for the Euro Area: Proposals for Economic Stability* (Brussels: Lisbon Council, 2010).

8 European Commission, “The Second Economic Adjustment Programme for Greece: First Review” in *European Economy Occasional Papers 123*, December 2012, pp. 61-131 (Brussels: European Commission, 2012).

9 International Monetary Fund, *2011 Review of Conditionality - Background Paper 1: Content and Application of Conditionality* (Washington DC: IMF, 2012).

Chart 1 : European Commission structural conditionality in euro area programmes



The European Commission’s December 2012 report on Greece’s programme (not reflected in the chart) has 70 pages listing conditions covering minutiae in a wide variety of sectors (including, for example, tourist guides and slaughter houses).[8] The IMF itself, in its latest review of conditionality, lamented that “the large and growing number of structural reforms identified by the EU is increasingly at odds with the principle of parsimony.”[9]

There are of course objective reasons for the comparatively heavy recourse to structural conditionality in euro area programmes – in the first instance, the absence of monetary policy and exchange rate tools for countries in a monetary union. The need to improve competitiveness via “internal devaluations” required addressing entrenched product- and labour-market rigidities to a greater degree than elsewhere. But this does not suffice to explain the extent of conditionality overload, and particular institutional factors have also contributed to the overkill. Foremost among these is the European Commission-ECB-IMF “troika” framework,

'The ESM needs to… establish and publish clear conditionality guidelines for its support.'

with each institution (and several relevant directorate-generals in the European Commission) adding their particular ornament to the conditionality "Christmas tree." Indeed, loans to euro area countries require not only the IMF's traditional memorandum of economic and financial policies (MEFP), but also an additional "European" memorandum of understanding (MoU), as a basis for the granting of EFSF/ESM support.

As has been noted, "the European MoU is significantly more detailed and includes specific conditions, for example of a structural character, that are not part of the MEFP. IMF conditionality therefore has a narrower scope than European conditionality."[10] This is a consequence of Art. 13 (3) of the ESM Treaty, whereby

"The MoU shall be fully consistent with the measures of economic policy coordination provided for in the TFEU [Treaty on the Functioning of the European Union], in particular with any act of European Union law, including any opinion, warning, recommendation or decision addressed to the ESM member concerned."[11]

This provision compels the Commission to include a vast range of conditions in the "European" MoU, stemming also from EU directives and other initiatives in areas of limited macroeconomic relevance. As noted by the IMF, "striking the balance between the structural reform needs and macro-criticality of measures has been complicated by collaboration with regional institutions with broader mandates than the Fund."[12]

Why is overly detailed conditionality a problem? Essentially for five reasons. First, it stands to strain a country's implementation capacity – especially where, as in Greece, this is already institutionally weak.[13] Second, it lacks focus and thus prioritisation. Third, it complicates monitoring and requires an excessively demanding assessment of implementation. Fourth, it raises the risk of a lack of coherence between the multitude of conditions in the programme documents. Finally, the perceived intrusiveness of conditionality on the part of recipient countries and their electorates weakens programme ownership, itself important to implementation (and a significant contributor, for example, to Ireland's comparative success).

What is the remedy? In essence, the ESM needs to:

1. Establish and publish clear conditionality guidelines for its support, and back them up with operational guidance to the European Commission's negotiators in the troika.

2. In this endeavour, it should be guided by international experience, in cooperation with the IMF, and follow the principles of parsimony, focus, macroeconomic criticality and ownership. Conditions should be strictly limited to the minimum necessary to achieve the programme's goals. What matters is the burden of proof: if it is not critically important, it should not be a condition.

10
Jean Pisani-Ferry, André Sapir and Guntram Wolff, *EU-IMF Assistance to Euro-Area Countries: An Early Assessment* (Brussels: Bruegel, 2013).

11
Treaty Establishing the European Stability Mechanism, DOC/12/3, 01 February 2012.

12
International Monetary Fund, *Review of 2002 Conditionality Guidelines – Overview Paper* (Washington DC: IMF, 2012).

13
In this connection, the possibility of a conditionality "Laffer curve" has been raised, whereby increased conditionality weakens the incentive to implement reforms; see Graham Bird, "IMF Programmes: Is There a Conditionality Laffer Curve?" in *World Economics Journal*, Vol. 2, No. 2, April 2001. For a contrary view, which finds that programme implementation is not related to the number of conditions (but rather to the borrower's domestic political economy), see Anna Ivanova et al., "What Determines the Implementation of IMF-Supported Programs?" in *IMF Working Paper WP/03/8* (Washington DC: IMF, 2003).

'ESM programmes should not be used to resolve certain long-standing disputes.'

3. ESM programmes should not – as is currently the case – be used as a vehicle for enforcing EU directives that are not *per se* macro-relevant, or to close gaps in the *acquis communautaire* in the affected economies. Nor should they be used to resolve certain long-standing disputes, as was attempted by some vis-à-vis Ireland's low corporate tax rate – an issue treated more appropriately in the broader realm of the proposed EU tax harmonisation dossier.

4. The ESM should put in place procedures for periodic reviews of its conditionality practices, conducted both internally and by an external reviewing body.

Clear calibration by facility

Besides conditionality overreach, observed in programmes currently in effect, the other main drawback in ESM conditionality is that of a perceived uniformity of conditionality across very diverse facilities. This affects most notably the ESM's precautionary facilities – with the main obstacle to their activation having been the uncertainty surrounding their conditionality, and the related concern that it might be as invasive as that of current macro-stability programmes.

The arsenal available to the ESM is a broad mix of interventions having different aims, to be delivered in turn via different facilities (see Chart 2 on page 10).

The aims are essentially three: 1) the support of macroeconomic stability; 2) the financing of bank recapitalisations (via, at present, only direct loans to governments); and 3) the purchase of government securities on the primary or secondary markets. Except for macro-stability support, which can only be delivered through a full-fledged stability loan (such as those granted to Greece, Ireland and Portugal), other interventions may take the form of precautionary credit lines. These in turn can be of two types: 1) the precautionary conditioned credit line (PCCL) or 2) the enhanced conditions credit line (ECCL). The latter is of particular interest since the ECB has prescribed that, absent a full macroeconomic adjustment loan, access to outright monetary transaction purchases is contingent on agreement on a precautionary ECCL programme, i.e., one with strengthened or "enhanced" conditionality.[14] This was preferred to the PCCL, which is subject to pre-established eligibility and lighter, *ex ante* conditionality.

The difficulty is that such "enhanced" conditionality has not been fully spelled out.[15] Apart from some rather general guidelines set out on the ESM website, the type of conditionality that would be attached to an ECCL programme, and to the associated ECB purchases, remains largely undefined.[16] The oft-repeated official mantra is that conditionality must be "strict and effective," as per the September 2012 ECB press release quoted above.[17] But the interpretation of the phrase is far from uniform, with some providing reassurance that there would

14 In its note on the OMT's technical features, the ECB states that "a necessary condition for outright monetary transactions is strict and effective conditionality attached to an appropriate European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) programme. Such programmes can take the form of a full EFSF/ESM macroeconomic adjustment programme or a precautionary programme (Enhanced Conditions Credit Line), provided that they include the possibility of EFSF/ESM primary market purchases." See European Central Bank, "Technical Features of Outright Monetary Transactions," *ECB Press Release*, 06 September 2012.

15 Alessandro Leipold, "The European Council of 14-15 March 2013: Can It Deliver?" *Economic Intelligence 01/2013* (Brussels: Lisbon Council, 2013), and *Ibid.*, "Conditionality: High Time for Clarity," in *Il Sole 24 Ore*, 23 September 2012.

16 For the current guidelines, which devote only a short paragraph to the ECCL, see European Stability Mechanism, "Guideline on Precautionary Financial Assistance."

17 *Op. cit.*

‘Delays are at loggerheads with the rationale of precautionary facilities: be pre-emptive and serve as crisis prevention tools.’

be no new conditions relative to existing commitments under EU surveillance, with only a prioritisation and a clear timetable, and others advocating full-fledged conditionality as under a traditional programme.[18]

The situation has been further obfuscated by the ECB’s unwillingness, to date, to publish the legal texts governing outright monetary transaction operations. It reportedly intends to do so only when activation becomes imminent.[19] Though this may reflect political tactics in light of the German Constitutional Court’s examination of ECB bond purchases later this year, it has raised potential clients’ diffidence. A possible further source of confusion was provided by the ECB’s Annual Report, released in April 2013, which stated that OMTs could be activated under ESM precautionary programmes, “*such as* [emphasis added] an enhanced conditions credit line” – at least implicitly opening the door to the softer PCCL.[20]

Such “unconstructive ambiguity” has compounded the stigma attached with drawing on official support – and the associated worries of loss of sovereignty – generating additional hesitancy and delaying recourse to the ESM’s precautionary facilities on the part of intended clients. Such delays are of course at loggerheads with the rationale of facilities that are intended to be pre-emptive and serve as crisis prevention tools. In facing a still fragile and risky environment (with tail risks being particularly pronounced), having such a buffer at hand could provide valuable insurance against shocks not only for Spain and Italy, but also for Ireland and Portugal once they exit their programmes.[21] If precautionary facilities continue to be dormant and OMTs remain phantom operations, the undoubted benefits that have stemmed from the latter’s announcement could well fade over time, renewing market pressures on periphery (and possibly other) countries.

Against this background, there is a need for joint clarification from both the ECB and the ESM along the following lines:

- The ECB should agree that OMTs can be activated also on the basis of a precautionary conditioned credit line (PCCL), which is subject to lighter, *ex ante* conditionality, with pre-established eligibility based on adherence to existing EU recommendations. This would be in keeping with the OMTs’ rationale, that of addressing what the ECB itself has defined as “severe distortions in government bond markets which originate from… unfounded fears on the part of investors of the reversibility of the euro.”[22] The ECB has defined this risk as the euro’s “redenomination risk,” adding that it was “unrelated to the assessment of a borrower’s solvency but which, in fact, came about owing to unfounded concerns regarding a systemic breakdown in the euro area.”[23] Correcting a market “distortion,” “unrelated” to a euro area member’s situation and affecting it in an “unfounded” manner, does not justify imposing additional conditionality on the member concerned. Furthermore, to the extent that the difficulties faced by the member are largely exogenous to its policymakers’ decisions, moral hazard

18
For his part, when asked whether the ECCL was a soft option, ECB President Mario Draghi responded “Oh no, not at all, you should look at the conditionality of the ECCL. It is a full macroeconomic conditionality and it would also see the involvement of the IMF.” Mario Draghi Press Conference, 06 September 2012.

19
Tyler Durden, “The ECB’s Press Corps Realize They Have No Idea What OMT Is: ‘The Rules Are What They Are’ Explains Draghi,” *Zero Hedge* 07 March 2013, and Eva Kuehnen, “ECB Only to Publish OMT Legal Act If Activation Imminent,” *Reuters* 29 April 2013.

20
European Central Bank, *Annual Report 2012* (Frankfurt: ECB, 2013), page 83.

21
For a recent in-depth assessment of the forthcoming risks faced by Ireland, see Central Bank of Ireland, “Macro-Financial Review,” 2013:I (Dublin: CBI, May 2013).

22
European Central Bank, *Introductory Statement to the Press Conference*, 06 September 2012.

23
Mario Draghi, “The Euro, Monetary Policy and Reforms,” *Speech at LUISS Guido Carli University*, 06 May 2013.

'The ESM's board of directors should put an end to the current state of "unconstructive ambiguity".'

concerns (of the Bundesbank and others) should be allayed. In such a setting, the success of OMTs would not be measured by their use, but by the increasing number of eligible countries and a related stabilisation of euro area risk spreads.

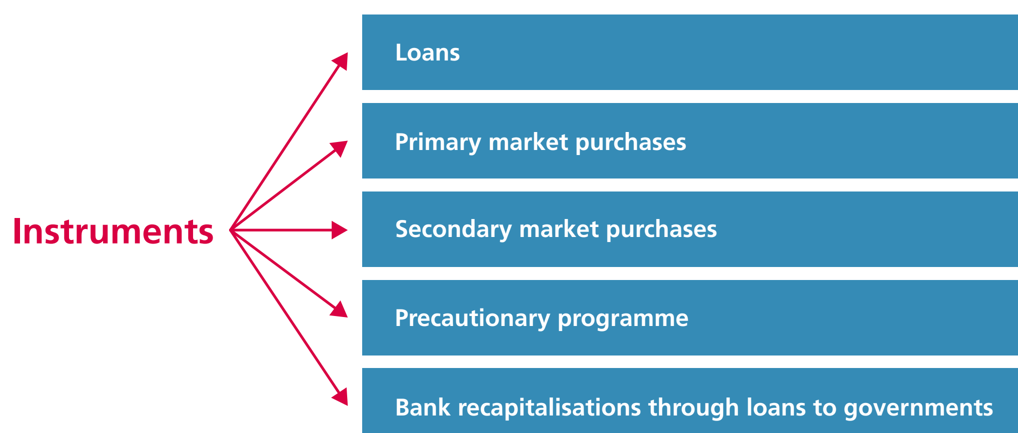
- For its part, an urgent task of the ESM's board of directors is that of putting an end to the current state of "unconstructive ambiguity," by adopting – as required by Art 14.4 of the ESM Treaty – "detailed guidelines on the modalities for implementing the ESM's precautionary financial assistance." The present text is far from "detailed." In doing so, the ESM need not re-invent the wheel, and should draw from international experience, calibrating conditionality appropriately across its facilities, and moving away from the blanket mantra of "strict conditionality" for all its facilities. It must, in particular, design conditionality in a way that early intervention mechanisms are used promptly, by relying on pre-qualification criteria (i.e., *ex ante* conditionality).[24]

- In defining pre-qualification criteria, particular prominence should be given to a country's observance of the country-specific recommendations issued to it under the EU's "European Semester" process.[25] The Commission presented its 2013 recommendations on 29 May 2013, and they are to be ratified by the June European Council. Conferring an operational role to the recommendations by way of access to precautionary financing would usefully bolster the EU's enhanced surveillance framework, endowing it with operational "teeth."

24 The IMF's prolonged quest for a precautionary facility that would attract borrowers in good standing but still in need of a buffer against contingent risks provides useful guidance in this respect. Following several failed attempts, with facilities that remained unused mainly because they still entailed overly burdensome conditionality, in 2009 the IMF modified its flexible credit line (FCL), basing it on a set of pre-qualification criteria – i.e., on *ex ante* conditionality, rather than on traditional *ex post* policy targets. The facility has been activated, and renewed several times (but not drawn upon), by Colombia, Mexico and Poland, with these countries' authorities deeming it to have added an important layer of protection during the severe global crisis of recent years. See International Monetary Fund, *Factsheet: The IMF's Flexible Credit Line (FCL)* (Washington DC: IMF, 2013).

25 See "Making it Happen: The European Semester"

Chart 2 : Scope of ESM activity



'The interconnected issues of debt sustainability and capacity to repay have been poorly handled.'

II. Lending Parameters: The Need for Boundaries

The complex and "unique institutional apparatus"[26] of international crisis lending, as developed in the more than 60 years since the Bretton Woods Conference, is based on two main pillars. The first – covered in the previous section – rests on guidelines that govern the appropriate scope and depth of conditionality. The second pillar, examined here, sets lending parameters, i.e., limits on the volume of access to official facilities, securing the assurances that a programme is fully financed (via, in IMF parlance, a policy of "financing assurances").

By providing rules-based parameters for official sector intervention, limits on access to facilities serve to determine the financing gap, and how the burden of its closing should be shared between the debtor and its creditors, including the private sector. They thereby also serve to indicate the possible need and size of any debt restructuring. Relatedly, they offer guidance on the required pace of adjustment, and a metric to judge the appropriate balance between adjustment and financing, thus also informing the growth-versus-austerity debate. Together with conditionality, they provide both debtors and creditors with a framework that assures the flow of funds to the debtor and eventual repayment to the creditor. They thus offer the debtor a "commitment device," via the promise of regular disbursements on a predictable timetable under certain conditions, and the creditor(s) with the required assurances regarding eventual repayment. The latter have indeed worked satisfactorily to date, limiting the number of countries with protracted arrears to the IMF to exceptional cases (in recent years, Somalia, Sudan and Zimbabwe).

The interconnected issues of debt sustainability and capacity to repay have however been poorly handled in euro area crisis management to date – essentially because of the absence of fleshed-out ESM policies on access and financing assurances. Taken together, these deficiencies have meant that, in most cases, and in contrast to traditional lending programmes, official assistance entirely replaced markets in filling the sovereign borrower's financing gap. The result has been an exceptionally large size of official financial assistance packages, allowing a private sector rush for the exits, and leaving official creditors with the bulk of the exposure to overly indebted euro area sovereigns.

The most prominent case is of course that of Greece, where the absence of country limits on official lending spawned the largest financial support package ever. Such massive official support served to mask the country's insolvency and unduly delayed private sector debt restructuring. It automatically led to public-sector overexposure and, ultimately, an unprecedented need for public sector debt relief, as embodied in the agreement of November 2012.[27] For the first time (leaving aside the special and distinct cases of debt forgiveness for highly-indebted poor countries and of Paris Club debt relief to developing countries), the notion of official sector involvement (OSI) made its appearance alongside the long-standing practice of PSI (private sector involvement). While the latter has the clear-cut rationale of burden sharing (avoiding

26
As defined by Jeanne, Olivier, Jonathan D. Ostry and Jeronim Zettelmeyer, "A Theory of International Crisis Lending and IMF Conditionality," *IMF Working Paper WP/08/236* (Washington DC: IMF, 2008).

27
In late November 2012, the eurogroup agreed on a set of measures to reduce Greece's debt burden, comprising not only private sector debt buy-backs but also substantial concessions on debt owed to official creditors. See *Eurogroup Statement on Greece*, 27 November 2012.

‘ESM guidelines on access limits… (should) provide confines beyond which larger loans would need to be justified.’

outright bail-outs of private creditors via official money), OSI has no similar *raison d'être*. Problems related to public sector bailouts of the private sector arose, albeit in a different form, also in the case of Ireland, and an easing of the terms and maturity of official assistance has been granted to the initial three programme countries (Greece, Ireland and Portugal).[28]

The consequences of official creditors' high exposure have been fully incorporated in market expectations. In upgrading Greece's credit rating in May 2013, Fitch Ratings noted: "The degree of default risk for private creditors… has subsided. Sovereign debt restructuring and debt buy-backs have reduced private creditors' share of general government debt to the point (15%, excluding T-bills), where there would be little to be gained financially from any further restructuring. Barring Greek exit from the euro, Fitch could envisage official creditors bearing the brunt of any future default."[29] In the circumstances, it saw grounds for proceeding with the ratings upgrade, almost a year to the day of its previous downgrade.

Looking forward, further restructuring of official sector debt (OSI) remains an issue. First, in the case of Greece, the euro area will be called upon to live up to its commitment, made alongside the November 2012 restructuring, to consider further assistance if necessary to maintain the debt ratio on its programmed path when Greece reaches a primary fiscal surplus (envisaged for 2014). Second, official debt concessions will likely also be needed in the case of Cyprus, given programme projections that again appear overly optimistic – in the widespread view of analysts, IMF board executive directors, and (only shortly after programme approval) the Cypriot authorities themselves.[30]

Thus, what was successfully avoided in more than 60 years of international crisis lending – losses borne by official creditors – stands to arise several times within a short time span in the euro area. The notion of a confidence inducing, catalytic role of public sector intervention is thus stood on its head. While the existing cases of public sector overexposure and likely OSI are now an *acquis*, about which little can be done, steps to avoid further such episodes requires a rules-based framework that should include:

- ESM guidelines on access limits to its facilities: these, as experience has indicated, cannot be set in stone, but serve to provide at least some confines beyond which the granting of larger loans would need to be justified. This is the case with the IMF's exceptional access policy, which has itself been stretched to the limit by the euro area cases, with a lowering of the bar that has caused notable unease within the institution.[31]

- The definition of a broader financing assurances policy, shared in a formalised understanding between the IMF and the EU institutions. In its latest conditionality review, the IMF highlighted "the importance of clearly communicating the Fund's financing principles when joining in co-financing operations" such as those in the euro area.[32]

28 In the case of Ireland, in February 2013, the government announced the liquidation of the Irish Bank Resolution Corporation and the replacement of costly promissory notes with a series of very long-dated bonds – an arrangement that met with ECB consent. For details, see Karl Whelan, "Ireland's Promissory Note Deal," *Forbes*, 11 February 2013.

29 Fitch Ratings, "Fitch Upgrades Greece to 'B-'; Outlook Stable," 14 May 2013. See also Alessandro Leipold, *Thinking the Unthinkable: Lessons of Past Sovereign Debt Restructurings* (Brussels: Lisbon Council, 2011).

30 For an example of a leading analysts' view, see Mohamed El-Erian, "Hey, They Are Stretching the Truth Way Too Far," *Huffington Post*, 04 April 2013. For a summary of IMF executive directors' views – in an unprecedented leak – see Joseph Cotterill, "Something To Ponder While Hoping for the Best: Cyprus and the IMF," *FT Alphaville*, 15 May 2013. Finally, the Cypriot authorities themselves, in late May, warned about a deeper-than-programmed recession; see "Cyprus Minister Says 2013 GDP Fall Could Be Double-Digit," MSN News, 21 May 2013 and "Cyprus Central Bank Sees 'Substantial' Risks to Economy," *Ekathimerini*, 22 May 2013.

31 In essence, since the staff could not find, as required for exceptional access, that Greece's debt was sustainable "with a high probability," the rules were amended to allow the IMF to lend in excess of the limits when "there is a high risk of international systemic spill overs." Only euro area countries have benefitted from this proviso to date.

32 International Monetary Fund (2012), *op. cit.*, page 23.

‘High-level political summits are no way to run a crisis.’

- The finalisation of work that would clarify the contributions of private and public sectors in banking crises, via swift definition of the modalities of direct ESM bank recapitalisations and their early implementation, and finalisation of the bank recovery and resolution directive. These will serve to establish a clearer hierarchy among private creditors (regarding notably senior unsecured bondholders and uninsured depositors).

- The time is also ripe for reviving consideration of a sovereign debt restructuring mechanism (SDRM), and Europe would do well to be an active advocate of a statutory mechanism to handle unsustainable debts, or at least of steps to strengthen the current market-based approach to debt restructuring.[33] This approach has, in several cases, proven ineffective in overcoming collective action problems, with hedge fund holdouts securing some appreciable gains or legal victories (e.g., in Greece and Argentina).

III. Governance: The Need for Efficiency and Competency

The euro area crisis – or at least its persistence – is to a large extent a crisis of governance. The latter is rooted in the adoption of an intergovernmental approach to eurozone crisis management – implying the prevalence of national interests, the institutionalisation of political interference and, relatedly, endless nightly marathons in Brussels. High-level political summits are no way to run a crisis, whose management is best handled by an eminently technical body (subject to adequate political accountability), in so-called “permanent” session, i.e., available to meet as needed.[34]

The ESM’s governing bodies could have provided such a forum, but the intergovernmental approach prevailed, and the ESM board of governors is itself a mere replica of the eurogroup ministers of finance. These arrangements have been amply critiqued.[35] The ECB itself would have preferred a community approach, as stated in its official opinion on the ESM in 2011.[36] Noting that the new institution was being created as “an intergovernmental mechanism instead of a Union mechanism,” the ECB emphasized its preference for “recourse to the Union method,” adding that it “would welcome that, with the benefit of the experience gained, the ESM would become a Union mechanism at an appropriate point in time.”[37] The intervening experience would suggest that the appropriate point in time has been amply reached, but the transformation of the ESM into a community institution remains beyond the realm of the politically feasible at this point.

There is however another governance issue whose resolution is at least as pressing and definitely more tractable than amending the legal character of the ESM. It concerns the workings of the European Commission-ECB-IMF negotiating troika. While troika participants tend, in public, to highlight the benefits of cooperation and of reliance on comparative advantages, the behind-the-scenes reality is that of an unwieldy, time-consuming and ultimately inefficient setup.

33
See Alessandro Leipold (2011), *op. cit.*. The issue is indeed again on the agenda, prompted primarily by the case of Greece. In late May 2013, the IMF board considered a staff study on ways to improve the debt restructuring process, updating the current market-based approach as needed. See International Monetary Fund, *Sovereign Debt Restructuring—Recent Developments and Implications for the Fund’s Legal and Policy Framework* (Washington DC: IMF, 2013).

34
The nature of the body that would conduct the IMF’s operations was the subject of considerable debate at Bretton Woods. Some participants (notably the US) held the view that the executive board should function in continuous session, while others (including the UK) preferred a body composed of top national officials with political responsibilities, who would work in their capitals and meet at headquarters as needed. As observed by Leo Van Houtven, “Underlying this debate were distinct philosophies regarding the need for continuous oversight by a body of experts versus less continuous but high-level political oversight from capitals.” The ESM is clearly modelled on the latter. See Leo Van Houtven, *Governance of the IMF: Decision Making, Institutional Oversight, Transparency and Accountability*, IMF Pamphlet Series, No. 53 (Washington DC: IMF, 2002).

35
See *inter alia* Alessandro Leipold, *Making the European Stability Mechanism Work* (Brussels: Lisbon Council, 2012).

36
European Central Bank, *Opinion of the European Central Bank on a Draft European Council Decision Amending Article 136 of the Treaty on the Functioning of the European Union* (Frankfurt: ECB, 2011).

37
Ibid..

'The lack of primary responsibilities (within the troika) results in analytical weaknesses in programme design.'

Problems within the troika have contributed to conditionality overreach, implausible growth projections, and flawed debt sustainability analyses, with related programme implementation difficulties and slippages. These failings have inflicted reputational damage on both the European Commission and the IMF, undermining their credibility and the return of confidence. Proposals to deal with these difficulties span two extreme views: one, that the IMF should unilaterally withdraw from the troika, and the other that the EU should rid itself of the IMF.[38]

The difficulties encountered in the workings of the troika are unsurprising: it is an unprecedented institutional construct, created in the midst of a crisis, with little previous experience of crisis cooperation among institutions with very different cultures, mandates and procedures. Previous cases of joint EU-IMF financing covered only non-euro area members (e.g., Hungary, Latvia and Romania in 2008-09), not comparable to those currently at hand.

The causes of the difficulties are thus deep-rooted and diverse, but two problems stand out in the troika's day-to-day operations. The first – already covered in the previous sections – concerns the absence of shared principles and guidelines on key programme design features such as conditionality, access and financing assurances. The second – examined here – regards the absence of a clear division of labour within the troika. Although such a division has emerged *de facto*, its contours remain blurred, with no agency unequivocally having "primary responsibility" over key programme inputs (such as macroeconomic projections, debt sustainability analyses or specific policy sectors). As explained by the IMF itself, the approach "relies on the principles of mutual trust and reciprocal evaluation rather than a strict division of labour within teams. There is no formal distribution of roles in discussions with the authorities, with each team steering discussions… independently of its own area of expertise."[39] This sounds like a recipe for drawn-out and possibly frustrating negotiations.

Most importantly, the lack of primary responsibilities results in analytical weaknesses in programme design. In particular, debt sustainability analyses (DSAs) have been consistently too sanguine. As revealed by a recent leak of a European Commission DSA for Cyprus, there is no established procedure for the elaboration of such assessments. The initial draft left open the possibility of various degrees of cooperation between the European Commission and the IMF, stating that "the assessment has been [agreed/conducted/discussed] with IMF staff."[40] The three verbs imply quite different degrees of consensus, and the revealed absence of an agreed procedure is both surprising and disquieting.

Finally, there is an accountability issue for the troika. As Jean Pisani-Ferry and co-authors observed, "being composed of three very different institutions, the troika is by essence unaccountable as an entity."[41] The absence of well-defined responsibilities amongst troika members compounds this problem, so that not only is the entity as a whole unaccountable, but so are each of the participating institutions. Where everyone is responsible in a diffuse manner, no one can be held accountable. Such a setting also

38 For the first point of view, see Ousmène Mandeng, "The IMF Must Quit the Troika to Survive," *Financial Times*, 17 April 2013; for the second, see Juergen Baetz, "Top Officials Call to Overhaul Euro Institutions," *Associated Press*, 18 May 2013.

39 International Monetary Fund, *2011 Review of Conditionality – Technical Appendices* (Washington DC: IMF, 2012).

40 The leaked document first appeared on *Financial Times Brussels Blog*, 10 April 2013.

41 Pisani-Ferry et al., *op. cit.*.

‘Keeping (market pressures) in check depends on moving swiftly to get ESM lending right.’

lends itself to blame games and finger pointing, as occurred in the debate on fiscal multipliers and, more openly, on the failings of DSAs.[42] On the latter, the IMF recently lamented the "incentives on the part of official creditors, who accordingly may have an interest in accepting, *and pressuring the Fund to accept* [emphasis added], sanguine assessments of debt sustainability and market access."[43] In other words, as put by *The Wall Street Journal,* the IMF maintains that "the Europeans pushed [it] to accept a rosier picture of Greece's debt outlook."[44] These sorts of exchanges do not have the makings of a collaborative setting, and calls for work toward an improved partnership.

The present market calm offers the opportunity for an improved partnership, principally by building a mutual understanding on the workings of the troika. Here I propose a middle road between the extreme views of either a voluntary or imposed withdrawal of the IMF from the troika. Its experience, expertise and multilateral perspective remain vital. Its continued presence is furthermore required by the ESM Treaty, which stipulates "close cooperation" with the IMF, and its "active participation… both at technical and financial level," adding that "a euro-area member state requesting financial assistance from the ESM is expected to address, wherever possible, a similar request to the IMF."[45]

Against this background, the European Commission, ECB and IMF should undertake to elaborate a common understanding on the workings of the troika, leading to a public MoU or concordat that would:

1. Develop a well-defined "lead agent" framework, assigning clear-cut primary responsibilities per institution. A transparent division of labour along lines of relative institutional competencies and expertise would also contribute to strengthened accountability.

2. Identify in particular a lead agent for the most basic programme input: its underlying macroeconomic projections and related debt sustainability analysis. While an overly detailed division of responsibilities per policy sector and issues is likely neither workable nor necessary, the robustness of projections does require a single experienced and independent hand. In this light, both macroeconomic forecasts and debt sustainability analyses should be the sole responsibility of the IMF, which in recent years has undertaken considerable work to refine its framework for rigorous DSAs. This culminated in early May 2013 in a staff guidance note for DSAs in market-access countries, and further refinements are actively on the agenda.[46] There is no comparable effort or guidance for staff at EU level.

3. Clarify the role of the ECB, which participates in the troika "in liaison with the European Commission" (the terminology used in programme documents). The ECB's operational participation as a full negotiating partner of the troika is inopportune and a source of potential conflict of interest. We share the conclusion of Pisani-Ferry et al., that, while the central bank's presence is necessary for it to have access to full information, it should discontinue co-signing mission statements and behave as a "mostly silent" participant.[47]

42
On the fiscal multipliers debate, see Olivier Blanchard and Daniel Leigh, "Growth Forecast Errors and Fiscal Multipliers," *IMF Working Paper 13/01* (Washington DC: IMF, 2013), and the riposte from Commissioner Olli Rehn in a letter to EU finance ministers, dated 13 February 2013, defining the debate as "unhelpful."

43
IMF (2013) *op. cit.,* page 15.

44
Matina Stevis, "IMF Searches Soul, Blames Europe," *The Wall Street Journal,* 24 May 2013.

45
ESM Treaty, *op. cit.,* Article 8. The "wherever possible" proviso should not be seen as constricting; it was added after the extension of the EFSF/ESM's range of possible interventions to cover cases not contemplated by the Fund's Articles of Agreement, such as bond purchases or the financing of bank recapitalisations.

46
International Monetary Fund, *Staff Guidance Note for Public Debt Sustainability Analysis in Market-Access Countries* (Washington DC: IMF, 2013).

47
Pisani-Ferry et al., *op. cit.*.

‘The present market calm offers the opportunity for an improved partnership.’

4. Ensure the operational independence of the troika's workings. Given the intergovernmental nature of crisis management in the euro area, we should guard against the risk of undue political interference in programme negotiations. IMF, European Commission and ECB statutes already contain provisions designed to protect staff independence in the exercise of their duties, but there is no similar stipulation in the ESM. In addition, EU member states should all undertake to respect the supranational character of the duties of these institutions' staff and, in the words of the IMF's Articles of Agreement, “refrain from all attempts to influence any of the staff in the discharge of [their] functions.”[48]

48 Article XII, Section 4(c)) of the IMF's Articles of Agreement reads: “The managing director and the staff of the Fund, in the discharge of their functions, shall owe their duty entirely to the Fund and to no other authority. Each member of the Fund shall respect the international character of this duty and shall refrain from all attempts to influence any of the staff in the discharge of these functions.” See International Monetary Fund, *Articles of Agreement* (Washington DC: IMF, 2008).

Getting It Right: Safeguarding the Calm, Exiting the Crisis

The current financial calm provides a welcome reprieve but also a dangerously lulling environment. This calm stands on shaky legs, with financial conditions largely disconnected from developments on the ground. Its persistence cannot be taken for granted, and will be tested in individual countries in 2013-14 – possibly already as from this summer, a notoriously crisis-prone season. Looking forward, Cyprus, Greece, Ireland, Italy, Portugal, Slovenia, Spain and possibly others stand – in albeit different ways – to raise crisis management issues for which the current framework is ill prepared. If the gaps in this framework are not addressed, the potential for further *accidents de parcours* remains high.

Indeed, as we have seen, markets are prone to sudden shifts in sentiment. They react more to short-term developments than to longer-term designs. And as important as longer-term designs are to EMU, they are not the determinants of short-term capital flows and sovereign bond yield spreads. Keeping these in check depends on moving swiftly to get ESM lending right – in terms of conditionality, access and the workings of the troika – so as to deal effectively with the problems of tomorrow. As a Spanish proverb tells us, “tomorrow is often the busiest day of the week.” The only time to prepare is today.

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