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"LESSONS FROM THE IMF BAILOUT OF GREECE"

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Chairman Barr, Ranking Member Moore, Members of the Subcommittee on Monetary Affairs and Trade:

I have attended many hearings on Capitol Hill as a newspaper reporter, but this is my first time as a witness—an honor for which I sincerely thank the Subcommittee. I mention this because the expertise I bring to the subject of this hearing is that of a journalist, my main research technique being extensive interviewing as well as examination of countless documents, both publicly available ones and those which remain confidential but which interviewees kindly furnish to me, including memoranda, notes of meetings and the like. This sort of material provided the basis for my book, *Laid Low: Inside the Crisis That Overwhelmed Europe and the IMF.*

The Subcommittee's hearing on the IMF's bailout of Greece is welcome evidence of Congressional interest in a complex topic of profound importance to the future of the global economy. The Fund's involvement in Greece is rich in lessons about the workings—and failings—of the international finance system. It's a saga of many twists and turns, which I spell out at length in my book and am presenting in summarized form in this testimony.

The phenomenon of countries laid so low by financial crises as to require international bailouts was once thought confined to the emerging world—Mexico, Thailand, and Indonesia for example. The euro-zone crisis showed that advanced economies may be equally susceptible to the vagaries of globalized finance, and may need rescues too.

The importance of a muscular IMF, wielding power and authority commensurate with the strength of world markets, is thus greater than ever. The Fund, after all, is the chief guardian of global financial stability. By seeking to prevent financial crises from occurring and managing crises when they erupt, the Fund provides a global public good—that is, a good from which all nations broadly benefit and which no single nation can deliver alone.

But the IMF's involvement in the euro zone was a bruising and enfeebling experience for the institution. During the euro-zone crisis, the Fund joined in several rescues despite grave misgivings among members of its Executive Board and top economic and legal officials—and it did so under pressure from top European

policymakers, who maintain heavy influence over the Fund's levers of control. Some of these emergency loan packages worked out well, but all too often debt was piled atop debt, and excessively harsh conditions were imposed on crisis-stricken countries. This approach, taken in conjunction with the Europeans, suited nations such as Germany and France, whose banks were anxious to stave off losses and whose voters were incensed at paying to bail out countries they perceived as irresponsible. It also suited the European Central Bank (ECB), because it helped preserve the international status of the euro and the ECB's independence—principles on which the central bank's leaders attach supreme importance.

The approach that was taken was not entirely misplaced; it was based on fears that the crisis would spread, via financial "contagion," to the rest of Europe and elsewhere around the world. But the legitimate interests of the crisis-stricken countries were sacrificed in the process—and I believe the crisis was more prolonged, painful, and near-catastrophic than it ought to have been. Although IMF economists—to their credit—perceived serious flaws in these bailouts, they often yielded to the clout of policymakers in Berlin, Frankfurt, Brussels and Paris. Especially in the early years of the crisis, the Fund was relegated to the role of junior partner in the tripartite arrangement known as the Troika, which consisted of the Fund, the European Commission and the ECB.

The result sapped the institution of its most precious asset—its credibility as an independent, neutral arbiter of how to address economic and financial problems in countries around the world. Heavy damage was thus inflicted on the IMF's ability to serve as a crisis-fighter and fixer of economic problems—and that raises concerns about the management of future crises.

Given its weighty duties, the IMF has consistently strived to maintain an image as a technocratic institution, free of gross political interference. Although it has often fallen short, there are sound reasons for hewing as close as possible to the ideal. The Fund stands the best chance of success when, in both appearance and reality, it represents the interests of the world community writ large rather than any single power or region. In the case of financial emergencies, one of the Fund's primary goals is to help a country that has lost the confidence of investors regain access to

financial markets. The money the Fund lends is only a part, and perhaps a relatively unimportant part, of its value. Equally crucial, if not more so, is its seal of approval—its signification that the country is adopting policies conducive to economic fitness. If the Fund's seal of approval is severely tarnished, especially by the perception of manipulation by forces from on high, its effectiveness at restoring market confidence will be eroded. Cynicism among market players about the Fund's susceptibility to political meddling makes its job much harder—an unwelcome development at a time when financial crises have become so pervasive.

The Greek crisis was where the damage was greatest, both to the country and to the IMF. In retrospect, Greece was saddled with an excessively high debt and should have gotten relief from its indebtedness much earlier than it eventually did. Although we will never know whether earlier debt relief might have made a difference, it seems quite reasonable to surmise that the Greek economy would have undergone a significantly less wrenching collapse than the 25% contraction in GDP that occurred between 2008 and 2015. And in retrospect, the IMF should not have submitted as readily as it did to European political exigencies; reputation-wise, the Greek crisis has been perhaps the worst debacle in the Fund's history.

In my book, I use the term "Faustian bargain" to describe how the IMF became involved in Greece in the spring of 2010. This bargain is crucial to understanding much of what happened as the crisis unfolded.

THE ORIGINS OF THE IMF'S INVOLVEMENT IN GREECE

In January 2010, a secret meeting took place in a hotel kitchen in Davos, Switzerland, during the annual meeting of the World Economic Forum. There were three participants—Dominique Strauss-Kahn, then the IMF's managing director; George Papanadreou, then the newly-elected prime minister of Greece; and George Papaconstantinou, who was Papandreou's finance minister. They met in a kitchen, with waiters bustling back and forth carrying trays, to make sure they wouldn't be seen by the many reporters who cover the Davos gathering.

Here's the background to this meeting: Greece had borrowed its way into deep trouble—its government debt totaled more than

€300 billion, which was a bit more than the country's annual GDP. Worse yet, the Greek government had done so without properly disclosing the degree of its profligacy. The budget deficit for 2009 was turning out to be several times higher than previously reported, and the ratio of debt to GDP—then estimated at 115%—was clearly on the rise. Financial markets were worried that Greece would fall prey to what economists call "exploding debt dynamics," which refers to an ever-increasing debt-to-GDP ratio as higher interest rates, a sluggish economy and chronic deficits drive the ratio inexorably upward with the passage of time. (This phenomenon is analogous to an individual who, having borrowed an excessive amount from credit card companies, gets hit with much higher interest rates at the same time as his or her income falls, and keeps trying to borrow more until eventually being overwhelmed by mushrooming demands for interest and principal.) The nightmare scenario was that Athens would default on its debt obligations, leading ultimately to the country's abandoning or effectively being expelled from the euro zone, with hellish chaos certain to ensue.

Papandreou's government was doing what any over-indebted entity is supposed to do—cut spending and raise income. But the markets were highly skeptical that Athens could or would go far enough, and interest rates on Greece's borrowing were soaring, which of course increased the threat of exploding debt dynamics.

So Papandreou and Papconstantinou had a question for Strauss-Kahn: Suppose Greece couldn't borrow money at anything like an affordable rate. Would the IMF provide the money the government needed to continue paying its obligations? At that point, in early 2010, Greece's European partners—especially Germany—were balking at the idea of lending to Athens, on the grounds that the rules of the European Monetary Union contain a "no bailout" clause. The European position would later change, but at that point it appeared that Greece's only recourse might be the IMF.

Strauss-Kahn's answer to the Greeks was not as comforting as they had hoped. He said that of course the IMF would try to help any member country requesting aid, but there were two problems: First, Greece would need a lot more money than the Fund alone could provide; and second, the Fund would not be able to provide a loan without the support of Europe, because European countries held a large (and disproportionate) share of the votes on the IMF

board.

At that point, the overwhelming majority of top European policymakers were vehemently opposed to an IMF rescue for Greece. This aversion resembled the denial syndrome that afflicts leaders of pretty much any government facing the need for an international bailout. They believed that Europe could—and should—handle its own internal problems, and that seeking help from the Fund would be tantamount to admitting that their monetary union was weak and ineffectual. According to Papaconstantinou, who has written a memoir, French president Nicolas Sarkozy told him: “Forget the IMF. The IMF is not for Europe. It’s for Africa—it’s for Burkina Faso!”[1]

But the IMF was eager to play a part—Strauss-Kahn most of all. One big reason was that the world had gone for many years after 2002 with no major financial crisis for the Fund to manage, and the Fund’s very relevance and *raison d’être* had been called into question. The Fund had undergone a sort of existential crisis during this period, when it was forced to downsize its staff on the grounds that the need for such an institution had diminished.

On the surface, Strauss-Kahn and other IMF officials avoided any comments indicating that they were pressing for a big role in Greece or yearning for an invitation to provide major assistance. Behind the scenes, however, Strauss-Kahn was doing whatever he could to assuage Europeans’ worries and objections to IMF involvement, because of his anxiety to to avoid exclusion lest doubts arise anew about the Fund’s *raison d’etre*. He made it clear that the Fund would accept a junior partner role—an almost unprecedented step, because in past cases when the Fund joined forces with other institutions and donors (such as the World Bank), it has played the dominant role in designing terms and conditions, in recognition of its expertise and status as agent of the international community. Only in one case, the 2008 crisis in Latvia, had the IMF accepted a junior partner position, putting up a minority of the funding and acceding to the view of European officials in a disagreement over Latvia’s exchange rate policy.

This is where the Faustian bargain comes in. In my interviews with

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[1] George Papaconstantinou, 2016, *Game Over: The Inside Story of the Greek Crisis,* CreateSpace Independent Publishing Platform, Chapter 8.

Strauss-Kahn, he told me that he felt it would have been "lethal to the IMF if the Europeans would handle the crisis by themselves." Accordingly, he recalled telling top European Commission officials at a meeting in Brussels: "We [the IMF] have to be in, but you will be the leader." His reasoning was that the IMF would bring expertise and credibility to the crisis that no European institution could match, and to ensure that its views were taken seriously, the Fund would have to make some financial contribution—something less than 50% of a rescue loan, but well above zero. At the same time, the Fund could not expect to exercise the sort of total control over economic policy that it does in most countries because, in this case, it could not realistically demand policy action by the central bank—the ECB being the central bank for all 300 million people living in the euro zone, only 11 million of whom are Greek.

As is well known, the decision about the IMF ultimately came down to one person—German Chancellor Angela Merkel, who effectively overruled Sarkozy and other European leaders at a summit in late March 2010. She concluded that the German Bundestag, and the German public, would never accept funding an emergency loan for Greece unless it came with severe conditions, enforced by arbiters with recognized neutrality and competence—and the IMF was the only institution that came close to this description. So the IMF was in, albeit on junior partner terms, which eventually were negotiated to mean that the Fund's contribution to the rescue loan would be roughly one-third of the total requirement.

I should add in this regard that the term "junior partner" has been rejected by some at the IMF, including the Fund's own Independent Evaluation Office, as an apt description of the role the Fund played.[2] But I can assure you that Strauss-Kahn himself accepted that term in conversations with me and in emails he sent me. He contended, with some reason, that the IMF had little choice if it was to be involved at all.

THE FIRST GREEK BAILOUT (MAY 2010)

With the Troika having thus been constituted, missions from the three institutions were dispatched to Athens in mid-April 2010, the aim being to negotiate what came to be known as "Plan A"—that

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[2] IMF Independent Evaluation Office, 2016, "The IMF and the Crises in Greece, Ireland and Portugal: An Evaluation by the Independent Evaluation Office," July.

is, a loan of many billions of euros to restore stability by ensuring that Greece could avert a catastrophic default on its obligations coming due over the next two or three years. A huge deadline was looming only a few weeks away, when €8.5 billion was due on May 19 to Greece's bondholders. So intense negotiations took place over a relatively short period of time, in late April and early May, over the terms of this loan. The result was an international bailout of unprecedented size.

Of course, emergency loans of this type invariably come with conditions, and the toughest demands for Greece to accept austere policies were coming from two power centers, the German government and the ECB. It was perfectly reasonable to expect Greece to undergo substantial belt-tightening, since the country had essentially been living well beyond its means for some years. The question was how much austerity would be sensible, because by taking too much money out of Greek pockets, the country's economy—already in recession—would undergo additional contraction, which would be counterproductive; it would cause a vicious circle in which the debt-to-GDP ratio would rise, exacerbating fears about exploding debt dynamics.

The IMF was commendably "dovish" in arguing within the Troika for a somewhat less harsh approach that would give Greece a couple of extra years to shrink its budget deficit. Even so, the rescue program was going to oblige Athens to undertake one of the biggest changes in budget and tax policy in history. Government outlays would be cut by 7% of GDP—and to put that into more understandable dimensions, it is a greater amount, as a percentage of U.S. GDP, than the our government spends on Social Security, Medicaid, military retirement and unemployment insurance combined. Tax revenues would increase by 4% of GDP—which is equivalent to an increase of $8,600 in the taxes paid by an average American family of four.

Plainly, Greece would require measures to counter the recessionary impact of a tight fiscal policy, or it would fall into an endless downward spiral of recession and a worsening debt-to-GDP ratio. Because of its membership in the euro zone, the country was precluded from the policies that most governments adopt under such circumstances—that is, pumping up the money supply and devaluing the currency. That left one option, namely structural reforms aimed at enhancing the productivity, efficiency

and flexibility of the economy. The Fund and European Commission had long been exhorting Athens to embrace such reforms, and now they had the leverage to impose them. These reforms included streamlining Greece's notoriously overstaffed state owned enterprises, changing labor laws that favored unions, and opening up professions that had long enjoyed protection from competition. According to Troika projections, if Greece faithfully adopted all of these measures, its economy would begin to recover in 2012, after contracting by 2.6% in 2011.[3]

For an idea of the skepticism about this plan that pervaded the IMF staff, see the confidential memo dated May 4, 2010 by Olivier Blanchard, then the Fund's chief economist, which I disclose in my book. (A copy of the most relevant portions, with key phrases underlined, is reproduced as Exhibit 1.) The degree of budgetary belt-tightening required of Greece "has never been achieved" by any other country, the memo warned. Furthermore, "even with fully policy compliance…there is nothing that can support growth against the negative contribution of the public sector….the recovery would likely be L-shaped, with a recession deeper and longer than projected." The program is thus likely to go "off track even with perfect policy implementation." Put in plainer English, this meant that even if Greece did everything being asked of it, the economy would sink further, because the structural reforms—no matter how sensible—simply wouldn't generate enough of a stimulatory effect. Structural reforms, after all, almost always take a fair number of years to generate positive effects on GDP.

A graphical depiction (See Exhibit 2) helps make clear the grim implications of Blanchard's concerns. In this graph, originally included in a public IMF document in May 2010, the dark solid line shows the projected path for Greece's debt-to-GDP ratio—first peaking, at about 150% of GDP, then sloping back down to relatively sustainable levels—if all the assumptions in the program proved valid (that is, if Greece did everything demanded of it, and the economy responded as forecast.) The dotted line shows what would happen if *just one* of the major assumptions proved too optimistic—that is, if economic growth turned out to be one percentage point a year worse than projected. Under that less rosy scenario, the debt-to-GDP ratio wouldn't decline; it would stay very

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[3] IMF, 2010, "Greece: Staff Report on Request for Stand-By Arrangement," Country Report No. 10/111, May.

high, almost certainly above sustainable levels. An even more explosive debt path would result if several of the assumptions went unmet.

One credulity-strainer in the first Greek rescue merits particularly close attention. The table in Exhibit 3 shows the Troika's projections in 2010 for Greece's primary budget surplus (that is, the budget surplus excluding interest payments on government debt). The Troika was assuming that the Greek government would run a surplus of about 6% of GDP each year from 2014 to 2020. Obviously if Greece could achieve such a high degree of fiscal rectitude that would help reduce its debt-to-GDP ratio to sustainable levels. But such a large budget surplus entails taking massive amounts of money in taxes from ordinary citizens while putting much less back into the economy in the form of government spending. The assumption that a country like Greece could achieve such a goal year after year was absurd—and other assumptions were too.

THE INTERNAL DEBATE OVER THE RESCUE

Small wonder, given the shaky prospects for Greece to stabilize its debt-to-GDP ratio, that a debate was raging behind the scenes at the IMF about whether to try a Plan B—namely, a "haircut" for the country's creditors in which they would accept reduced and/or delayed payments of interest and principal. Fund economists were divided on this issue; some, especially in the European Department, contended that the rescue stood a decent chance of working if Athens fulfilled all of its promises. But others were more in the Blanchard camp, and in any event the Fund had a high standard for approving a large loan in such cases. The Subcommittee is well familiar with this standard, I believe—its formal name is the Exceptional Access Policy, but in my book I call it the "No More Argentinas rule," because it was implemented not long after the disastrous failure in 2001-2 of the Fund's rescue for Argentina, when the country defaulted and fell into total economic chaos a few months after receiving a Fund loan. Under the No More Argentinas rule, the IMF could make a large loan to a country in crisis only if rigorous analysis showed that the country's debt was "sustainable with high probability"; otherwise the country should undergo a debt restructuring. Very few people if anyone at the IMF believed Greece met this criterion.

At Strauss-Kahn's direction, high-level staffers from two departments that favored a Plan B-type approach (the Strategy, Policy and Review Department and the Legal Department) held secret discussions in late April 2010 with officials from the German and French finance ministries, in the hope of starting to lay the ground for a debt restructuring. As I report in my book, these discussions were so sensitive that they were held at a Washington hotel rather than in the IMF headquarters building. One reason for the secrecy was the concern that if word leaked, markets would go even more haywire than they already were.

Equally important, any talk of a debt restructuring was drawing enormously powerful and vehement opposition, the most formidable critic being Jean-Claude Trichet, the president of the European Central Bank. For Trichet, who was one of the founding fathers of European Monetary Union, it was unthinkable that a euro zone country would fail to honor its debt obligations in full and on time. In addition to the moral issue, he feared the contagion that might result; once bondholders saw the debt of one euro zone country restructured, they would dump the bonds of other countries in the zone, potentially leading to a catastrophe redolent of the Lehman Brothers bankruptcy in 2008. Advocates of Plan B tended to agree that such fears were reasonably well-founded, but their rejoinder was that countermeasures could be put into place to limit contagion and keep markets stable. And as we now know, the ECB finally took action in the summer of 2012—the so called "whatever it takes" strategy, technically dubbed "Outright Monetary Transactions"—to quell market turbulence once and for all, an action that pretty much ended the viral stage of the crisis. But in 2010, the ECB was unwilling to use its money-creation powers to nearly such an extent.

So it was back to Plan A—€110 billion in loans for Greece, including €30 billion from the IMF and the rest from European governments and institutions. Even if the secret meetings had fully persuaded the German and French ministry officials (which they didn't), opposition to Plan B from other quarters was too strong. Time was of the essence, given the bond payments coming due on May 19; in a sign of the urgency involved in getting Plan A finalized, the IMF board scheduled a meeting on Mother's Day, May 9, to approve the Fund's part of the bailout.

This board meeting was one of the most consequential in the

IMF's recent memory—the loan the Fund was making to Greece, after all, was the largest in history, both in absolute terms and relative to the size of Greece's quota (contribution to the IMF's pool of resources). It has been known for some time, thanks to the leak of a memo to the *Wall Street Journal*, that although the board approved the loan to Greece based on its tradition of consensus, members were sharply divided and quite a few expressed deep reservations about the wisdom of imposing austerity on Athens without requiring the country's creditors to accept any losses. It is also well known that the board enacted a change in the No More Argentinas rule that was inserted into the staff report for the program the board was approving.

A more recent revelation about this meeting, which is reported in my book and came to light with the release of the official minutes in 2015,[4] is that the directors didn't know about the rule change until the meeting was almost over, when one of them raised questions about some jargon-laced wording on the 19th and 20th pages of the staff report. So not only was the Fund breaking its rule, it was doing so in a manner that can charitably be described as fast and loose.

THE MISSED OPPORTUNITY

A few days after this board meeting, Strauss-Kahn summoned Panagiotis Roumeliotis, who served as Alternate Executive Director for Greece on the board, to his office, and urged him in confidence to convey to Athens the need for an early debt restructuring. This episode reflects well on Strauss-Kahn's perspicacity. But it also raises one of the most troubling questions about the Greek crisis: why wasn't a strenuous effort forthcoming to reduce the country's debt burden soon after May 2010, in the latter months of that year?

The IMF had good reasons to avoid risking a debt restructuring during the spring of 2010. Substantial time would have been required for all the legal procedures that are involved, and failure by Athens to make the payments due to its creditors on May 19 might well have led to a "Lehman moment," given the lack of an

[4] IMF, 2010, "Minutes of Executive Board Meeting 10/45-1," May 9 (published in the IMF Archives in July 2015).

adequate “firewall” to prevent contagion and other groundwork that would have been necessary for bondholders to accept losses. But suppose Strauss-Kahn had quietly told the IMF’s Troika partners that very soon thereafter, the Fund would insist on a restructuring. He might have said that the Fund would simply not lend its good name and credibility to a plan with insufficiently high likelihood of leading to debt sustainability.

Such an approach would have required confronting Europe’s high and mighty. It presumably would have also required overcoming resistance from the U.S. government, which was still suffering from post-Lehman trauma. Although American officials were playing a much less dominant role in this crisis than they had in previous ones, the United States is the IMF’s most powerful single shareholder, and its officials were opposed to any debt restructuring in the absence of a strong firewall.

Most daunting of all would have been the face-down with Trichet. The ECB president was prone to umbrage when the subject of restructuring a euro-zone country was broached, and he had declared himself loath to take the kinds of monetary policy steps that would have been needed to limit contagion.

In my book, I call this hypothetical scenario a “poker play that would have been the greatest in the history of the global economy.” If the IMF had forged ahead with a debt restructuring, how might Trichet have reacted? Would he have stood his ground, even at the cost of risking a breakup of the currency union? Or would he have grudgingly used every conceivable monetary policy instrument to pacify market alarm? Could the IMF have called his bluff?

The IMF did not attempt this audacious step because—to carry the poker metaphor further—its managing director believed the Fund would only have gotten itself expelled from the card table. As Strauss Kahn told me when I asked him about this imaginary showdown: “We were just recovering, trying to re-establish our role in the global system. I could play this game a little. But I couldn’t go too far.”

THE SECOND BAILOUT OF GREECE (MARCH 2012)

By the third quarter of 2011, with Christine Lagarde now serving as

IMF managing director, it was clear that Plan A was going terribly awry. GDP was declining much more rapidly than the Troika projected; the Greek economy ended the year contracting by 7.1% (vs. the minus 2.6% forecast), and the debt-to-GDP ratio rose to 170% (vs. the 133% forecast). Greece was falling into exactly the sort of vicious cycle that had been feared in the spring of 2010. Was Greece fully abiding by the conditions to which it had agreed? No, but the main reason for the woes afflicting the Greek program was the counter-productive effect that fiscal austerity was having on an economy that had no real means of stimulating growth in the short term.

A new rescue program was in the works, and within the Troika, the IMF was in the forefront of insisting that this time significant "PSI"—private sector involvement, in which Greece's bondholders would undergo a haircut—must be included. The final deal, approved in March, provided for Greece to receive the biggest debt relief in history. Approximately €200 billion worth of Greek government bonds were subject to a haircut that amounted to well over 50%—estimates have ranged as high as 75%, depending on the calculation method[5]—in which each €1000 of bonds would be exchanged for a package with €465 in face value (consisting of a modest amount of cash, plus new government bonds.) To effectuate such a deep haircut, an ingenious scheme was used involving collection action clauses (CACs). These clauses oblige all holders of a bond issue to accept the terms of a debt restructuring if a sufficient number agree, and the Greek government was able to approve legislation retroactively inserting the clauses into the vast majority of its bonds, which happened to have been issued under Greek law.

Was this debt restructuring desirable? Absolutely, but the problem was that it was too little, too late. Despite all the relief Greece was receiving on its private debt (that is, its bonds), Athens would still be laboring under a huge, €300 billion-plus debt burden because of all the money it borrowed from the official sector (that is, European governments and institutions, and the IMF itself). This point illustrates why bailouts of unsustainably indebted countries can be so injurious. One major drawback is the moral hazard that

[5] Jeromin Zettelmeyer, Christoph Trebesch and Mitu Gulati, 2013, "The Greek Debt Restructuring: An Autopsy," Peterson Institute for International Economics, Working Paper 13-8, August.

occurs when private lenders conclude they will be able to get their money back, courtesy of the public sector, no matter how foolish their loans may have been in the first place. Another problem, of more profound concern to citizens of the country being "rescued," is that debt to official bodies may be very hard to restructure, harder even than debt to private creditors. That is especially true for money owed to the IMF; the Fund enjoys "preferred creditor status," which means that when a country has received international bailout loans, the Fund must be repaid ahead of all other creditors. The Fund, after all, is the closest thing the world has to an international lender of last resort, lending to countries in situations where all other sources of credit have dried up—metaphorically, entering burning buildings while others are fleeing. This means IMF claims get top priority and countries that fail to repay their IMF loans can expect to be treated like international financial pariahs.

Concern at the IMF about whether the second bailout would work is fairly evident in documents I reviewed for my book. Perhaps the most colorful illustration is a comment that Lagarde made when the broad outlines of the deal were struck at 5 a.m. on February 21, 2012, after a grueling, all-night meeting in Brussels. As European officials were clapping one another on the back in relief over the agreement, Lagarde said: "Don't celebrate guys. In a couple of years, you're going to have to dig in your pockets again for Greece." Again, to understand such skepticism, consider the size of the primary budget surpluses the Greek government was expected to generate under this program—between 4% and 4.5% of GDP each year all the way until 2030, as shown in the table in Exhibit 4. That was less than the 6% of GDP assumed in the first bailout, but it was still ambitious to a ridiculous extreme.

Internal Executive Board documents cited in my book reflect intense criticism at the meeting the board held on March 15, 2012, to approve this program. The Canadian representative at the meeting hit the nail on the head when he contended that Greece's debt should be "brought down to well below the level targeted in the program, through a combination of more ambitious PSI/OSI." By "OSI," he meant "official sector involvement"—in other words, acceptance by Greece's official creditors of reduction in their claims. But European officials were unwilling to go far in that direction; although they accepted lower interest payments and postponements in maturities on the debt Greece owed them, they

refused to accede to outright forgiveness of the loans they had extended to Athens—a position they have continued to staunchly maintain.

THE LATTER STAGES OF THE CRISIS AND THE THIRD BAILOUT OF GREECE

It is important to note that, although the IMF deserves criticism for bowing to European pressure, it deserves credit for standing up to Europe on a number of occasions, especially during the period starting in the latter half of 2011 after Lagarde became managing director. In August of that year, Lagarde gave a speech questioning whether European banks were adequately capitalized, which infuriated leading officials in the region. In October 2012, analysis issued by the Fund's Research Department, which Blanchard directed, sharply challenged the prevailing European orthodoxy favoring austerity for dealing with crises. In the spring of 2013, when Cyprus underwent a crisis, the IMF succeeded in overcoming European resistance to an approach that Fund officials favored. Although this victory wasn't quite as impressive as has been portrayed in the news media—an approach the IMF would have preferred even more for dealing with Cyprus was rejected by Europe, as my book reveals—it is fair to say that the Cypriot crisis was one of several examples of the Fund taking a considerably tougher and more independent stance than it had before.

Perhaps the most salient illustration of the IMF's increasing assertiveness was the drama that unfolded in 2015 when a radical leftist government came to power in Athens. During this period, the IMF was often credited, justifiably, with playing the role of "honest broker" between Greece and its European creditors—that is, demanding far-reaching reforms from the Greeks while simultaneously insisting that Europe accept debt relief that would put Athens on a sustainable path. For example, when European finance minsters met in Riga, Latvia in late April 2015—an episode that was widely depicted as a massive ganging-up on Greek finance minister Yanis Varoufakis—Poul Thomsen, the director of the Fund's European Department, said, according to notes of the meeting: "I want to caution you, ministers…very significant debt relief will be necessary…do not be surprised when this will come." Fund documents issued during the tense standoff between Athens and Europe in the summer of 2015 provided laudably candid

assessments about the dimensions of the debt problem. And when Greece's left-wing government capitulated to European pressure in July 2015 by accepting yet another harsh rescue package, the IMF finally refused to go along, stating that it would join only after a plan was agreed that would assure reductions in the debt burden in more realistic accord with the country's ability to pay.

It would be misleading, however, to attribute these developments to the change in IMF leadership in mid-2011. Tempting as it is to conclude that the dauntless Lagarde showed more gumption than the crafty Strauss-Kahn, the crucial factor was the different position the IMF found itself during the months after Lagarde's arrival. In contrast to the situation in 2010, when Strauss-Kahn was struggling to ensure that the Fund would play a role in the crisis, Europe was far more anxious during the period starting in late 2011 to keep the Fund involved. This was the time when Europe's need for Fund involvement—both its money and its credibility—was at its peak, and so was the Fund's leverage.

Commendable as the IMF's frankness was in 2015 regarding Greek debt sustainability, I believe the Fund should have been tougher regarding the country's official debt—and acted sooner. It should have exploited the greater leverage that it had to better advantage.

Consider in this regard the strong public statements that Fund officials have made in the past couple of years concerning Greece's primary budget surplus. In mid-2015, an IMF document derided European expectations that Athens could maintain a 3.5% of GDP surplus over the medium term, noting that "few countries have managed to do so."[6] In April 2016, Lagarde declared at a press conference: "What we find highly unrealistic…is the assumption that this primary surplus of 3.5% can be maintained over decades. That just will not happen."[7]

Lagarde was absolutely right, and she should be applauded for speaking out. Yet recall that the IMF went along with much bigger long-term primary surplus targets, both in the first *and* second bailouts. Why did it take so long for the Fund to deem these

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[6] IMF, 2015, "Greece: An Update of IMF Staff's Preliminary Public Debt Sustainability Analysis," Country Report 15/186, July 14.
[7] IMF, 2016, "Press Briefing of the Managing Director," April 14.

targets to be economically and socially unattainable? A charitable answer would go as follows: Only later in the crisis did the Fund gain sufficient insight into the Greek political system to see how misplaced its confidence was in the attainability of those targets, and only then could the Fund act resolutely in the face of European resistance. A less charitable answer—which I believe is more apt—is that the IMF took too long, both for Greece's stake and its own, to muster sufficient pluck.

CONCLUSIONS

Christine Lagarde has restored the IMF's luster and enhanced its public profile since taking over after the sordid episode of May 2011 that led to Strauss-Kahn's resignation. Indeed, she enjoys enormous admiration and popularity; her pronouncements on all manner of issues routinely receive respectful attention worldwide. She mobilized a major boost in the IMF's financial resources from member countries, and was a shoo-in for a second term in 2016 after serving her first five-year term, with unanimous and enthusiastic support of the Fund's board. When she appeared on *The Daily Show* in 2015, the studio audience welcomed her with wild applause as she bantered with host Jon Stewart—a public relations tour de force that would have boggled the minds of Fund press officers back in the day of her staid predecessors.

At a time when the managing director is held in such high esteem, concern about the IMF's place in the world might seem incongruous. But all the *bon mots* in the world cannot erase the more substantive developments involving the Fund's role in Europe both before and after Strauss-Kahn's departure, nor the harm that resulted.

One word aptly describes the IMF's role as junior partner in the Troika: travesty. The arrangement struck in the spring of 2010 was an original sin that led to many others. Even though the Fund was putting up a minority share of the loan package for Greece, it should have participated as senior partner, with the power to determine the terms and conditions of the rescue, based on an understanding that it would consult European policy makers without being obliged to defer to them or reach compromises with them.

This is not to say that compromise between the IMF and major

shareholders is necessarily bad; the Fund is a political institution at the end of the day, with a management and staff accountable to the board that represents the member countries. The Fund has been obliged to reach some sort of accommodation with major industrial countries in virtually every crisis it has confronted—one famous example being the role played by U.S. Treasury and Federal Reserve officials during the Asian crisis of the late 1990s.

But in the euro-zone crisis, the line separating legitimate influence from harmful interference was not only crossed, it was trampled on. From the standpoint of the IMF's integrity, the control that Europeans exerted in the euro-zone crisis posed a different and much more harmful threat than that of U.S. officials during previous crises. Unlike the United States, European nations were borrowing from the Fund. Even the rich European countries that never needed IMF aid were in many respects supplicants, using the Fund—both its seal of approval and its money—to save their terribly flawed system of money union. Not only were policy makers from these rich European countries desperate to protect the euro, they were aiming at the same time to ensure their political survival; they were concerned about placating angry, fed-up electorates. For Europeans to be pushing the Fund around under such circumstances was an affront to robust multilateralism.

When it came to the euro zone, therefore, the Europeans should not have been "the leaders," as Strauss-Kahn put it in his meeting with them in the spring of 2010; the working assumption all along should have been the opposite. Ideally, the Fund should have gotten even more clout, in the form of what I call "super senior" partnership—that is, the authority to set terms and conditions for the entire euro zone. Under the Troika arrangement, the Fund was sitting on the same side of the negotiating table as the ECB, but it should have sat on the opposite side, and it should have had the power to require action from all of the member countries, not just the ones urgently in need of international assistance. As just noted, the Fund was coming to the rescue of the euro; if the countries using that currency were not willing to take the steps that the Fund believed necessary, they of course had the right to refuse. But the Fund had the right, and arguably the duty, to tell the Europeans they would then to be left to their own devices.

This is not to imply that the IMF is endowed with such brilliant insight that it can be assured of diagnosing every international

economic and financial problem accurately and prescribing optimal policies. Quite the contrary, my book provides extensive evidence showing how the Fund often makes faulty assessments—for example, the Fund completely failed to foresee vulnerabilities in Europe prior to the crisis. But the case for the Fund exercising supreme authority in financial crisis situations should be based not on its infallibility (which it clearly does not have), but on its independence, objectivity, and global perspective. In other words, although the Fund cannot credibly claim to have superior wisdom regarding each and every crisis that comes along, it should be in a position to assert that its analysis must take priority by dint of its status as a multilateral institution entrusted by the international community to exercise neutral, objective judgment about the best possible resolution.

The question is what the IMF ought to do now to undo, or at least mitigate, the damage done to its credibility and effectiveness in future crises.

Nobody can foresee with any degree of certainty where the next crisis will arise—perhaps it will be Asia, or Latin America. But when it happens, powerful countries may insist that the IMF play a junior partner role again, based on the precedent set in Europe. They may wish to use the IMF to endorse their view of how matters should be handled, possibly for narrow reasons of national interest (protecting their big banks from taking severe losses, for example). Although the euro zone is *sui generis* to some extent, as the only major region of the world with a currency union, that does not mean the problem that arose there with regard to the IMF's role could not happen elsewhere.

Regional financial institutions and ad hoc arrangements among countries are on the rise, one motive being to create alternatives to the IMF or at least influential adjuncts to it. The most recent of these is the BRICS countries' $100 billion Contingency Reserve Arrangement (CRA), a pool of currencies intended "to forestall short-term balance of payments pressure, provide mutual support and further strengthen financial stability." Although entities such as the CRA will never supplant the IMF, it is not hard to imagine that, in a crisis, they could be used to help tilt the terms of rescue packages in directions that suited major countries' governments, against the Fund's best judgment. Such an approach would erode the IMF's value as a global public goods provider, which would be

to the long-term detriment of all.

In the final chapter of my book, I list a host of policy recommendations aimed at addressing the problems I have cited. These proposals include changes in IMF governance and the establishment of a new Fund facility for handling countries in need of debt restructuring. This portion of the book is the least valuable; many people with greater expertise than I have on these issues are more qualified to figure out how to fix the system. As a journalist whose competitive advantage lies in reporting and writing a narrative, I like to fancy that I have provided an accurate chronicle of events that will be useful to informing the public debate.

Whatever remedies are adopted, they should fully take on board the extent of the IMF's misadventures in Greece. Only then will the Fund stand a decent chance of providing global public goods of the sort the world needs.

EXHIBIT 1

Office Memorandum

To: Mr. Thomsen

May 4, 2010

From: Olivier Blanchard

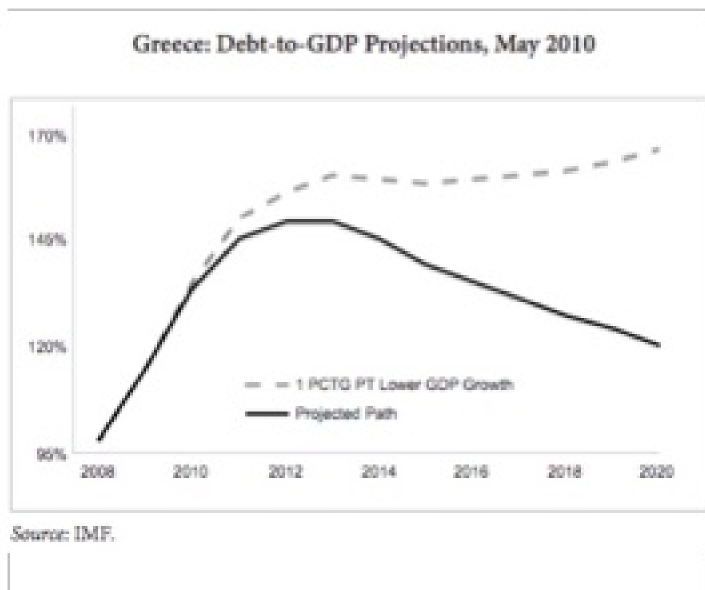
Subject: **Greece: Request for Stand-By Arrangement**

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).

EXHIBIT 2



Source: IMF, 2010, “Greece: Staff Report on Request for Stand-By Arrangement,” Country Report No. 10/111, May.

EXHIBIT 3

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
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

Source: IMF, 2010, "Greece: Staff Report on Request for Stand-By Arrangement," Country Report No. 10/111, May.

EXHIBIT 4

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

Source: IMF, 2012, "Greece: Request for Extended Arrangement Under the Extended Fund Facility—Staff Report," Country Report No. 12/57, March; and IMF, 2013, "Greece: First and Second Reviews Under the Extended Arrangement Under the Extended Fund Facility," Country Report No. 13/20, January.