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Lessons Learned From Greece

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OVERVIEW

Bottom Line: Recognizing that the recent debt restructuring was insufficient to restore Greece's creditworthiness, the IMF will likely toughen conditions for lending to countries with unsustainable debt levels.

What is in the espresso at the International Monetary Fund (IMF)? In well-publicized discussions of debt restructuring and the Greek crisis, the IMF has shown refreshing candor and clear-headed analysis of what has gone wrong. The Fund readily admits that mistakes were made, to which European policymakers have taken offense. Beyond the headlines, the reports provide hints of how the Fund's involvement, and the broader strategy for resolving debt crises, is likely to evolve in coming years. Mostly, the change is for the better.

Too Little, Too Late

The IMF's core insight is that recent debt restructurings have come too late and have often been insufficient to restore creditworthiness. The answer in some cases is to pull the plug earlier. For example, the Fund acknowledges that Greece deserved support in 2010 despite severe doubts about creditworthiness (doubts that could have been more properly acknowledged at the time), and that a restructuring should have taken place in early 2011 when it became clear the bailout program was failing. The 200-billion-euro sovereign debt restructuring did not occur until February 2012.

Where solvency is uncertain but risks are high, the alternative would be to extend maturities and keep creditors at the table until success or failure becomes clear. In some cases, that can include "moral suasion" (e.g., Korea in 1997); in other cases it can involve more formal agreements to maintain exposure (e.g., the Vienna Agreement for coordinating commercial bank exposure to eastern Europe in 2009). The Fund also sees merit a restructuring that extends maturities on similar terms so official funds don't go to financing the exit of private creditors—a "light dusting" restructuring in the words of law professors Lee Buchheit and Mitu Gulati. Time will tell whether a subsequent restructuring will be needed to achieve debt sustainability. Last week's €1 billion bond exchange by Cyprus showed this approach in action.

THE POWER OF YES

A second set of arguments questions whether fear of contagion, the time needed to build firewalls, or the desire to put off hard choices is delaying smart policies. In his play about the financial crisis, *The Power of Yes*, David Hare commented on the inherent allure of deal-making in the private sector and the optimism it engenders that all can go well. So, too, for international rescue efforts. It will nearly always be the case that countries on the precipice

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of default will see the temptations of deal-making as a route out of their problems and plead for a chance to make good. Faced with the possibility of a successful deal, it is difficult for the official community to say to countries “no, we don’t believe you can make it,” especially when faced with severe risks of contagion. Thus, there will always be a built-in bias toward giving the country another chance. Similarly, countries will put off hard choices when “friends with money” are willing to finance the delay. This scenario is as true in Egypt, where aid from countries in the region is allowing the government to delay agreement with the Fund on a sustainable energy and food-subsidy program, as it is in Europe. Particularly at a time of systemic crisis, when creditor countries may flinch at taking tough stands for fear of contagion, the risk of delay rises.

A PROBLEM WORTH FIXING?

The Fund’s argument that the recent experience with debt restructuring reflects a problem with markets that requires a policy change is problematic. Absent a few well-publicized cases (e.g., Angola and Argentina), holdouts and litigation have not been an important deterrent to getting deals done or countries achieving their macroeconomic objectives. The Fund fears the upcoming decision in Argentina’s legal battle in New York courts will change that. But it is hard to argue the current approach of market-based debt restructuring is failing. In fact, government sensitivities about holdouts, especially in Europe, are more likely behind the current drive to punish “vultures.”

“ITS STATED POLITICAL PREFERENCE”

The Fund’s admission of fault about its involvement in Greece further stirred the pot in Europe. Its report blames excessive optimism about economic growth for contributing to other misjudgments about fiscal policy, financial sector stress, the capability of the government to implement structural reforms, and debt sustainability. The analysis brought a sharp reaction from Olli Rehn, the European Union’s economic chief, who complained, “I don’t think it’s fair and just for the IMF to wash its hands and throw the dirty water on the Europeans.”

The report highlights a number of successes with the program, including strong fiscal consolidation and pension reform. And, in classic Fund speak, it notes that “Greece remained in the euro area, which was its stated political preference.” What it does not do is make a convincing case that Greece benefits from remaining there.

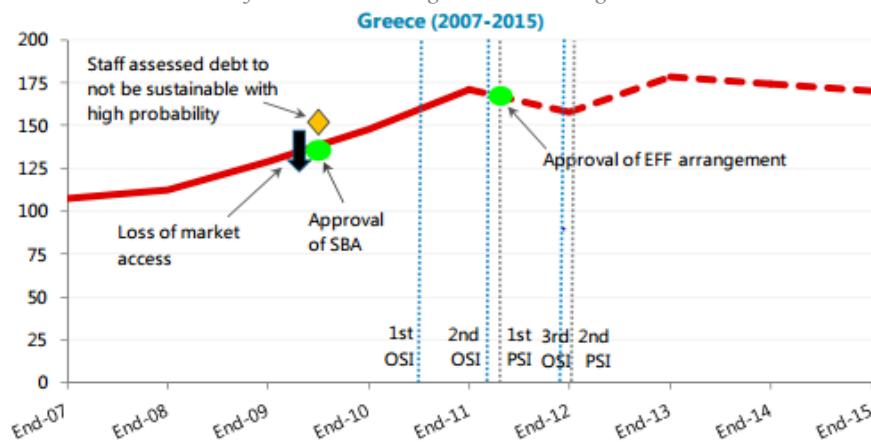
It is surprising that Greece has not yet left the eurozone. The country has endured through a profound economic depression. Gross domestic product fell by 22 percent between 2008 and

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2012, unemployment increased to about 27 percent in the same period, and prospects for growth remain distant. The program remains on track for now, but a financial gap of around 4 percent of GDP remains to be filled, and, even the Fund admits, more debt relief will be needed to restore a viable debt path toward the Fund's target of 110 percent of GDP in 2022. Even if this is achieved, something on the order of 60 percent is more reasonable for Greece. Ultimately, however, Greece will likely decide to leave the eurozone, and the subsequent depreciation and financial distress, though painful at the time, will set the basis for recovery.

Public Debt-to-GDP and Timeline of Debt Restructuring and Fund Arrangements:



Source: imf.org

THE WAY FORWARD

All this suggests that the Fund will act differently in future crises. A bitter divorce, however, is unlikely: the Fund will remain engaged in Europe and will still provide financing to countries in need. But there will be changes. The Fund will likely support strengthening binding rules for dissident creditors (collective action), and is likely to toughen up the conditions for lending when debt sustainability is in question. This is likely to be seen in an IMF threat to cut lending to Greece if there is not a fix for a shortfall in the financing of its program, which has resulted from European central banks being unwilling to take previously expected haircuts on their debt holdings. And they are likely to modify or eliminate their rule (put in place for Greece) allowing extra IMF funding when contagion is a concern. All these are important steps toward a better framework that reflects lessons learned from past mistakes.

Looking Ahead: Kahn's take on the news on the horizon

Greek Aid Cutoff?

The Greek program has a financing gap in 2014. Will the Fund approve a disbursement in July? Perhaps, but a showdown over shortfalls in official aid is coming soon.

China's Shadow Banking Sector

Allowing shadow banks to fail could be a sign of needed discipline, or the canary in the coal mine for bigger problems.

The Fed's Unemployment Threshold

Expect a debate to heat up on lowering the threshold for exit from 6.5 to 6 percent. Does it matter?