Testimony before the

Subcommittee on Monetary Policy and Trade

Committee on Financial Services

U.S. House of Representatives

May 18, 2017

Meg Lundsager

Public Policy Fellow

Woodrow Wilson International Center for Scholars

Chairman Barr, Ranking Member Moore, and Members of the Subcommittee, thank you for inviting me to testify on the "Lessons from the IMF's Bailout of Greece." Many complex issues surrounded IMF lending to Greece during my tenure as U.S. Executive Director on the IMF Executive Board from 2007-2014. I continue to focus on these issues as a Public Policy Fellow at the Woodrow Wilson International Center for Scholars. My testimony today reflects my personal views, not those of the Wilson Center.

Summary:

International Monetary Fund (IMF) lending to countries that are members of the Eurozone has strained key IMF principles and undermined its lead role in designing adjustment programs and financing packages for countries suffering balance of payments crises. IMF lending programs that normally encompass all aspects of macroeconomic and financial sector policy have been shaped more by European needs than by IMF standards.

Conditionality for Eurozone members differs sharply from that for most other IMF members and weakens the IMF's commitment to treat its members uniformly in terms of the types of policy adjustments demanded in lending programs. The IMF's principle of uniformity of treatment has been a foundation of the IMF's ability to treat each member fairly while designing programs to achieve economic and financial stability. Programs are shaped to country circumstances and therefore are not necessarily identical across the membership. In the Eurozone crisis however, key policies were set by European institutions, leaving the IMF little room to design a program that could create conditions for Greece's recovery.

IMF financing requirements have come second to European practices and procedures, despite the decades long priority treatment all IMF members have accorded to their loans from the IMF. Eurozone governments have created their own €500 billion financial rescue fund, the European Stability Mechanism (ESM), and therefore do not need IMF funding. With little likelihood that Europe will adjust its internal rules and regulations to accommodate the IMF, the preferred

future approach is that Eurozone countries do not seek IMF lending. If Eurozone members do exercise their right to request IMF financing, the IMF should have in place a defined policy establishing its primacy in program design.

The following statement outlines IMF practices and how programs for Eurozone countries, particularly Greece, deviated from those practices, leading to the conclusion that the Eurozone members should address their financing needs with their own internal resources. Finally, recognizing that the IMF Articles of Agreement enshrine each member's right to seek IMF financing, this statement includes recommended policy reforms the IMF should adopt before lending to a Eurozone member.

IMF Role and Challenge of Eurozone Country Programs

The International Monetary Fund serves as a foundation of the international economic order and over the seven decades of its existence, has supported numerous international economic policy objectives of the United States. The IMF has moved quickly to help crisis countries restore financial and economic stability. This has helped put a floor under a country's economic contraction, preventing economic recessions from becoming economic depressions, thereby reducing the loss of jobs and incomes. This also reduces the likelihood of financial crises spilling across borders.

IMF programs condition lending on economic reforms such as tightening monetary policy by raising interest rates, reducing government deficits, taking action to resolve tottering domestic banks, and in some cases, depreciation or devaluation of a country's currency. The program negotiation enables the country and IMF staff to discuss policy alternatives to achieve the desired objectives. Monetary policy expectations are always included in an IMF program and each program aims to achieve debt sustainability.

The IMF considers exchange rate policy to be a key part of its discussions in all programs. If the country is a member of a currency union and cannot on its own change its exchange rate, the IMF will devise policies that likely have the impact of lowering domestic prices and wages, or reducing that country's inflation relative to trading partners. Relatively lower domestic prices then substitute for an exchange rate adjustment. This is what is meant by 'internal devaluation,' which in the end occurred to some extent in all Eurozone program countries as sharp economic contractions put downward pressures on domestic wages and prices.

This traditional approach is often viewed as the IMF imposing austerity on the member. But of course a country only approaches the IMF for assistance once its economic crisis has destroyed investor confidence and currency outflows have depleted foreign currency reserves. Once foreign exchange reserves are dangerously low, the country has little choice but to devalue its currency and/or drastically tighten its monetary and fiscal policies. IMF policy advice/conditionality and financial support can mitigate the economic contraction needed to restore stability.

The IMF also will work closely with key bilateral and multilateral partners, as aid and credit programs provide valuable technical assistance and critical funding. Debt relief from official and private creditors may also be included in the financing package.

Partnering with other institutions providing assistance requires reconciling divergent institutions' mandates. In recent years, managing such relationships has become much more complex and has put the IMF in the middle of trying to navigate the cross currents among the various partners, while negotiating difficult economic policy choices with the member country. This is what occurred in the case of Greece.

The IMF's lending programs with countries that are members of the Eurozone have brought to light new complexities which the IMF has yet to resolve. IMF involvement in early Eurozone country programs was critical to preventing a broader European wide crisis that ultimately could threaten the existence of the Eurozone. But that engagement also revealed the lack of clarity regarding the IMF role vis-a-vis the European entities providing financial support. European priorities limited the ability of the IMF to follow its traditional approach and adhere to its own policy of uniformity of treatment.

The Eurozone Crisis Impact on the IMF

All countries borrowing from the IMF must show a balance of payments need. Each Eurozone country faced balance of payments difficulties as their trade balances and capital flows worsened. Each Eurozone member also faced large fiscal challenges as economic recessions reduced government revenues. Domestic banking systems needed shoring up and unemployed workers received benefits, requiring additional fiscal resources.

In the end, the governments of Greece, Ireland, Portugal and Cyprus ran out of ready access to Euros, their own domestic currency as depositors shifted funds to other Eurozone countries and governments could only roll over very short term debt at high interest rates.

These four countries are members of the European Central Bank (ECB), which creates Euros and manages monetary policy for the Eurozone. As Greece first slid into crisis, European partners, particularly Germany, planned to resolve the problem within the Eurozone. Once the depth of economic mismanagement in Greece and the size of the financing gap became clear, European partners asked Greece to approach the IMF for financing as well.

Negotiating Greece's adjustment program was complex as the European Commission (EC), the European Central Bank (ECB), bilateral partners, and the IMF all were demanding Greek reforms in exchange for financing. This negotiating pattern evolved into the 'troika' consisting of the European Commission (EC), the ECB and the IMF.

The IMF loan for Greece was put together quickly in 2010 in order to prevent Greece defaulting on its debt obligations. In the months leading up to the Greece program approval in May fears grew that Greece's crisis would spread to other Eurozone members, including Spain and even Italy. Europeans needed the IMF's quick action to keep Greece solvent while they arranged European financing. The IMF could act quickly, while European partner financing required

decisions by national governments and Parliamentary votes. Furthermore, the Eurozone did not at that time have an institution tasked with imposing the kind of macroeconomic conditionality Greece needed and the IMF could provide.

Since that time, Europe has established the European Stability Mechanism (ESM), which has the ability to lend €500 billion and is now the primary source of new Euro funding to Eurozone members. European leaders themselves are now expecting to finance future crisis programs from this mechanism, and claim they are less likely to turn to the International Monetary Fund for financial participation in a lending program. This is a welcome development.

Where does this leave Greece?

In the meantime Greece has yet to restore economic growth or generate new jobs, as investment has stalled amid the uncertainty over external financial support, including how European partners will honor their commitment to restore Greece's debt sustainability. Greece's outstanding debt is very high, at 180 percent of its GDP, and likely to remain high for a number of years.

Greece's European partners have insisted Greece pursue a new program with the IMF to coincide with the final year of Greece's ESM program. Germany seeks a parallel IMF agreement in order to secure domestic German support for the ESM loan disbursement.

The IMF asserts that it will not join a new lending program without European creditors clarifying how they will reduce Greece's indebtedness over the longer term. European officials have ruled out any outright reduction of principal, or 'haircuts', but have signaled that sustained low interest rates and very long maturities could be considered, if necessary, assuming Greece completes its current ESM program successfully next year. The IMF has signaled that it would accept further maturity extensions and longer term commitments of very low interest rates, instead of outright haircuts on outstanding debt.

European officials have repeated previous commitments but as of last week, have not yet specified the extent of debt relief that will be provided to Greece after 2018, assuming Greece meets its ESM program targets. An IMF official stated that the European partners "need to have numbers on what are the potential (debt) measures, to show these potential measures really entail a game changer as far as debt is concerned." The IMF Managing Director, Christine Lagarde, stated "European partners need to be more specific in terms of debt relief."(Reuters May 12, 2017)

The IMF has rightly focused on reducing the level of outstanding debt, to signal to Greek and potential foreign investors that future debt servicing requirements will not impede profitability and investment, which are needed for job creation.

The IMF is also concerned that the Europeans are expecting Greece to run a very tight fiscal policy for a prolonged period of time, something very few countries have succeeded in doing. The IMF would prefer that additional fiscal resources provided by further debt relief be applied to investment and some basic social services in Greece.

Given that the largest share of the debt is owed to Greece's European partners, this is the opportune time for the IMF to disengage from financing Greece's adjustment program. At this time, Greece's outstanding debt to the IMF has dropped to less than $14 billion, while its debt to European partners remains over $200 billion.

Contradictions revealed in IMF Eurozone programs

Lending to Eurozone members has been an unusual situation for the IMF. The ECB placed itself as a member of the troika, along with the IMF and the European Commission (EC), when normally a country's central bank is part of the country team negotiating with the IMF. The central bank is typically expected to make commitments as to its path for monetary policy, or its intentions regarding bank supervision, if the central bank has the responsibility for bank regulation.

The Greece program revealed the conflicting priorities among the involved partners:

- European countries were not meeting their self imposed fiscal deficit targets and were not effectively enforcing their own internal fiscal rules, undercutting their ability to impose conditionality on Eurozone crisis countries.
- Europe looked to the IMF to impose that conditionality, but the IMF is a crisis resolution institution focused on restoring basic macroeconomic stability using traditional monetary, fiscal, financial sector and exchange rate policies. This crisis resolution approach should stabilize domestic finances and limit economic contraction while restoring debt sustainability.
- In the past, the IMF left longer term 'structural' measures, such as labor market, pension, or judicial reform for the country to tackle over time, perhaps with the assistance of other multilateral institutions or bilateral partners. As Greece in particular made little progress in these areas needed for fiscal sustainability, the IMF included such structural reforms in its programs. Without sufficient funding or debt relief to cushion the economic downturn, political support for reform dissipated and Greece's program performance fell short.
- As these internal inconsistencies became more obvious, EU and Eurozone institutions nonetheless insisted that their own institutions be repaid, putting pressure on the IMF to join in financing packages.
- Greece delayed repayment to the IMF briefly in 2015 and fell into arrears. The ESM ultimately found a way to enable temporary financing for Greece, which allowed Greece to repay the IMF. But European partners' seeming disregard for the IMF's preferred creditor status, or top ranking among all creditors, raised concerns regarding Europe's willingness to recognize the IMF's paramount role.

The Eurozone as a monetary union creates unique challenges for the IMF. Under the IMF Articles of Agreement, each member country is entitled to seek financial assistance, recognizing that the IMF imposes conditions on that lending in order to achieve economic viability and secure high probability of repayment. Countries come to the IMF to borrow foreign exchange, the global reserve currencies that the country needs to pay for imports or service its external obligations.

The ‘foreign exchange’ the European crisis countries needed was their own domestic currency, the Euro, created by their own central bank, the European Central Bank. In that respect, it was unprecedented for Eurozone members to borrow Euros, a global reserve currency, from IMF members which are not part of the Eurozone and which hold Euros as part of their foreign exchange reserves. Eurozone members should be able to secure Euros directly from their own central bank, the ECB, which creates Euros for its members.

IMF Staff View of Lending to Greece

The IMF staff have undertaken several reviews of their European programs, the most recent being the Ex-Post Evaluation of the 2012 IMF Greece Extended Fund Facility which was published this past winter. Included below are some of the key concerns raised by IMF staff in this recent review:

- IMF staff are not certain that they have the information needed to evaluate the health of Greece’s banks, due to fears that European regulators are not sharing all the relevant information. They are also concerned that European policies regarding bank regulation may not coincide with measures that IMF staff feel are needed to address banking sector weakness.
- IMF staff note that few countries have maintained very tight fiscal policies for many years, as the European partners are assuming Greece will do to achieve debt sustainability. Staff also worry that insufficient attention is being given to broadening the tax base and instead EU partners push higher rates on a small base, further reducing producer incentives to invest or hire new workers.
- IMF staff point to Greece choosing to repay other creditors while briefly falling into arrears to the IMF in summer 2015, contrary to the Fund’s internationally respected preferred creditor status. The European Stability Mechanism (ESM) includes in its treaty recognition of the IMF’s priority status among creditors, but this does not cover the bulk of the European partners’ financing for Greece, which predates ESM lending to Greece. Europeans condition future support on Greece continuing its agreed economic reforms. That provides little assurance if Greece falls short and European partners cease providing new financing, as happened when Greece fell into arrears to the IMF in 2015.
- Finally, staff note that the IMF still has not established a policy for lending to countries that are in a monetary or currency union.

Next steps for the IMF

The IMF is planning to discuss these concerns this summer, according to its work program, which includes conditionality in currency unions among policy items for Executive Board consideration. Development of a Fund wide policy is past due.

In sum, just as the IMF has formalized its approach on exceptional access (or large programs) the IMF should formalize its approach to program countries in reserve currency monetary unions. This could help restore the IMF’s principle of uniformity of treatment among all its members.

The approach should include a process for the IMF to participate in formulating the country's economic reform program and monitoring its performance, without necessarily providing financial support.

If the country requests IMF financing (a right established in the IMF's Articles of Agreement), the monetary union should respect the IMF's lead role in program design and debt sustainability assessments.

An IMF policy on conditionality in currency unions should include the following elements:

- The role of the central bank – the monetary union central bank should include the borrowing country in its normal monetary policy operations;
- The role of currency union fiscal institutions – these institutions should specify the resources and timing of flows that will be provided to the borrowing country, ranging from loans to public investment commitments;
- The role of the currency union's banking regulator – regulators should specify the nature of their supervisory requirements and range of their support to a borrowing country's banking sector and importantly, share data with the IMF and defer to the IMF's policy conditionality requirements;
- The IMF financing role – the IMF contribution to a financing package should be relatively small. A return to shorter term standby arrangements, instead of extended fund facilities with 10 year maturities, should be expected and the levels of IMF financing should be kept within normal limits.
- Program conditionality should adhere to IMF norms and currency union institutions should defer to all IMF requirements.
- The currency union's members and lending institutions should explicitly recognize the preferred creditor status of the IMF, including with regard to their earlier disbursements.

Conclusion

The IMF, European creditors, and Greece have agreed on Greece's policy package for the next year, now before Greece's Parliament. Discussions are ongoing as to the extent of the commitments the European creditors will make at this time for future debt relief for Greece. As noted above, the IMF is insisting on more specificity in order to assess whether Greece will achieve debt sustainability.

The Europeans remain reluctant to provide concrete promises, stating that Greece could achieve debt sustainability by adhering to tight fiscal positions for many years, which the IMF does not believe is feasible or desirable. These divergent positions reinforce the conclusion that the European partners should finish the last year of the Greece program without the IMF, as they have managed to do for the past two years. European institutions can facilitate financing to enable Greece to meet debt payments this summer, as they did in 2015.

A European decision to assume full responsibility for restoring Greece's economic vitality could be a first step in recognizing that the long term viability of the currency union rests on the

members becoming a union and not a collection of widely divergent economies. The new President of France has made some suggestions to move towards centralized fiscal activities, although Germany and other stronger economies remain reluctant to centralize more government activities in European Union institutions.

Taking initial steps towards a fiscal union could lead to a strong *European* economy instead of a group of a few exceptionally strong economies carrying several economically weaker partners. German recognition that a successful union will entail more internal sharing along with France's commitments to its own needed structural reforms could form the basis for a stronger future Europe, which would contribute to higher global growth and financial stability benefiting all countries.

The IMF cannot deliver that, only European citizens and their governments can.