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LAID LOW THE IMF, THE EURO ZONE AND THE FIRST RESCUE OF GREECE

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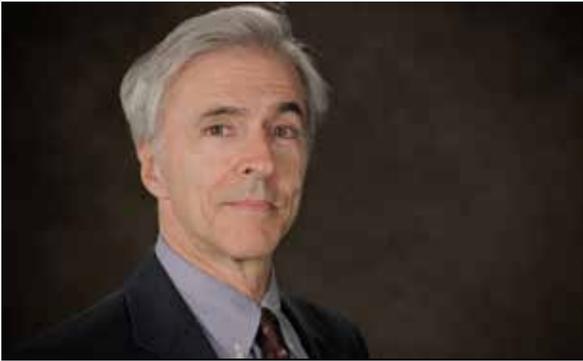


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ABOUT THE AUTHOR



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A native of Washington, DC, Paul attended the University of Wisconsin (B.A., history), before heading to Oxford University on a Rhodes Scholarship, graduating with an M.A. in philosophy, politics and economics in 1975. Paul began his career as a business and economics journalist shortly thereafter, returning to the United States to work as a writer at *Forbes* magazine. He then moved to *The Wall Street Journal*, where he became the newspaper's chief economics correspondent, covering the US Federal Reserve, budget and tax policy. In 1987, Paul moved to *The Washington Post* and began to focus his writing on the global economy, serving five years in the paper's Tokyo bureau and eventually becoming the paper's international economics correspondent in 1995.

Paul is the author of *The Chastening: Inside the Crisis That Rocked the Global Financial System and Humbled the IMF; And the Money Kept Rolling In (and Out): Wall Street, the IMF, and the Bankrupting of Argentina; Misadventures of the Most Favored Nations: Clashing Egos, Inflated Ambitions, and the Great Shambles of the World Trade System; and Off Balance: The Travails of Institutions That Govern the Global Financial System*, published by CIGI in October 2013.

EXECUTIVE SUMMARY

As Greece descended into a financial maelstrom in the spring of 2010, a small group of staffers at the International Monetary Fund (IMF) held top-secret talks with officials from the German and French finance ministries to discuss the idea of restructuring Greece's debt. Many independent analysts believed a restructuring was inevitable because the country's debt burden appeared unsustainable. But instead, the "Troika" — the tripartite group of lenders that included the IMF, the European Commission and European Central Bank — attempted to resolve the crisis by giving Athens bailout loans of unprecedented magnitude, piling debt atop debt. The idea considered in those secret talks would come to fruition only much later, in March 2012, when Greece received the largest debt relief in history. In the meantime, the rescue effort would go terribly awry, with consequences that continue to reverberate today as the euro area struggles with weak growth and a rekindled crisis in Greece.

This paper tells the story of the first Greek rescue, focusing on the role played by the IMF. A detailed look back at this drama elucidates significant concerns about the Fund's governance and its management of future crises. The Fund has come under attack for yielding to the clout of European policy makers and lending its credibility to a rescue that some of its senior staffers viewed with grave misgivings. The result, critics lament, tarnished the Fund's reputation for technocratic judgment, rendering it less effective at promoting international stability.

The 2010 rescue enabled Greece to avoid default at that point, which might well have sparked a global conflagration akin to the 2008 bankruptcy of Lehman Brothers. European banks holding Greek bonds continued receiving payments of interest and principal for quite a long time thereafter, from the money lent by the Troika. But the interests of the Greek people were arguably sacrificed, and among economists there is widespread agreement that the country's debt should have been restructured much sooner.

In addition to shedding new light on what happened, this chronicle of events highlights the importance of the IMF's acceptance, as a condition of its participation in the rescue, of a "junior partner" role in the Troika. This step is judged in the concluding section as being particularly ill-boding for the IMF's ability to manage future crises, and policy recommendations are offered for alleviating the harm.

INTRODUCTION

At 2:00 a.m. on April 24, 2010, a plane bearing George Papaconstantinou, Greece's finance minister, landed at Andrews Air Force Base outside Washington, DC, leaving little time before an important 7:00 a.m. breakfast meeting at the IMF. Papaconstantinou's trip came amid urgent negotiations in Athens for an international bailout — the first ever for a country in the euro zone — and although the deadline for completing the talks was just days away, he wanted to make sure he had a firm understanding with Greece's rescuers about what they expected from the Greek government and what they would offer in return. The spring meetings of the IMF and World Bank, which were then underway, afforded an excellent opportunity to see the right people.

Joining Papaconstantinou at breakfast that morning were top officials of the institutions comprising the Troika, the tripartite group of crisis lenders with whom he was negotiating: Dominique Strauss-Kahn, the IMF managing director; Jean-Claude Trichet, the president of the European Central Bank (ECB); and Olli Rehn, the European Commission's commissioner for economic and monetary affairs. "It was a very good meeting, in that the three of them — and me — were all champions of a bailout taking shape quickly," Papaconstantinou recalled in an interview, adding that the meeting focused on the amount of funding Greece would get as well as the procedure for completing a deal.

One message was emphatically conveyed in the meeting: there would be no restructuring of Greece's debt. A growing number of independent analysts, seeing market pressures driving borrowing costs on Greek bonds to unsustainable levels, were predicting that Athens would eventually have to obtain relief one way or another from the hundreds of billions of euros it owed to private investors.¹ But the Troika bosses wanted the Greek leadership to entertain no such thoughts.

"It was in the most clear terms, aimed at me: 'George, do not open this issue,'" Papaconstantinou recalled. "I was not a fool. I would never have opened this issue unilaterally, and then be told, in the media, that it is not an option, and have all the investors running for cover in 24 hours. It was a very delicate situation."

Unbeknownst to Papaconstantinou — and the other principal officials in the room, except Strauss-Kahn — a debt restructuring was being actively explored at the IMF, though in the most *sotto voce* way imaginable. A small group of Fund staffers held secret talks that spring, outside of Fund headquarters to avoid attracting notice, with officials from the German and French finance ministries.

Only much later, in March 2012, would the idea discussed in those talks come to fruition, when Greece was granted the largest debt relief that any country has ever received. First, the Troika would attempt to resolve the Greek crisis by giving Athens bailout loans of unprecedented magnitude — an effort that would go terribly awry.

This is the story of the first Greek rescue. Its consequences reverberate today as the euro area struggles with weak growth and a rekindled crisis in Greece, where a half-decade of economic misery led to the electoral victory of a radical left-wing party in early 2015. Fateful decisions taken in the spring of 2010 are in no small part to blame for this dismal outcome. The 2010 rescue enabled Greece to avoid defaulting on its obligations at that point, which some policy makers and analysts believed would have sparked a financial conflagration akin to the bankruptcy of Lehman Brothers. Greece's legitimate interests, however, were arguably sacrificed in the process; though bound to undergo privation, the Greek people almost certainly suffered substantially more than was necessary, as the nation's economy contracted by 22 percent since 2008 and the unemployment rate soared above 27 percent. Debt was piled atop existing Greek debt — much of it at steep interest rates — and the already-slumping economy staggered further under the impact of belt-tightening measures demanded by the Troika in exchange for the rescue loans Athens received. Among economists, there is widespread agreement that Greece's debt should have been restructured much sooner, with some contending that 2010 would have been the ideal time.² A case can be made that because of the delay in dealing decisively with Greece's debt, the euro-zone crisis overall was more severe and prolonged than it ought to have been. Indisputably, the bailout proved a boon to many European banks, which received payment in full and on time on tens of billions of euros worth of Greek bonds in 2010, 2011 and early 2012. Their gains, however, were essentially subsidized by taxpayers who had to bear the burden and the risk of the official loans extended to Athens.

The main focus of this paper is the role played by the IMF, whose actions are examined in far greater depth than has been heretofore available. Many books and articles about the euro-zone crisis have reported at length on the machinations of top European policy makers, which are of particular interest to readers living in the euro area. This paper, by contrast, dwells on the IMF, because doing so imparts a more global perspective to events and because people everywhere — not just Europeans — have an enormous stake in nurturing a healthy multilateral institution capable of fulfilling its lofty mission. Founded seven decades ago when memories of the mutually-destructive policies of the 1930s were still fresh, the Fund

1 See Beattie (2010). For a specific example of one gloomy assessment, see Lachman (2010).

2 For insightful analyses of this issue, see Zettelmeyer, Trebesch and Gulati (2011) and Xafa (2014).

fosters international economic cooperation and serves as chief guardian of global financial stability. In so doing, it provides what academics call “global public goods,” from which all nations broadly benefit and which no single nation can deliver alone.

A detailed look back at the Greek drama of spring 2010 elucidates significant concerns about the IMF’s governance and its future management of sovereign debt and economic crises. The Fund has come under attack for yielding to the clout of European policy makers and lending its credibility to a rescue that some of its senior staffers viewed with grave misgivings. The result, critics lament, inflicted damage on the Fund’s long-run ability to serve as an independent arbiter and fixer of economic and financial problems; after all, the more tarnished the Fund’s technocratic judgment is by evidence of gross political interference, the less effective it can be at promoting international stability.³ Moreover, the perception that the IMF was doing Europe’s bidding inflamed tension over the Fund’s long-standing governance problem — the disproportionate share of voting power that European countries hold relative to their economic size, the overrepresentation of those countries on the Fund’s executive board and the control Europe has exercised over the managing directorship. This problem undermines the Fund’s legitimacy and is a festering source of resentment among the world’s rising powers, notably the BRICS (Brazil, Russia, India, China and South Africa).

Some of the most scathing criticism about the IMF’s approach in the spring of 2010 has been aimed at legal acrobatics that Fund officials performed to facilitate the first Greek rescue. Up until then, the Fund was operating under a set of restrictions that for simplicity’s sake might be called the “No More Argentinas rule,” because it was adopted following one of the Fund’s worst debacles in history — an effort in 2001 to rescue Argentina that ended in a catastrophic default a few months later. With the aim of preventing the IMF from ever again heaping fresh loans on a country so unlikely to pay its debts, the Fund board established criteria in 2003 that a country receiving a large loan would have to meet — one criterion being “a high probability” that the country’s public debt is sustainable, based on “rigorous and systemic analysis” (IMF 2003). But when the Greek crisis arose, the Fund created a last-minute loophole in the restrictions at the same time as it was approving the first rescue. Susan Schadler (2012a), a former deputy director of the Fund’s European Department (and a CIGI senior fellow), has accused the institution of having “bowed to short-sighted pressure from Europe” in making this rule change, arguing that as a result, “the IMF was set adrift” from sensible discipline over its lending.⁴ That could make future crises more difficult to handle, and it

deals a setback to hopes for an orderly system of dealing with over-indebted countries.

Beyond the rightness or wrongness of the IMF’s approach is another controversy about what the Fund actually did. The Fund issued a post-mortem in mid-2012 acknowledging a number of its own mistakes in the first Greek rescue, notably over-optimistic growth assumptions. The report also pointed the finger at European officials for the length of time Greece remained laden with excessive debt, asserting: “An upfront debt restructuring would have been better for Greece although this was not acceptable to the euro partners” (IMF 2013). That contention drew outraged rebuttals from Brussels and Frankfurt, with a number of officials accusing the Fund of historical revisionism. “I do not recall the IMF’s managing director Dominique Strauss-Kahn proposing early debt restructuring,” Rehn said, “but I do recall that Christine Lagarde was opposed to it.” (Rehn quoted in Spiegel and Hope 2013). (Lagarde, who succeeded Strauss-Kahn in mid-2011, was French finance minister at the time of the first Greek rescue.)

The account that follows is based on interviews with dozens of key participants as well as IMF documents, some of which the Fund has released publicly and some of which it has not.⁵ In addition to shedding new light on what happened, this chronicle of events helps explain the reasons for the IMF’s actions, thereby providing fresh grounds for questioning whether the Fund did the right thing for Greece and for the long-term good of the global economy. It highlights the importance of the IMF’s acceptance, as a condition of its participation in the rescue, of a “junior partner” role in the Troika. This step is judged in the concluding section as being particularly ill-boding for the Fund’s ability to manage future crises, and policy recommendations are offered for alleviating the harm.

At the centre of the story stands Strauss-Kahn, the former French finance minister whose dynamic persona, combined with economic and political astuteness, gave him formidable powers of persuasion on the international scene. The actions he took in the spring of 2010 and the thinking behind them receive major new illumination in this paper, but his true intentions ultimately remain a bit of a mystery, because he was keeping his cards so close to his chest as he parlayed among conflicting interests and views.

5 To the extent documents are available in the public record, source information will be given in this paper, but not for documents unavailable publicly. As for interviews, nearly all were conducted on a “deep background” basis, with interviewees assured of confidentiality unless they gave permission to be quoted, the purpose being to encourage candor about sensitive matters. In cases where permission for quotation was requested and granted, interviewees will be identified to the extent they have permitted, but source information about other material obtained from interviews will not be disclosed.

3 See, for example, Mandeng (2013).

4 For fuller treatment of this subject, see Schadler (2013).

One oft-heard theory is that, as a leading potential candidate of the Socialist Party for the French presidency, Strauss-Kahn was using his IMF position to further his political ambitions. He surely laboured under an implicit conflict of interest, because he would have been loath to take actions at the Fund that might have upset French voters. But this paper offers no support for suspicions that he allowed his personal interests to cloud his judgment; no one provided me with a shred of convincing evidence that ethical dilemmas of that sort arose. If anything, the evidence strongly suggests that Strauss-Kahn was motivated by a desire to do what he thought best for the institution he led. He was deeply concerned about making sure the IMF participated in resolving the crisis, because the Fund had just undergone its own institutional crisis — a crisis of relevancy — during a period from roughly 2003 to 2008 when financial markets were buoyant and international rescues almost non-existent, raising questions about whether the world needed an institution like the Fund.⁶ For the IMF to be kept out of the euro zone, which some powerful European officials preferred, would have been “lethal” to the Fund, as Strauss-Kahn put it in one interview with me.

The IMF’s complicity in the rescue might therefore be deemed a Faustian bargain of sorts. To become involved in the Greek crisis, the Fund had to overcome strenuous opposition from European officials who felt that their region ought to handle its own problems without international help. In the process, the Fund accepted subordinate status in the Troika. As with many such bargains, the hope at the time was that the costs would be less oppressive than they eventually proved to be. But the IMF — and the global financial system it oversees — may be paying the price for years to come.

THE FIRST SOS

Scion of a famous family of Greek Socialist politicians — both his father and grandfather had served as prime ministers, and his father had founded the Panhellenic Socialist Movement (PASOK) — George Papandreou had a natural affinity with Strauss-Kahn, whom he had met several times in gatherings of left-leaning European leaders. So in late 2009, after ascending to the prime ministership himself, Papandreou began a series of conversations with the IMF managing director, mostly by phone, about the challenges Greece was facing.

The two men had a lot to discuss. Since joining the euro in 2001, the Greek government had taken advantage of the low interest rates that came with being part of an established currency union, and borrowed its way into deeper and deeper trouble — more than €300 billion of debt

by the end of the decade. Moreover, it had done so without properly accounting for its profligacy, as became shockingly clear in mid-October 2009, when Papandreou’s newly elected government disclosed that Greece’s budget deficit for that year would be upwards of 12.5 percent of GDP, more than triple previous estimates. Although this revelation suited the Socialists’ political interests — they could point fingers at the previous centre-right regime for dishonesty — it also squared with the background and personality of Papandreou, a US, UK and Canadian-educated man who put great store in transparency and good governance. The same was true of Papaconstantinou, his finance minister, a London School of Economics Ph.D. whose rimless glasses enhanced his technocratic demeanour. They got kudos from their European colleagues for their candour, but having drastically revised the deficit estimates, they had to deal with the consequences. The newly disclosed data sparked nervousness in the financial markets that Greece’s debt could swell beyond the government’s capacity to repay.

Over the previous six years, the ratio of Greek government debt as a proportion of GDP had hovered in the 95–99 percent range — high compared to most euro-area partners, but stable. Suddenly, the ratio was being adjusted upward to 115 percent of GDP for the end of 2009,⁷ and there was no telling how much higher it might go in the future. Greece was obliged to pay much steeper interest rates on new bonds than it had during its economic heyday in the years following its entry into the euro zone; moreover, the economy was hobbled by recession in 2009, as was much of Europe in the wake of the global financial crisis. So the debt-to-GDP ratio was bound to rise, which might cause markets to become even more jittery and raise the country’s borrowing costs still further. At the extreme, the country could get caught in a vicious cycle, called “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 stagnates, and keeps trying to borrow more until eventually being overwhelmed by mushrooming demands for interest and principal.

The obvious first step for an over-indebted country, just as for an over-indebted individual, is to cut spending and raise income. That was exactly what Papandreou repeatedly vowed to do in late 2009 — specifically, to shrink the budget deficit by 2013 to below three percent of GDP, the ceiling set under the euro-zone treaty. Despite his pledges to freeze public sector wages and raise substantial

⁶ For more background on the period leading up to the euro-zone crisis, see a companion paper by the author, Blustein (2015).

⁷ The ratio for year-end 2009 was adjusted again later, after additional scrutiny of government spending and revenue data, to 130 percent of GDP. In later years, the ratio rose much further, but not because of data revisions.

new tax revenue, markets were unconvinced about the government's ability to achieve sufficient deficit-reduction measures to bring the debt under control; for one thing, PASOK was under intense political pressure to keep campaign promises for increased welfare spending. In December, the three major credit-rating agencies (Moody's, Standard & Poor's and Fitch) all downgraded their ratings on Greek debt. Investors who had once happily snatched up Greek bonds were refusing to continue holding them unless compensated for the risk with higher yields. The result was a steady climb in interest rates that, by the end of January 2010, reached the seven percent range on Greek 10-year bonds. That was roughly twice the yield on equivalent German bonds, and a level of borrowing costs that Athens could not afford for long.

Previously unthinkable outcomes for Greece became the subject of speculation in market analyses and media reports — one grim but all-too-plausible scenario being a default on interest or principal payments. The endgame that inspired the most dread was abandonment of the euro, because of the hellish chaos that would ensue, both for Greece and economies elsewhere. A handful of economic commentators were arguing that Athens ought to leave the monetary union and bring back the drachma, because by adopting the euro, Athens had given up control over its own money supply and interest rates, as well as the ability to gain competitive advantages by cheapening its currency. But the overwhelming consensus was that the costs of quitting the euro would far outweigh the benefits. It was not hard to imagine, for example, the fierce and convoluted disputes that would arise over contracts between Greek companies and firms elsewhere in the common currency area. Were the Greek parties still obliged to make payments in euros (which might bankrupt them) or could they legally pay in drachma (which might entail huge losses for their European counterparties)? Since no laws had been written to cover such an eventuality, whose courts would decide, and what basis would they use for rendering judgment? Even more nightmarish was the prospect that, once the taboo of quitting the monetary union was broken, other vulnerable countries would be forced out too, as their terrified citizens shipped their money to banks in safer havens such as Germany. A full-blown economic collapse in Europe, far-fetched though it might seem, no longer seemed beyond the realm of possibility.

All this was the backdrop for Papandreou's conversations with Strauss-Kahn. The prime minister and his advisers knew that any government, including theirs, would pay a terrible political price for throwing itself on the mercy of the IMF, but they wanted to explore all options and thought the managing director might at least have a sympathetic approach. Besides having a friendly relationship with Strauss-Kahn, Papandreou also knew that the Frenchman had been moving the IMF in new directions during the 2008-2009 crises in Eastern Europe, relying less on the

Fund's traditional prescriptions of strict austerity for financially distressed countries.

The talks quickly led to the IMF's Fiscal Affairs Department sending technical assistance missions to help Athens improve its tax collection and public management policies. But Papandreou and Papaconstantinou had a separate, much more pressing concern: what if market sentiment toward Athens turned so negative that the government was unable to raise fresh funds at any reasonable cost? Greece needed to borrow more than €50 billion in 2010 to pay off maturing bonds and keep paying salaries and pensions; suppose the government could not obtain the money from private sources? Who, if anyone, would lend to Greece in such a pinch, and calm the markets by showing that there was no question of default? Might the IMF do it?

The public position of the Greek government, of course, was that emergency aid was not being considered, and European officials were equally adamant on that score, the Germans in particular. The treaty underpinning the euro contains a provision popularly dubbed the "no bailout clause," which states that neither the EU nor its member states shall "be liable for or assume the commitments of" other governments. In the view of German officials, as well as other European policy makers, the only viable option for overcoming Greece's financial strains was resolute action in Athens. Since the prospects for European aid appeared dim, the Greek leaders wanted to know whether Fund assistance might be available if worst came to worst. The answer was not as comforting as they had hoped.

First of all, Strauss-Kahn told them, Greece would need much more money than the IMF could provide. Although the Fund had undergone a substantial financial upsizing in 2009, there were constraints on the amounts the institution could lend to a single country.

"And Strauss-Kahn had a second point," Papaconstantinou recalled. "He said there was no way the IMF could make a loan to us without European agreement — if for no other reason than the Europeans control more than 25 percent of the [Fund's] board."

An IMF role in the Eastern European crises was one thing. Inviting the Washington-based institution to help rescue a euro-zone country was another. Some extremely powerful Europeans opposed the idea — in particular, one man whom even Strauss-Kahn held in a measure of awe.

GAINING ENTRÉE ON JUNIOR PARTNER TERMS

Central bank heads, being entrusted with the sacred responsibility of keeping money sound, are renowned for their rectitude, and few if any surpassed ECB president Jean-Claude Trichet in that regard. Having risen in the late 1980s to the pinnacle of the French civil service as

director of the Treasury, followed by a term as governor of the Banque de France, Trichet had represented his country at nearly all the major conferences that led to the European monetary union, and he viewed the project with almost spiritual reverence. Appointed to the ECB presidency in 2003, he remained keenly aware that the central bank he headed had been established, and enshrined in treaty, on the model of Germany's Bundesbank — that is, with primacy on price stability, independence from political pressure and a ban on using money-creation powers to finance government borrowing — all of which Germany had demanded as the price for surrendering the Deutschmark. Although courtly and cultivated, Trichet does not shrink from expressing his wrath, sometimes at high-decibel levels, especially when denouncing opinions that he perceives as threatening the principles and institutions he has spent his life building and defending. And IMF involvement in the rescue of a euro-zone country, he believed, could pose just such a danger.

His allies on this issue included nearly all of the leading players in the European establishment. The most notable among them were French President Nicolas Sarkozy, European Commission President José Manuel Barroso, EU Economic and Monetary Affairs Commissioner Olli Rehn, Euro Group President Jean-Claude Juncker and German Finance Minister Wolfgang Schäuble. German Chancellor Angela Merkel was ambivalent, at least in the early weeks of 2010, as was Christine Lagarde, although as Sarkozy's finance minister she loyally followed his lead, saying publicly at one point that the IMF had no more business lending money to Greece than it did to California, since each belonged to a single-currency area (Barber 2010a).

In many ways, this aversion among European chieftains to the idea of IMF intervention 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 European institutions were too weak and ineffectual to sustain the monetary union experiment. IMF loans, as they saw it, were for poor and emerging countries, not members of a currency zone with income and wealth levels comparable to those of the United States.

Trichet and his ECB colleagues had their own, supplementary reasons for resisting IMF involvement. The Frenchman feared that if European governments saw the Fund riding to the rescue of Greece, it would diminish their own willingness to take responsibility for what needed to be done to overcome the crisis. Also of concern in the Eurotower, the ECB's Frankfurt headquarters, was the possibility that the central bank's cherished independence might be compromised. IMF programs almost invariably come with conditions requiring the affected nation's

central bank to change policy in one way or another — raising interest rates, for example.

The forces opposing IMF involvement were at first winning the day as Europe struggled in early 2010 to formulate a response to the markets' unrelenting assault on Greece. The first big test was a European leaders' summit on February 11 in Brussels, which came days after a scary market sell-off indicating that Greece's ills were infecting economies elsewhere; the cost of insuring the Spanish and Portuguese governments against default surged to record levels. At this stage, Europe was riven by fundamental differences between Paris and Berlin that would continue long thereafter to colour the debate about how to handle the crisis.

The French vision, championed by Sarkozy with characteristic impetuosity and melodrama, put primacy on "solidarity" among euro-zone countries. In Sarkozy's view, plenty of money should be forthcoming from European institutions to assure markets that Greece had the necessary backing to avoid disaster, and Greek reform efforts should also be overseen by those European institutions. It was not that the French president and his team held warm, fraternal feelings for Greece. They cared much less about what happened to the Balkan nation than they did about the implications of the Greek crisis for bigger countries in the euro zone, specifically Italy; if markets perceived that the bloc lacked the solidarity to keep one of its own member states financially afloat, Italy might be the next victim, and the euro would be in mortal peril. A logical corollary to this line of thinking was that the IMF had no substantial role to play; indeed, its involvement would be inimical to the concept that euro-zone membership conferred privileged solidarity.⁸

German leaders had almost diametrically opposite ideas, stemming from their long-standing wariness about European unity leading to a "transfer union" in which taxpayers of big, rich countries would subsidize less-prosperous member states. The Germans, together with like-minded policy makers from Northern European countries such as Finland and the Netherlands, wanted the no-bailout clause taken seriously. This was not a matter of petty stinginess. Writing Athens a fat check, in Berlin's view, would lead to the worst sort of moral hazard — that is, it would reward bad behaviour, create incentives for more and reduce or even eliminate incentives for reform. And since no European check of any fatness was conceivable without German backing, Merkel easily rebuffed Sarkozy's fervid demands at the February 11 summit to put a large sum on the table. In an effort to

⁸ Sarkozy also had an implicit conflict of interest that was a mirror image of Strauss-Kahn's, because IMF involvement could transform his political rival into Europe's saviour. But people who were advising Sarkozy at the time maintain that this was not an important motivating factor for him.

soothe market jitters, the leaders' statement declared that member states "will take determined and coordinated action, if necessary, to safeguard financial stability in the euro area as a whole" (European Council 2010a). Although this language marked a step toward providing a rationale for a possible rescue, investors were unimpressed, seeing little sign of any agreement about how bailout funds might be mobilized.

But on the IMF issue, the Sarkozy-backed view prevailed. The leaders implied they would relegate the Fund to a sort of advisory role, in which its "expertise" would be sought in helping European Commission economists monitor Greece's economic and budgetary policies. This news evoked gloom at IMF headquarters; staffers wondered whether their institution, having only recently regained relevance, might be heading back to its bad old days when it was publicly derided as "slipping into obscurity" (King 2006) with "not even a cat to rescue" (*The Economist* 2006).

In public, IMF officials assiduously avoided pressing for a big role in Greece or giving any hint that they were yearning for an invitation to provide major assistance. Strauss-Kahn was frequently asked by reporters about possible Fund involvement in a Greek rescue; he routinely responded, in diplomatic terms well-attuned to the mentality of European leaders, that although the IMF always stands ready to consider a request from a member country, it had received no request from Greece, and he understood the desire in Europe to sort out the region's problems without outside interference (Strauss-Kahn 2010).

Behind the scenes, however, Strauss-Kahn was doing whatever he could do to assuage the Europeans' worst worries and objections to IMF involvement. Anxious to avoid exclusion from participation in the crisis-fighting effort, lest doubts arise anew about the Fund's *raison d'être*, he made it clear that the Fund would accept a sort of junior partner status. It had done so for the first time during a late-2008 crisis in Latvia, when officials of the European Union — to which Latvia belonged — strongly disagreed with the Fund about the way to handle Latvia's pegged foreign exchange rate, and insisted on putting up the bulk of the rescue loan so they could get their way on the currency issue.⁹

The managing director's reasoning was as follows: The IMF would bring expertise and credibility to the task of managing 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 percent of a rescue loan, perhaps, 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, the second-most powerful central bank in the world, conducts monetary policy for more than 300 million people, only 11 million of whom are Greek. So although Europe had to accept an IMF role, the Fund had to play second fiddle.

Strauss-Kahn told me about a meeting he had at the European Commission with its president, Barroso, together with Marco Buti, the chief civil servant in Brussels for economic and monetary affairs. "I said, 'We have to be in, but you will be the leader,'" Strauss-Kahn recalled. "I told them, 'I want to be the leader myself. I cannot, because for political and logical reasons, I cannot take over the ECB. We will give technical assistance, and some financial resources, but you are leading.'"

Ultimately, the decision came down to one person — Merkel. The German chancellor, although famously cautious and deliberative, tends to be immovable once she feels she has mastered a subject. And in the weeks after the February 11 summit, as she weighed both economic and domestic political considerations regarding the IMF, her position hardened to the point where she deemed it imperative to overrule her fellow European leaders.

Ideal as it might be for Europe to be able to handle the crisis on its own, its institutions — specifically, the European Commission — were nowhere near up to the challenge, Merkel believed. For all the professionalism of the eurocrats who toiled in Brussels' high-rise offices, the commission lacked the program-designing skills of the IMF; more importantly, the commission had shown itself to be too cozy with European politicians and too timid about offending them. The German public, which was overwhelmingly negative toward rescuing a country that had clearly gotten itself into a mess, would never accept an emergency loan 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 that description. All in all, involving the Fund in the rescue of Greece was not only desirable from Merkel's perspective, it was essential if Berlin was to provide support.

Even so, weeks passed, financial agitation intensified and Greece's predicament worsened before a concrete plan of action emerged. The anti-IMF forces finally had to yield at a European summit on March 25, where Merkel made it clear that excluding the Fund was untenable. The leaders' statement contained a pledge that, if necessary, Greece would get a "package involving substantial International Monetary Fund financing and a majority of European financing" (European Council 2010b). This didn't mean that actual money was being disbursed; the leaders were clinging desperately to the hope that Athens, through its own budget-cutting efforts, would win back the confidence of investors. To avoid violating the spirit of the no-bailout rule, a number of conditions were attached: Aid would be

9 For more on the Latvian episode, see Blustein (2015).

given only to protect the stability of the whole euro zone (not, in other words, as a favour to Greece). The European portion would be in the form of bilateral loans extended by individual member states, all of whom would have to approve. Interest rates on the European funding would be “non-concessional” — these were loans, not gifts.

At last the IMF was in, albeit on junior partner terms. This status would require considerable mental adjustment.

“A STRANGE DOG’S BREAKFAST”

Normally, when an IMF mission chief arrives in a country to negotiate a rescue program, he or she can start meeting with the country’s top economic policy makers almost immediately upon landing in the capital. Not so for Poul Thomsen, the IMF’s mission chief for Greece. A Danish economist with extensive experience working on bailouts, Thomsen was facing a challenge unlike any he had previously worked on. For the Greek program, he first had to reach a common position with representatives from the European Commission and the ECB before negotiating with Greek officials — that was the condition set by European leaders for the Fund’s inclusion. And to make matters worse, when he arrived in Athens on the weekend of April 17-18, 2010, Thomsen learned that his counterparts from the European Commission were stuck more than 2,000 km away. A volcanic eruption in Iceland was spreading so much ash over Northern Europe that it was forcing the closure of airports all over the region, making it impossible for the half-dozen members of the commission team to fly out of Brussels.

By that time, dithering over Greece was no longer a luxury in which policy makers could indulge. A deadline was looming: the Greek government was obliged to pay its creditors €8.5 billion on May 19, and emergency funding was clearly needed to ensure against default. Before receiving that financing, the Greeks had to negotiate the terms of their program, which would involve countless details for how to put their nation’s economy on a long-term sustainable path. The commission team’s inability to fly, therefore, came at a particularly inconvenient moment.

Frantically seeking alternatives to air travel, the commission team procured a van, with the intention of driving to Athens, even though they learned that the trip requires about 24 hours on the road. They left Brussels early on Monday, April 19, and drove past Vienna before hearing that, with special intervention from the Austrian government, they could board an Athens-bound flight from Vienna. So they turned around to catch that flight, arriving in the Greek capital on Tuesday morning.

With that inauspicious beginning, the Troika convened for the first time. The leaders of the teams from the three institutions involved were soon to become household names, or at least household faces, in Greece, where the

local population saw them as the country’s new overlords. In addition to Thomsen, they included Servaas Deroose, a Belgian economist who headed the commission team, and Klaus Masuch, a German from the ECB. So often did they appear on newspaper front pages, and on TV, that their personal safety became of major concern as protests gripped Athens. They first stayed at the Grande Bretagne, a landmark hotel close to Parliament and key government buildings, but on several occasions strikers blocked them from leaving and the police could not, or would not, intervene. A move to the Hilton Hotel made their lives more convenient; it was farther away and had a parking garage, enabling negotiators to travel back and forth from government buildings by car.

For the IMF, this arrangement was more than unusual, it was highly irregular. Although the Fund has a long history of lending alongside other official creditors, such as the World Bank and regional development banks, it has insisted on the understanding that it maintains final say, at least concerning the issues in which it has expertise. In the Greek case, not only was the Fund playing junior partner to the commission — which it had done just one time before in Latvia — it was also sitting alongside the ECB at the negotiating table, facing the Greek team. In typical negotiations with a country seeking an IMF loan, the Fund’s negotiators sit opposite from the central bank and finance ministry, in the expectation that the conditions of the loan will oblige the central bank to adopt certain policies. By contrast, the Fund had to acclimate itself to being the ECB’s confederate in the Athens negotiations — and qualms abounded as the first Troika meetings got underway. “This has the makings of a strange dog’s breakfast,” Morris Goldstein, a former deputy director of the IMF’s research department, told the *Financial Times*. “If a regional grouping can set IMF conditionality, what is the point of the Fund anyway? This could set a very dangerous precedent” (*Financial Times* 2010).

Good crisis management involves contemplating fallback positions — “Plan Bs” — in case the primary approach comes to grief. Within the IMF, a sense of foreboding about “Plan A” for Greece was on the rise, and Strauss-Kahn, wily fox that he is, launched secret channels of discussion about alternative strategies, which will be covered later in this paper. At the same time, however, he felt obliged to support Plan A as far as possible. He was anxious to keep the IMF at the table exerting influence, which meant he had to avoid arousing any suspicion of harbouring an agenda for usurping European prerogatives. As frustrating as this was to some of his subordinates, Strauss-Kahn believed he had little choice, both because of European political realities and the danger of adverse market reaction to signs of dissension.

“The IMF can be a strong institution, but it has a huge limitation: its duty, especially the duty of the MD [managing director], is to avoid creating a mess,” Strauss-Kahn told

me. “We were totally convinced that one of the strengths of the Troika was to appear united. So we couldn’t take the risk of showing any kind of disagreement. Even if we believed something was wrong, I wasn’t going to go to the media and make a statement like, ‘What the hell are they doing!’ In those cases, my institution just shut up. The idea that the Fund ought to be a ‘ruthless truth-teller’ is fine when it comes to the member countries — but not the public.”

AUSTERITY, AMELIORATED?

A policy of *pas devant les enfants* (not in front of the children) regarding internal arguments was also applied by the Troika in their relations with the Greek government. But try as they might to hide their differences, the Troika members did not always succeed, especially when it came to the issue that most sharply divided them — namely, how fast and how rigorously Greece should be required to implement measures aimed at changing its profligate ways.

“They would sometimes be open about their disagreements,” recalled Papaconstantinou, who as finance minister was lead negotiator for Greece. “The commission would say, ‘We’re not on the same page here as the IMF; we need to talk about it and get back to you.’ And we would sometimes talk with them unofficially, on a bilateral basis.”

Conversations with Thomsen, the IMF mission chief, left little doubt in Papaconstantinou’s mind that the Fund was often the Troika’s odd man out, favouring a more gradual approach to austerity than the others — just as the Greeks had hoped, given the less-traditional views that Strauss-Kahn brought to the institution. “But once a decision was taken, the IMF would not second-guess,” Papaconstantinou added. “Poul might say to me on certain occasions, ‘It’s not exactly what I would have wanted, but that’s the decision.’”

Papaconstantinou had an extraordinary vantage point. Not only was he dealing with the Troika in Athens, he was a member of the Eurogroup (finance ministers from euro-area countries), which enabled him to see how his fellow ministers were exerting influence over the commission. Pressure from Germany, he concluded, was the most important factor by far in determining the commission’s position. The Germans enjoyed support from other northern European countries, while other members of the Eurogroup were, in Papaconstantinou’s words, “often hiding under the table,” as they feared their policies would come under assault too.

It was understandable that Germany’s political class and public opinion would insist on the Troika taking an extremely tough line in demanding stringency from Athens. Examples of Greece’s economic irresponsibility were both

abundant and flagrant. The Greek pension system was far more generous than the country could afford, with an official retirement age of 60 and the average pension close to that received by a typical retiree in Germany, where the retirement age was 65. Collection of taxes, both income and value-added, suffered from severe shortcomings; the German press was full of horror stories about tax evasion among wealthy Greeks. And it was not as if Greek society had earned the right to lavish lifestyles; the country’s economy ranked among the least competitive in Europe, as witnessed by a current account deficit — the broadest gauge of the imbalance between imports and exports — that exceeded 11 percent of GDP. All the more galling to Germans was the contrast with their own country’s manifestation of thrift, hard work and other virtues. The German economy had undergone a painful adjustment during the decade from 1998 to 2008, with wages and purchasing power creeping upward at a sluggish pace even as consumption booms and property bubbles were materializing elsewhere. German industry, which had lost its edge during the 1990s following unification between East and West, regenerated itself to world-beating form in the 2000s, and by 2007 the government had brought its budget into balance. Requiring Greeks to embrace a similar regimen struck Germans as only fair — and as a necessity for Greece’s long-term staying power in the euro zone.

The trouble was that proponents of austerity — whose most zealous adherents also included ECB officials — anticipated that budgetary rectitude would generate near-magical benefits. Whereas mainstream Keynesian economic theory holds that slashing government outlays and hiking taxes will worsen a country’s recession by reducing the spending power of ordinary citizens, the extreme pro-austerity view was that if Greece adopted a credibly abstemious fiscal policy, the “confidence effects” would lead to an economic expansion. An almost laughable illustration of this ideology was an agreement the European Commission had struck with Greece earlier in the year, under which Athens pledged a brutally rapid shrinkage in its budget deficit to below three percent of GDP by 2012. The deal envisioned the Greek economy undergoing only a mild contraction in 2010 of 0.3 percent of GDP, followed by three years of steady growth (European Commission 2010).

Notwithstanding its image, the IMF put little stock in such hard-core versions of economic orthodoxy. Fund economists were concerned that too much austerity would be self-defeating, at least concerning the objective of restoring Greece’s ability to pay its obligations. Although a tighter fiscal policy was essential, an overly severe approach would undoubtedly deepen the country’s slump, thereby lowering tax revenue, which would lead to a wider deficit, higher debt and more worries about default. This was especially problematic because European officials, led by Germany, were demanding that Greece pay relatively

high interest rates on the money it would borrow from European governments. Charging high borrowing costs was a way to show that loans to Athens were not subsidies and were, therefore, consistent with the no-bailout rule. But the result would make it all the harder for Greece to keep its debt-to-GDP ratio from exploding.

So instead of the European preference for setting 2012 as the goal for reducing the Greek budget deficit to below three percent of GDP, Fund economists argued for allowing Athens to wait until 2014 — and the other Troika members yielded on that point. Even then, however, the program was going to oblige Greece to undertake one of the biggest changes in budget and tax policy in history, with an indisputably negative impact on economic growth overall. Government outlays would be cut by seven percent of GDP — and to put that in more understandable dimensions, it is a greater amount, as a percentage of the American economy, than the US government spends on Social Security, Medicaid (which provides medical care to lower-income people), military retirement and unemployment insurance combined. Tax revenues would increase by four percent of GDP — and to put that in perspective, it is equivalent to an increase of US\$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 never escape its debt trap. The Greek economy was also in need of a boost in competitiveness. 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 had long been exhorting Greece to embrace such reforms in annual missions staffers make to most member countries. The European Commission had its own, similar list of directives that Athens was supposed to follow. And now that Greece was on its knees, Thomsen and his colleagues in the Troika could insist on their institutions’ advice being followed, by making their aid conditional on Greek implementation. The list was long: Laws protecting workers from firing would be revised, as would policies that gave advantages to unions in wage bargaining. Professions and trades that for decades had enjoyed restrictions from competition — law, auditing, pharmacy, engineering, architecture and road haulage — would be opened up. Licensing and other regulations inhibiting business formation would be scrapped. Bloated state enterprises, such as the national railway and other public transportation companies, would be streamlined.

It was far from certain that these policy changes, if adopted, would rekindle growth any time soon. Arguably, the chances were nil; in the short run, they would

presumably increase joblessness. But their long-term economic merit was hard to dispute, and they could also help Greece achieve another essential goal — an “internal devaluation,” in which production costs decline absent any move in the exchange rate. Latvia was undergoing an internal devaluation, and although the impact on living standards was horrendous, it was showing signs of working, by improving the trade balance. If the Latvians could knuckle down, accept lower incomes and attain a miraculous turnaround in the process, maybe the Greeks could too — or so went the logic of the Troika-mandated reforms.

Recognizing that he was negotiating a wholesale makeover of his country, Papaconstantinou decided he ought to speak directly with higher-ups, to make sure Greece was going to get what it needed for such far-reaching concessions. That is why he departed the negotiating table in Athens, with a promise to return promptly after meeting with Strauss-Kahn, Trichet and Rehn on April 24.

As Papaconstantinou left for Washington, a sell-off in Greek bonds was intensifying, with the yield on 10-year bonds reaching 8.83 percent — a level unseen since the 1990s. The case for debt restructuring was getting stronger. Although Papaconstantinou would not hear the argument from anyone at the IMF, others would.

HAIRCUTS ON THEIR MIND

So clandestine was the scheme hatched by an IMF coterie in the spring of 2010 that even today, people who were intimately involved in working on Greece express surprise upon hearing about it. Extracting details has been difficult; one interviewee whom I asked about it replied, “That is a subject I will not discuss until I die.” This much I can confirm, from multiple sources on both the IMF and European side: with Strauss-Kahn’s encouragement, top Fund staffers met officials from the German and French finance ministries at a hotel in Washington to make the case that a restructuring of Greece’s debt was likely to prove necessary before long.

The IMF was divided, as is clear from a confidential March 24, 2010 memo by Marek Belka, director of the IMF’s European Department, whose members included mission chief Poul Thomsen. In a paragraph discussing the idea of a debt restructuring for Greece involving a “haircut,” the memo said that the European Department believed a haircut “should not even be considered at this juncture,” but “several departments” favoured it.

A haircut refers to a reduction in the amount that a debtor owes to its creditors — a typical method being a negotiated deal to swap new bonds for old ones, with the new ones paying lower principal and interest payments. Such a step is supposed to be taken, of course, only when there is no reasonable expectation that the debtor can make full

repayment, because important principles are at stake in ensuring that contracts to borrow money are honoured. But it is also a well-established financial truth that serious debt problems, left unaddressed, almost invariably burgeon, so if losses are inevitable it is better to take them sooner rather than later. This was one of the lessons of Argentina, where the impact of default was all the worse because of costly efforts to stave it off. Another well-established truth is that if losses are inevitable, it is best to take them in an “orderly” fashion — that is, with creditors well-prepared for reduced payment, and willing to accept it voluntarily — than in a “disorderly,” chaotic failure or refusal to make payments when they are due.

Two IMF fiefdoms were in the vanguard of the forces working behind the scenes for a haircut on Greek debt. One was the general counsel’s office, headed by Sean Hagan, who had been one of the crusaders for an international sovereign debt system after the Argentine default. The other was the Strategy, Policy and Review Department (SPR), whose director, Reza Moghadam, wielded more power than anyone at IMF headquarters except for Strauss-Kahn, according to commonly received staff wisdom. Moghadam’s influence stemmed partly from his department’s authority — it is sometimes mocked as the “thought police,” or “defenders of the faith,” because one of its prime missions is to ensure that Fund programs, monitoring and advice are applied consistently and in accord with the institution’s standards. Another source of Moghadam’s clout was his closeness with Strauss-Kahn, whom he had served (until the fall of 2008) as chief of staff. A Briton of Iranian descent, with degrees from Oxford, the London School of Economics and the University of Warwick, he was disliked and mistrusted by some on the staff for his ruthlessness at bureaucratic infighting. He surrounded himself with loyal allies by ensuring the promotion of those who supported him, and those who opposed him often seemed to find their careers stifled. But his admirers, of whom there were plenty, held his leadership talents in awe and viewed the criticism as attributable to a combination of jealousy and ethnic stereotyping. No one doubted his intellectual firepower or resourcefulness.

The chief IMF representatives at the hotel meetings were Hagan and Lorenzo Giorgianni, a deputy director in SPR who was one of Moghadam’s top lieutenants. The department’s concern was a logical extension of its “defender of the faith” responsibilities. An IMF loan to Greece must not go simply for payments to bondholders, as it had in Argentina’s case. If Greece, like Argentina, had an unsustainable debt, a big IMF loan could be granted only on condition that the debt was restructured — so said the No More Argentinas rule. Imposing a haircut promptly would ensure that the burden of loss would fall on the private creditors who had lent money to Greece in the first

place. Giving Athens a big international rescue loan, with no haircut, would shift the burden to taxpayers.

At the same time, secrecy was of the essence, because if word leaked that plans were afoot to inflict losses on Greek bondholders, investors might stampede. The official position in capitals was to dismiss talk of debt restructuring as absurd. The purpose of the secret talks was to see if support might be forthcoming from two key governments, before moving on to other players.

The idea of “involving” private lenders in a rescue — bailing them *in*, instead of bailing them *out* — was nothing new. During the Latin debt crisis of the 1980s, the IMF had insisted that if taxpayer money was going to help save indebted countries from defaulting on their loans to major international banks, the banks would have to pony up too, by providing fresh loans or accepting delayed payment on old ones. Another prominent example was the rescue package for South Korea in late 1997, which included the expectation that foreign banks would “voluntarily” maintain their credit lines to the country. In the next few years came the cases of Pakistan, Ecuador, Ukraine and Uruguay, where the IMF made loans in conjunction with debt restructurings.

For the IMF to insist not only on private sector involvement, but a major haircut, entails tricky considerations. The biggest is how to decide when a country really has no reasonable prospect of paying its debts. This is similar to the dilemma any commercial bank faces in deciding whether, say, a struggling company can survive over the long haul. Maybe the company just has a liquidity problem — a shortage of cash — which, if addressed, would put the firm on the road to profitability. But maybe the problem is one of solvency — an insurmountable surfeit of liabilities over assets — which an emergency loan would alleviate only temporarily. Making such an assessment about a company is often difficult; when the debtor in question is a country, the judgment is even more an art than a science. If one assumes a healthy level of growth, declining interest rates and government willingness to embrace budgetary austerity, the country’s debt dynamics will appear stable. If one assumes a low growth rate, high interest costs and limitations on the government’s ability to impose fiscal discipline, the country’s debt-to-GDP ratio will appear certain to explode in the future.

Greece’s place on the spectrum was on the insolvency end, according to the data Giorgianni presented at the hotel meetings, which is called a “debt sustainability analysis.” The details of this one remain secret, but like any debt sustainability analysis, it projected what would happen to Greece’s debt-to-GDP ratio under various assumptions regarding economic growth, the government’s ability to run fiscal surpluses, interest rates and so on. These simulations indicated that Greece’s chances of falling

into explosive debt dynamics were uncomfortably high, implying that it was time to consider a restructuring.

Such a conclusion simply was not tolerable to Europe's senior-most leaders, the most implacable of whom was the ECB's Trichet. The issue arose at an ECB meeting in the spring of 2010, when Jürgen Stark, a member of the six-person executive board, argued that Greece's debt was unsustainable, and that therefore the solution should include losses for private creditors.

The ECB president "blew up," according to one attendee. "Trichet said, 'We are an economic and monetary union, and there must be no debt restructuring!'" this person recalled. "He was shouting."

Once faith in the creditworthiness of one euro-zone country was shattered, Trichet feared, confidence in the bonds issued by other European governments would be destroyed as well, the almost certain result being a Lehman-like event in which investors pulled money out of markets all over the continent. This anxiety over financial contagion was widely shared in Europe, and it was based on perfectly legitimate reasoning, starting with the fact that the biggest holders of Greek bonds included some of the region's most vulnerable banks. The exposure of French banks to Greece was €60 billion, and German banks had €35 billion worth (Bastasin 2012, chapter 13); if they were obliged to take steep losses on their Greek paper — and on their other euro government bondholdings as well — the financial system's viability would come under a huge cloud. Within the IMF, many agreed that this problem trumped concerns about what was right for Greece, taken in isolation. The reason for the European Department's rejection of a restructuring was "the large risk of contagion to other vulnerable advanced countries in the euro area," according to Belka's memo.

Contagion worries were not lost on the SPR economists and others at the IMF who favoured a haircut for Greece. They had a healthy respect for the tendency of panic to spread. Their answer, though, was that mitigating market unease about Europe depended first of all on a decisive and permanent resolution to Greece's problems; calm could not be restored as long as the danger of chaotic default continued to loom. And when it came to the impact that a Greek restructuring would have on investor worries about other countries, they argued, the ECB held the key. As a central bank, the ECB has the power to create unlimited numbers of euros and buy whatever it wants with them — that, after all, was pretty much how the Fed, with its determination to do "whatever it takes," had overcome the Lehman shock in US markets. If the ECB dealt with a Greek restructuring by sending a clear message that it stood behind the bonds of all other endangered euro-zone countries, and investors holding those bonds took comfort from the knowledge that they could always sell to the ECB, market hysteria would abate, perhaps even disappear.

Something pretty much like that eventually materialized, as anyone familiar with the history of the euro-zone crisis knows. Greek bonds received a haircut, and the ECB implemented a whatever-it-takes policy — but not until 2012, under Trichet's successor, Mario Draghi. In the spring of 2010, Trichet steadfastly opposed both moves. In fairness to him, he was operating under severe constraints against using his euro-creation powers in the way that other central banks had. The ECB's mandate, as previously noted, prohibits it from "monetizing" the debt of governments, since doing so could spark inflation and could also be construed as a backdoor way of getting around the no-bailout clause. And Trichet knew his every move was undergoing scrutiny by the most purist of monetary institutions, the Bundesbank, which enjoys a status unlike those of other euro-area national central banks because of its popularity among the German public for having safeguarded stability during the country's postwar boom. Although Trichet would show, at critical moments, that he was prepared to go further than Bundesbank representatives at the ECB thought appropriate, he would take such steps with extreme reluctance.

The hotel meetings ended inconclusively. The French government participants reacted badly to the case for a Greek restructuring, in keeping with their fears about the prospect of contagion reaching Italy. The response from the German government participants was more positive. That was in keeping with Berlin's long-standing concern about moral hazard: it was wrong to let irresponsible governments off the hook; and it was also wrong to let irresponsible lenders off the hook. The idea of penalizing bondholders for their folly, rather than using taxpayer money to save them, appealed to the German sense of discipline — as well it might.

Still, there was no time to implement Plan B, even if all the parties represented in the hotel meetings had agreed on its merit. Negotiations over terms for a debt restructuring typically take months, and Greece had only a matter of weeks to get the emergency funding it needed to avoid default on the May 19 payment that was coming due. For its part, the Papandreou government showed no inclination to pursue the idea; top Greek officials believed that obtaining European backing for debt relief was politically inconceivable until Athens had made a concerted effort to cut government spending. They were also concerned about the attitude of Trichet, whose institution, as the euro-area's lender of last resort, was keeping Greece's major banks afloat through the provision of short-term emergency loans, for which the banks had to post collateral consisting mainly of Greek government bonds. The ECB president's position was that such aid would be discontinued if those bonds were in default.

So it was back to Plan A.

BEGGARING BELIEF

The day after his breakfast meeting in Strauss-Kahn's office, Papaconstantinou flew back to Athens, resuming talks with the Troika the following morning, April 26. Knowing that whatever deal they struck would have to win approval in numerous parliaments and other official bodies, the negotiators worked around the clock every day that week, reaching a pact on May 1. Although the Greek public had been expecting Draconian terms, the specific details drew even larger crowds into the streets of Athens and other cities. The terms included significant cuts to the wages and bonuses of public servants, a rise in the normal retirement age to 65, restrictions on early retirement, hikes in cigarette and alcohol taxes as well as the value-added tax, "presumptive" taxation of professionals such as doctors who might be evading taxes, and the aforementioned structural reforms — most controversially, changes in policies protecting workers and unions. For this, Greece was promised loans totalling €110 billion over three years, with €30 billion coming from the IMF and the rest from European governments. This money, which would be doled out in amounts of a few billion euros every three months to ensure that the Greek government was complying with the conditions, would enable Athens to continue paying interest and principal on its existing debt, cover its salary and pension obligations and set up a special fund to protect Greek banks against collapse (IMF 2010).

The big question about the package was not whether Greeks should suffer; they would suffer even more in its absence, since the government would not have the resources to pay its bills. The question was whether it stood a fair chance of restoring the country's economic and financial health. The combined hit from spending cuts and tax increases, on an economy already contracting at a rate of four percent in 2010, was equivalent to more than one-tenth of economic output over the next three years. How, then, was the economy going to fare as well as the Troika projected — namely, a downturn of just 2.6 percent in 2011, followed by a resumption of growth in 2012? The answer, again, was the wondrous impact of the structural reforms. But could the Greek private sector really generate all the dynamism needed to replace the drain on the economy from the huge contraction in the public sector — especially when the country's banks were frantically curbing credit in response to swelling bankruptcies? Some of the specific projections about the performance of the private sector strained credulity. For example, exports of Greek goods and services were assumed to increase by 65 percent over six years — a rate of growth even surpassing that of the German export juggernaut during its most competitive years.¹⁰

Taken together, these concerns led to disquiet about the most critical assumptions of all — the debt figures. The plan anticipated that the debt-to-GDP ratio would peak at 149 percent in 2013 and gradually decline in years thereafter. As harrowingly high as a debt-to-GDP ratio of 149 percent was, keeping it from soaring even further depended on two stupendous gambles paying off: not only would the Greeks have to implement the measures as promised; those measures would have to engender the anticipated benefits on confidence and growth. In other words, prospects for stable debt dynamics were shaky at best.

Small wonder that, as analysts scrutinized the plan in detail, markets began to swoon anew in the days after the package was unveiled. By May 7, the day after the Greek Parliament approved the deal (following deadly rioting in Athens the day before), yields on Greek government bonds were above 12 percent, and the extra yields that investors demanded to hold Portuguese and Spanish bonds rather than safer German bonds reached euro-era highs. This was not just because of the terms of the Greek rescue; an additional source of anxiety was the absence of any mechanism that might keep Greece's woes from spreading.

Small wonder, too, that a number of independent economists and analysts expressed dismay at the program's lack of a debt-restructuring plan. "It beggars belief that Greek government debt can top out at 150 percent of GDP, as the IMF envisages," wrote Barry Eichengreen (2010), a Berkeley economics professor, in a commentary published five days after the accord's announcement. "Sooner or later, the creditors will have to exchange their existing bonds for new ones worth at most 50 cents on the euro. This will leave Greece with more public money for basic social services. That in turn will make it a tiny bit easier to achieve social consensus on the needed austerity measures. It will show the Greek in the street that he is not simply making sacrifices to pay the banks. All these are reasons for proceeding sooner rather than later."

Small wonder, too, that within the IMF staff, a question was being raised: how, in good faith, can we claim that this program complies with the No More Argentinas rule?

THE COP-OUT

The €30 billion loan that the IMF planned to give Greece was bigger than any the Fund had given any other country. It also set a record based on another key metric, going further than any previous loan in exceeding the Fund's usual rules limiting a country's annual borrowing to 200 percent of its "quota," which is essentially the amount that each member nation contributes to the Fund based on economic size. At 3,200 percent of quota, Greece's loan was, therefore, indisputably subject to the standards the IMF had established in 2003, after the Argentine default,

¹⁰ For the assumptions and projections underlying the program, see IMF (2010). The projection regarding growth in exports is on page 43.

restricting the use of giant loans to cases where they are clearly justified.

These standards, as will be recalled from the explanation above, required that a country receiving an extraordinarily large loan must have a high probability of debt sustainability. Unsurprisingly, SPR did not believe Greece met this standard — and SPR had unique leverage over this matter, because its signature is required on any document of this kind going to the executive board.¹¹

Strauss-Kahn was learning of the No More Argentinas rule for the first time, and during the first week of May 2010, he found himself in the middle of a bitter dispute that threatened to derail the Greek rescue, with potentially cataclysmic effects on markets. The board was scheduled to meet within days to formally approve the program — but what should the board be told? How could the board bestow its blessing and allow the disbursal of IMF resources, if it was going to blatantly break the rule? What sort of message might the Fund send by doing so, regarding both Greece and future programs?

Moghadam and his SPR colleagues, backed by Hagan and a few others, were firmly dug in: although it was unclear whether Greece's debt was sustainable or not, the probability of sustainability was not "high" by any reasonable definition of the word, so the department should not certify that the program fulfilled the criteria for an exceptionally large loan. Simply pretending otherwise would make a mockery of a rule that, for good reasons, was supposed to prevent the Fund from making bad mistakes. Senior staff members would be queried closely at the board meeting; how could they say, with straight faces, that they had reached comforting conclusions about Greece's debt based on "rigorous" and "systematic" analyses, as the rule required?

Their position elicited a torrent of denunciations from other members of the staff as well as some of the deputy managing directors, who accused Moghadam and his allies of risking a global crisis over a bureaucratic obstacle. Some rules are made to be broken, they contended, and this one surely merited bending under the circumstances. Determining debt sustainability is not like measuring temperature, or atomic weight; it is a subjective judgment. The European Department believed in good faith that the program stood a chance of working, which ought to suffice. "It seemed to a lot of us that [Moghadam and Hagan] were thinking about how their reputations might be affected," said one participant in the debate. "Your ultimate objective is protecting the global financial system, not your good name."

To the irritation of Moghadam's foes, Strauss-Kahn declared that he would not force anybody to sign something they were uncomfortable with. But the managing director was also determined for the program to go forward, with the big dollop of IMF cash that Greece had been promised. A compromise emerged: instead of certifying that Greece had a high probability of debt sustainability, the staff would tell the board that "on balance," the country's debt appeared sustainable. At the same time, the Fund would create a new exception to its rule, dropping the high-probability requirement for crises that risked general contagion (defined as "systemic spillovers"). This new exception could be applied in all future cases, not just Greece.

The IMF's first serious test of its No More Argentinas rule was ending in a cop-out. "Nobody was really happy," Strauss-Kahn acknowledged. But uppermost in his mind at the end of the first week of May were other developments: the negative market reaction to the Troika deal with Greece was reaching a crescendo; a new plan was in the offing for dealing with future European crises; and the Fund was once again in danger of being sidelined.

JUNIOR PARTNERSHIP, RECONFIRMED

Starting on Thursday, May 6, and ending in the pre-dawn hours of Monday, May 10, Europe's political and economic potentates were immersed in a marathon series of meetings that spanned three different countries. It was "a weekend of destiny," and "the moment of truth," Sarkozy told his fellow leaders — just two examples of the grandiloquence gushed during many debates. As for Strauss-Kahn, he arrived on May 9 in Basel, Switzerland, for a conclave of central bankers, and spent much of the evening on the phone trying to make sure the IMF would remain involved in any future crises in the euro zone. "That was my fight for this night," Strauss-Kahn recalled. "It was a real fight."

Much is known, from articles and books written by others, about these meetings.¹² This is a paper focusing on the IMF, so a detailed account of the interactions among European policy makers that weekend is not necessary, especially since the Fund played a minimal role in the most consequential discussions. The decisions taken had major import, however; a summary of events is therefore in order.

The fundamental challenge was to establish a "firewall" that would keep turmoil from spreading, by showing markets that Europe had both the financial resources and the institutional infrastructure to respond if any other euro-zone country came under speculative attack.

11 Technically, IMF management could have brought the document to the board without SPR's signature, but that would have been extremely awkward and embarrassing.

12 For the most comprehensive and authoritative account of these meetings, on which a number of others appear to rest, see Ludlow (2010). See also Walker, Forelle and Blackstone (2010); Hall, Peel and Atkins (2010); and Barber (2010b and 2010c). For books, see Irwin (2013, chapter 13); Bastasin (2012, chapter 14).

A chart displayed by Trichet at a Friday evening summit dinner in Brussels on May 7, showing how Portuguese government bonds were tracking Greek ones, had the desired sobering effect on the leaders, as did the central bank chief's remarks citing similarities with the period of the Lehman collapse. Exhortations were also forthcoming from Washington, where President Barack Obama and Treasury Secretary Tim Geithner — keenly aware that their country's economy was also at risk, given US banks' US\$3.6 trillion exposure to European banks — spent hours working the phones to prod bold action from their counterparts across the Atlantic. Fearful that the currency union might not survive the following week if they failed, the European leaders resolved to unveil a plan by the time Asian markets opened on Monday.

Several of the leaders, led by Sarkozy, demanded at the May 7 summit that the ECB assume major firewall responsibilities by using its euro-creation powers to buy the bonds of the most imperiled governments. Predictably, Trichet retorted that such political pressure would never influence him and his central bank colleagues — on the contrary, it would backfire, “with disastrous consequences.” He did not tell the leaders that the previous day, the ECB governing council had secretly agreed in Lisbon on a selective program to buy bonds of vulnerable countries. He kept that initiative under wraps for the time being because he wanted to make sure governments would also shoulder a hefty portion of the burden for the firewall; his reasoning was that they would not deliver if they thought they could depend on the ECB as a backstop. His strategy, and well-orchestrated theatrics, began to pay off when the governments drew up plans on Sunday, May 9 at another Brussels meeting for a sizable “stabilization fund” that could lend hundreds of billions of euros to crisis-stricken countries.

But battling over the terms in Brussels dragged well past midnight and into the early hours of Monday, May 10. One of the unsettled issues was the IMF's role, which was the focus of Strauss-Kahn's attention.

Joining the IMF managing director in Basel was Trichet, who was also attending a regularly scheduled meeting of central bankers at the Bank for International Settlements. The two men, huddling together with a handful of others, stayed in constant contact throughout Sunday evening with the finance ministers who were thrashing out the deal in Brussels. As Strauss-Kahn knew, the argument that Europe should handle its own affairs, with no outside interference, was gaining fresh momentum. A proposal tabled in the afternoon by the European Commission, with strong backing from Sarkozy, envisioned no IMF role in the new rescue mechanism. Once again, the anti-IMF forces were up against Merkel, who was sticking to her view that Fund involvement was essential. But the dispute over the IMF was just one among many, and events took an unexpectedly chaotic turn when Finance Minister

Wolfgang Schäuble, whom Merkel dispatched to Brussels to insist on the terms Berlin wanted, was rushed to the hospital because of an allergic reaction to medication, obliging Germany to send another minister in the evening, with only a few hours to go before the opening of Asian markets.

This time, Strauss-Kahn had Trichet's support for IMF involvement. The ECB chief no longer wanted to keep the IMF out; he had swung around to Merkel's position on the value of the Fund's expertise and credibility. Moreover, Strauss-Kahn could offer something else that European leaders wanted — money for the firewall, or at least the theoretical prospect thereof. He had no legal authority to commit IMF resources; only the board could do that. But he was willing to put his name and prestige in support of a statement that the IMF would presumably match a portion of the European commitment, at a ratio of €1 from the Fund for every €2 from Europe. The 1-for-2 ratio appealed to him because although the IMF would have to continue as junior partner in the Troika, contributing less than one-third of the total would risk putting the Fund in too junior a position. Since Europe was by then contemplating a firewall totalling €500 billion, the amount from the IMF could be up to €250 billion.

Just as Asian markets were opening on May 10, the deal was announced creating the €500 billion firewall, consisting mainly of the European Financial Stability Facility, which would raise money in financial markets, backed by guarantees from European governments. Trichet followed with an announcement at 3:15 a.m. of the bond-buying plan that the ECB governing council had endorsed the previous Thursday. The sentence Strauss-Kahn wanted was included in the European announcement: “The IMF will participate in financing arrangements and is expected to provide at least half as much as the EU contribution” (Council of the EU 2012).

The IMF's junior partnership in the Troika was intact. Meanwhile, on the same day as the frantic goings-on in Brussels and Basel, another important meeting was taking place at IMF headquarters. May 9 was Mother's Day in Washington, DC; the unfortunate timing was attributable to the urgency of the agenda.

“A BAILOUT OF GREECE'S PRIVATE DEBT HOLDERS”

An oval chamber 60 feet long and two stories high with plush blue carpeting and suede-and-wood panelling, the IMF boardroom is designed to convey the majesty of the international community passing judgment. There, the Fund's executive directors gathered on May 9, settling into their gray swivel chairs around a horseshoe-shaped table with microphones in each place, while staff members took seats a few feet away from the table. John Lipsky, the first deputy managing director, was presiding, since

Strauss-Kahn was in Basel. The board's task was to consider, and approve, the IMF program for Greece. But everyone knew some awkward questions and incisive criticisms would be forthcoming first.

In advance of the meeting, directors had received copies of the staff report on the Greek program, to which they responded with prepared statements circulated to their board colleagues as well as the staff and management. At least among the directors from outside the euro zone, the statements reflected profound skepticism about the wisdom of imposing austerity on Greece without requiring the country's creditors to accept any losses.

The assumptions about how the Greek economy would fare "seem to be overly benign," said Rene Weber, a director representing Switzerland and seven other countries, who wondered why debt restructuring was not being considered. "Even a small negative deviation from the baseline growth projections would make the debt level unsustainable over the longer term." Echoing similar sentiments, Arvind Virmani, the Indian director, fretted that the planned fiscal tightening would be a "mammoth burden [that] could trigger a deflationary spiral of falling prices, falling employment, and falling fiscal revenues that could eventually undermine the program itself," so a default or restructuring might be "inevitable." Poignantly, the Argentine director, Pablo Andres Pereira, harkened back to the mistakes made in his country's case, saying, "It is very likely that Greece might end up worse off" by borrowing from the IMF under the circumstances it was facing.¹³

Unsurprisingly to his colleagues, the most caustic comments came from Paulo Nogueira Batista, a Brazilian with swept-back salt-and-pepper hair who was the board's most outspoken detractor of the Fund's governance. As the representative from a large emerging market country that was taking the lead in seeking a reordering of control over institutions like the IMF, Nogueira Batista took discernible pleasure in goading the Atlantic powers for what he saw as their arrogance and hypocrisy. Characteristically, his attack on the Greek program dispensed with the diplomatic niceties favoured by his board allies; he used the term "Panglossian" to describe the staff report's projection of a V-shaped recovery. The program, he declared, "may be seen not as a rescue of Greece, which will have to undergo a wrenching adjustment, but as a bailout of Greece's private debt holders, mainly European financial institutions."

Beamed in by video conference to the boardroom from Athens, Thomsen and other staffers defended the program as supportable and necessary, however dicey it might be. They maintained that the economic assumptions were

reasonable; even those in other departments who were critical of the overall approach tended to concede that the assumptions were less a matter of cooking the numbers than exploiting the upper bounds of plausibility. Strongly endorsing the staff's recommendation were the directors from the euro zone, and given the board's custom of approving decisions by consensus, no one doubted that this decision would also pass muster with unanimity or something very close to it. Even Nogueira Batista was voting in favour; he could do no more than thunder, "Our decision to go along with this problematic and risk-laden program should not be taken to mean that we will support it in the future."

But fresh controversy arose when the realization spread that, along with the Greek program, the board was taking another important step that day — modifying the No More Argentinas rule. Weber, the Swiss director, questioned whether the staff had "silently" changed the policy, which he had noticed while poring over the 136-page staff report on a long flight to Washington. He cited a passage on pages 19-20, which contained the following words:

On balance, staff considers [Greece's] debt to be sustainable over the medium term, but the significant uncertainties around this make it difficult to state categorically that this is the case with a high probability. Even so, Fund support at the proposed level is justified given the high risk of international systemic spillover effects. Going forward, such an approach to this aspect of the exceptional access policy would also be available in similar cases where systemic spillover risks are pronounced. (IMF 2010)

In plain English, this language effectuated the compromise reached at the staff level on the No More Argentinas rule: henceforth, in cases where contagion was feared, the IMF could give exceptionally large loans to countries even if their debt sustainability could not be certified as highly probable. Normally, a policy change of this sort would be subject to careful deliberation, as it had been in 2003, perhaps over the course of several board meetings. Instead it had been inserted into a jargon-filled passage of the staff report.

Nogueira Batista took up the cudgels on this issue as well, essentially suggesting that the policy change was being snuck past the board. "This issue would not have been transparent, had it not been for Mr. Weber's question," he said, according to minutes of the meeting, and he demanded: "Should we not have a separate decision... instead of just a sentence on page 19 of the staff report, which would then be used as a precedent?"

¹³ Many of the directors' comments reported in this section (though not all) were first reported in the *Wall Street Journal*. See Catan and Talley (2013) and an accompanying blog post (*The Wall Street Journal* 2013).

Was this episode as deplorable as Nogueira Batista's complaint would imply? Was there an attempt to pull a fast one on the board, by obtaining its approval of a significant rule change without even calling attention to it? Some directors with whom I spoke recalled being clearly aware, before the meeting, that the rule change was explicitly incorporated into the Greek program. Many attendees pointed out that Sean Hagan forthrightly explained the issue at the meeting. But a number of directors, mostly from smaller countries, apparently did not know in advance. And the presentation in the staff report was a model of obfuscation.

The best gloss that can be put on this series of events is that it was the only practicable way to do what had to be done. The Greek program had to go forward. Great haste was required. IMF rules could not be grossly flouted, but they could be fudged, and there was no time for the kind of debate that would normally precede an important change in policy.

In any event, the shredding of the No More Argentinas rule had become official IMF policy. And Plan A was now in effect.

A WEAK POKER HAND

On May 13, four days after the board meeting on Greece, Strauss-Kahn called Panagiotis Roumeliotis, who represented Greece at the IMF as an alternate executive director, to his office. The two men had known each other since the 1970s, when both were studying at the University of Paris. According to Roumeliotis, the managing director urged him, in confidence, to convey to Athens the need for an early debt restructuring, perhaps by September, as well as a reduction in the interest rates that European governments were charging on their loans to Greece. On May 24, Roumeliotis met again with Strauss-Kahn, and the managing director reiterated his belief in the need for a restructuring. Strauss-Kahn confirmed Roumeliotis's account of their conversations.

This episode reflects well on Strauss-Kahn's perspicacity. It also raises one of the most troubling questions about the Greek rescue, because in the months immediately after May 2010, no strenuous efforts were forthcoming to launch a process for reducing Greece's debt burden. Why not?

The IMF had good reasons to avoid risking a restructuring during the spring of that year. Substantial time would have been required, 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 a firewall 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 could simply not lend

its good name and credibility to a plan with insufficient likelihood of leading to debt sustainability. He might have said that while Europe was free to do as it pleased with its own money, the IMF's loan would be contingent on a restructuring taking place later in 2010, so that Greece would obtain the relief it needed in a timely fashion and taxpayers would not end up assuming losses that banks ought to incur.

Such an approach would have required confronting Europe's high and mighty — and presumably the US government, still suffering from post-Lehman trauma, as well. Most daunting of all, it would have required facing down Trichet. As noted above, the ECB president was prone to umbrage when the subject of restructuring a euro-zone country was broached, and he had declared himself unwilling to take the kinds of monetary policy steps that would have been needed to limit contagion. Without his cooperation, a Greek debt restructuring would put the global financial system in danger of reverting to the horrors of September 2008.

The poker play would have been one of the greatest in the history of the global economy: If the IMF had forged ahead with a Greek debt restructuring, how would Trichet have reacted? Would he have stood his ground, even at the cost of allowing his beloved currency union to break up? Or would he have grudgingly used every conceivable monetary policy instrument to pacify market alarm about the creditworthiness of other euro-zone countries? At this sort of poker, Trichet's mastery was unsurpassed. The stakes were much higher than a poker game, though, and he was not bluffing. Or was he? Would he not have folded?

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. "We were just recovering, trying to re-establish our role in the global system," Strauss-Kahn said in response to my question about this imaginary showdown. "I couldn't accept the idea, which would have been lethal to the IMF, that the Europeans would handle the crisis by themselves. I could play this game a little. But I couldn't go too far."

Strauss-Kahn's grasp of *realpolitik* is hard to refute, no matter how lamentable that *realpolitik* might be. It might seem right and proper that an institution representing the international community, and providing a global public good, could insist on preserving its credibility in circumstances such as the ones described above. It might seem right and proper that the IMF could demand fair and sensible burden-sharing for an individual member country seeking its assistance. It might seem right and proper that the IMF, having overridden the objections of proud Asian mandarins and strongmen during the Asian financial crisis of the 1990s, could do the same with powerful European policy makers who needed international help

in saving their common currency. But the world in which Strauss-Kahn was operating did not work that way.

CONCLUSIONS AND POLICY IMPLICATIONS

Fast-forward to March 2012, when Greece finally received massive relief on its private debt, with investors in Greek bonds taking haircuts that reduced the value of their holdings by about 60–75 percent, depending on the calculation method. The operation proceeded amazingly smoothly, with barely a ripple in financial markets, defying predictions that disaster would ensue.

The arguments advanced by those favouring an early restructuring had proven largely correct. The imposition of sweeping budget cuts and tax hikes had driven the Greek economy deep into recession — a 7.1 percent contraction of GDP in 2011, far worse than the 2.6 percent decline projected at the time the first rescue was approved. The idea of using structural reforms to revive growth was coming to naught. (To be fair to the theory behind the original program, Athens had failed to properly implement many of the structural reforms because of fierce political resistance, which intensified as the economy deteriorated.) And Greece's debt-to-GDP ratio was on an explosive course — 170 percent at the end of 2011 instead of the 133 percent initially projected. Furthermore, the country would remain in a deep hole economically even after the restructuring of its private obligations, with the bailout loans it had incurred leaving it still heavily indebted. At the time of writing in March 2015, Greece is teetering on the brink of departure from the euro zone, as conflict escalates between European officials and the radical government in Athens. One of the key points in dispute is the Greek demand for an additional writedown of its debt — now at 175 percent of GDP, and owed almost entirely to official creditors.

It goes without saying, then, that the restructuring of Greece's private debt took far too long. Inspired, in part, by the country's wretched experience, a variety of proposals have been forthcoming in the past couple of years for improved methods of dealing with overly indebted sovereigns. Notably, the IMF staff has proposed scrapping the rule change that was hastily adopted in May 2010 and replacing it with a new set of guidelines. Under this new approach (which has been discussed but not approved by the board), the IMF would have the option — for cases in which a country's debt could not be deemed sustainable with "high probability" — of lending in conjunction with a "reprofiling" of the debt (that is, delaying repayment instead of reducing the amount owed). If reprofiling failed to lead to debt sustainability, haircuts would be the next step. This is a sensible idea, and would go part of the way

toward remedying the problems associated with sovereign debt. But it would hardly resolve all of them.¹⁴

Other ideas regarding restructuring of sovereign debt, many of them worthwhile, have circulated in the aftermath of the Greek debacle. Most of these are beyond the scope of this paper, because they require consideration of other complex developments that have arisen, such as Argentina's litigation with some of its bondholders. (I intend to address these topics in a forthcoming book.) But other important conclusions can be drawn from the events chronicled above, in particular concerning the subordinate role the IMF took vis-à-vis European policy makers, which has troubling implications for the future.

For the IMF to have been junior partner in the Troika was a travesty. Even though the Fund was putting up a minority share of the funding for the Greek program, it should have had the clearly understood power to determine the terms and conditions. Indeed, the Fund's authority should have gone even further. It should have been able to set terms and conditions for the entire euro zone. It should have been on the opposite side of the negotiating table from the ECB, rather than the same 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. The Fund was coming to the rescue not just of Greece, but of the euro; even the rich countries that never needed IMF money were, in many respects, supplicants, using the Fund to help save their terribly flawed system of monetary union.

Politically unrealistic as that may sound, the case has been advocated by none other than Edwin "Ted" Truman, a battle-hardened veteran of financial diplomacy from his decades at the Federal Reserve and US Treasury, now with the Peterson Institute for International Economics. As Truman (2013) has written: "The IMF should have insisted as part of the first program for Greece that the other members of the euro area adopt a complementary strategy as a condition for its approval of the Greek program," but the Fund "was too timid, paralyzed or conflicted to require such steps." In Truman's trenchant words, "The members of the euro area wanted to preserve the euro, but they were not prepared to accept conditionality applied to the euro area as a single entity. The rest of the world, to its regret, allowed the Europeans have it both ways — save the euro but by imposing all the policy conditions only on the countries in crisis."

To fully understand the merits of this argument, fast-forward again, to mid-to-late 2012. A host of measures were in motion that would finally quell the euro-zone crisis, at least in the virulent form it had taken starting in 2010. European banks were bolstering their capital under pressure from regulators, making them less vulnerable

¹⁴ See IMF (2014).

to a possible default and thus reducing the danger of contagion. A “banking union” was in the process of being agreed, which helped ease concerns that in some countries (Spain, in particular), governments might lack the financial wherewithal to bail out their fragile banking systems. Fiscal disciplines were being strengthened. Most important of all, ECB President Mario Draghi, who in late 2011 had launched one major monetary expansion that helped calm markets, unveiled an even more important initiative, which would be dubbed Outright Monetary Transactions (OMT), in the summer of 2012. This finally amounted to a “whatever it takes” policy in which the ECB would use its unlimited euro-creation powers to buy the bonds of euro-zone countries under attack, provided those countries agreed with the IMF on appropriate reform programs. At last, a credible firewall was being erected — and so far, the ECB has not even had to spend a single euro on OMT, because markets settled down after its adoption.

Why did it take so long — both to restructure Greek debt and do these other things? One big reason is that various steps had to be taken more or less in concert. Dealing with Greece’s debt, which was essential to minimize constant worries of the euro zone being shattered by a disorderly default, was hard to tackle until the problem of contagion looked like it could be contained. A credible, anti-contagion firewall had to wait because of the concerns of the German government and the ECB — the entities that controlled large amounts of euros. They were reluctant to commit massive resources to a firewall because they feared that doing so would ease pressure for resolving other fundamental weaknesses in Europe, both at the individual country level and at the monetary union level. In other words, no one wanted to move, even on measures that were clearly essential and desirable, unless others did too, and building political consensus for all these actions took time.

The only way to overcome this problem was for an outside actor to tell all the European actors what to do — to knock a lot of heads together, so to speak — and the only outsider with any legitimate credentials for playing such a role was the IMF. Instead, the opposite occurred. The Europeans would be “the leaders,” as Strauss-Kahn put it in his meetings with them in the spring of 2010, the problem being that nobody in Europe was fully capable of leading the others.

This is not to condemn Strauss-Kahn for having gone along with the idea of the IMF being junior partner. As noted in a companion paper published simultaneously alongside this one,¹⁵ he was heading an institution that was in a weak position because of the crisis of relevancy that it had undergone. Moreover, having played a second-fiddle role to Europe in the rescue of Latvia, the Fund could not easily

draw the line against doing the same in Greece’s case. If the managing director had taken a “my way or the highway” stance regarding the Greek program, European policy makers might very well have refused IMF involvement, especially if he had also demanded conditionality on the entire euro zone. He took a gamble, that keeping the Fund at the table would guide management of the crisis in a favourable direction and improve chances for a good outcome, while at the same time avoiding another marginalization for his institution. More broadly, he faced significant institutional barriers and trade-offs in pursuing a more technocratic approach to the crisis. As he noted above, his freedom of manoeuvre was constrained by concern about exacerbating market jitters.

Whether Strauss-Kahn ought to have played his cards more aggressively can be debated endlessly. The more crucial question is what the IMF needs to do now to undo, or at least mitigate, the damage that may have been done to its credibility and effectiveness in future crises.

When the next crisis erupts — in Asia, perhaps, or Latin America — powerful countries in those regions may insist that their influence over Fund policy be commensurate with that exercised by Europeans in the spring of 2010, and that the Fund play a junior partner role again. 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’ US\$100 billion Contingency Reserve Arrangement (CRA), a pool of currencies intended “to forestall short-term balance of payments pressures, provide mutual support and further strengthen financial stability” (People’s Bank of China 2014). The CRA, the establishment of which was agreed in July 2014, is modelled on the Chiang Mai Initiative launched some years ago among Asian countries. Although these entities 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. The Fund needs to reclaim its historic role as the ultimate arbiter of how to manage crises in which its money is at stake, based on its role as a multilateral institution empowered by the international community to exercise independent, objective judgment from a global perspective about the best possible solution. The Fund can,

15 See the companion paper, Blustein (2015).

and in certain cases should, join with other institutions in rescues, tapping them for money to supplement its own — as noted above, it has done so in past instances. And it should obviously listen to those institutions' opinions, along with the views of other outsiders. But there should be no doubt about which institution is calling the shots on the terms and conditions for the assistance involved.

Unfortunately, the IMF cannot command sufficient respect for its independence or neutrality to be able to stake out such a position. It has acquired too much “baggage,” in particular during the euro-zone crisis, that calls its independence into question. As I propose in my companion paper (Blustein 2015), considerable efforts should be made, both at the Fund and among its shareholders, to shed that baggage.

The first and most essential step is governance reform. The IMF's member countries agreed to a redistribution of voting shares in 2010 along with an accord to double permanent contributions. But this agreement goes only part way toward reducing the surfeit of European power on the executive board relative to Europe's share of world GDP — and even then the deal has yet to be implemented. It has been stymied by a stalemate in the US Congress, where Republican lawmakers have balked at approving the necessary legislation, in part because of antipathy toward the Fund. A strong IMF is in US interests, as many commentators have noted, and the White House and Congress should act accordingly.

Just as important in this regard, if not more so, would be an end to the European monopoly over the IMF managing directorship — which will, in turn, require an end to the American monopoly over the World Bank presidency. Despite repeated promises by US and European officials to eliminate this problem, political pressures to maintain the current system are strong on both sides of the Atlantic.

Second, the IMF should go further toward making sure that its judgments are as technocratic as possible — and seen to be so. One good way to do this is to borrow a leaf from the World Trade Organization (WTO) by using independent tribunals to weigh in on contentious issues. The WTO's system, for good reason, is widely recognized as one of the few successful innovations in international governance. When countries accuse each other of violating the rules of international trade, panels of outside experts weigh the evidence and render judgments, which command impressive respect and compliance because of their perceived fairness and objectivity. As I have suggested previously,¹⁶ the IMF could use tribunals of this kind to render verdicts on complaints that countries are guilty of fomenting “external instability” or maintaining “fundamentally misaligned” exchange rates. Emerging market countries are understandably skeptical that such

issues will receive a fair hearing if the judge and jury consists of the IMF staff, management and board; they would probably be more willing to abide by rules if the allegations were to be judged by neutral parties according to objective criteria. The Fund ought to look for ways of incorporating this kind of mechanism into all manner of important decisions. Schadler (2012b) raises an interesting example of how this might work in cases such as Greece:

Does the IMF have sufficient independence from political influences to make efficient and timely decisions on the balance between financing, adjustment and restructuring? Should a separate, independent body, charged with assessing the nature of crises — specifically whether a crisis stems from illiquidity or an inability/unwillingness to repay — be set up? Would such a body, serving its judgment in advance of decisions on financing and adjustment made by the IMF itself, help to offset political interference?

Third, the IMF board should formally adopt a “never again” position regarding the Fund's assumption of junior partner status in rescues. This would understandably draw objections from non-European countries that it is akin to closing the barn door long after the cow's escape, because it would come after the Fund had already been run roughshod over during the euro-zone crisis. The Fund cannot undo the past in Europe, but it can rectify at least some of the institutional damage that was inflicted. The board could state that if IMF assistance is required for any euro-zone member in the future — hardly an implausible scenario — members of the board representing the euro-zone's countries would be expected to refrain from voting. Jim Flaherty, Canada's late finance minister, offered this proposal in the spring of 2012 (CBC News 2012). It should be resurrected and approved. Furthermore, IMF aid for a euro-zone country would entail conditions for the entire euro zone, not just the individual member nation.

Whether these proposals offer the best way forward — and whether they are remotely achievable — is of course debatable. Others may draw entirely different lessons than I have from the chronicle of events above. But when international cooperation goes wrong, as it did in Greece in the spring of 2010, the international community should take corrective action, which requires accurate and comprehensive information. That is the spirit in which this paper was written.

¹⁶ See Blustein (2013, chapter 9).

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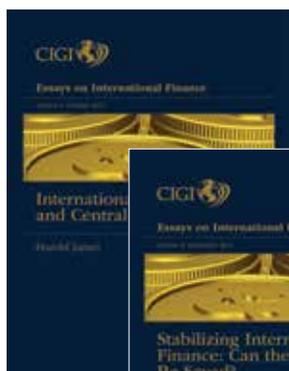
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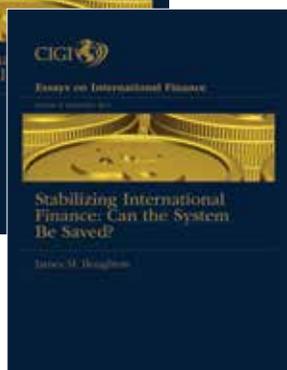
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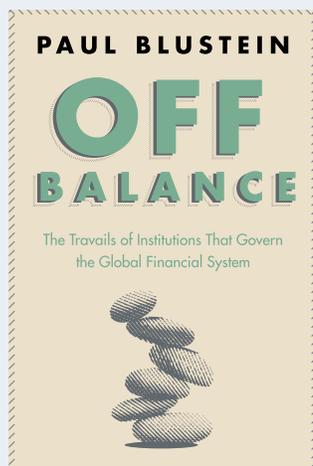
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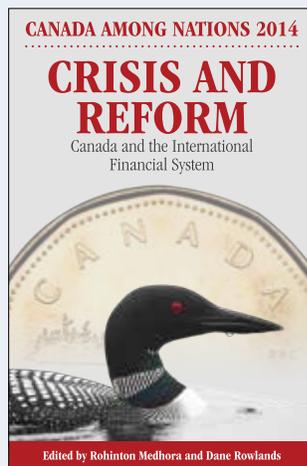
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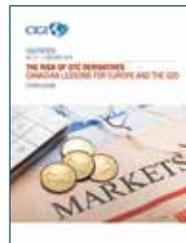
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Over Their Heads: The IMF and the Prelude to the Euro-zone Crisis

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Paul Blustein

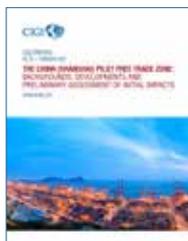
The years prior to the global financial crisis were a peculiar period for the International Monetary Fund (IMF). It was struggling to define its role and justify its existence even as trouble was brewing in countries it would later help to rescue. To understand the Fund's current strengths and weaknesses, a look back at this era is highly illuminating. Three major developments for the IMF, spanning the years 2005–2009, are chronicled.



The Risk of OTC Derivatives: Canadian Lessons for Europe and the G20

CIGI Papers No. 57
Chiara Oldani

Over-the-counter (OTC) derivatives played an important role in the buildup of systemic risk in financial markets before 2007 and in spreading volatility throughout global financial markets during the crisis. In recognition of the financial and economic benefits of derivatives products, the Group of Twenty (G20) moved to regulate the use of OTC derivatives. Attention has been drawn to the detrimental effects of the United States and the European Union to coordinate OTC reform, but this overlooks an important aspect of the post-crisis process: the exemption of non-financial operators from OTC derivative regulatory requirements.



The China (Shanghai) Pilot Free Trade Zone: Backgrounds, Developments and Preliminary Assessment of Initial Impacts

CIGI Papers No. 59
John Whalley

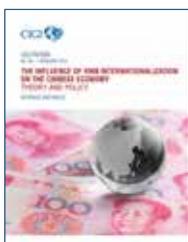
The China (Shanghai) Pilot Free Trade Zone (SPFTZ) was founded in September 2013, and up until now relatively little has been written in English about this unique initiative. This paper reviews the background and reasons for the SPFTZ, how it has developed and the impact it has had since its opening.



Sovereign Bond Contract Reform: Implementing the New ICMA Pari Passu and Collective Action Clauses

CIGI Papers No. 56
Gregory Makoff and Robert Kahn

The International Capital Market Association (ICMA) has recently published proposed standard terms for new, aggregated collective action clauses. Concurrently, the ICMA released new model wording for the pari passu clause typically included in international sovereign bond contracts. These announcements and the commencement of issuance of bonds with these clauses are an important turning point in the evolution of sovereign bond markets.



The Influence of RMB Internationalization on the Chinese Economy

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Since China's pilot scheme for RMB cross-border settlement was launched in 2009, it has become increasingly important for monetary authorities in terms of macroeconomic policy frameworks. The authors use an analytical model that includes monetary supply and demand to examine the influences of RMB cross-border settlement on China's domestic interest rate, asset price and foreign exchange reserves. They also look at how RMB settlement behaves in different ways with the various items in China's balance of payments.



Completing the G20's Program to Reform Global Financial Regulation

CIGI Papers No. 55
Malcolm D. Knight

The measures regulators have largely agreed on for a strengthened and internationally harmonized financial regulatory regime, which were endorsed at the 2014 G20 leaders summit in Brisbane, are a major step toward achieving a robust and less crisis-prone global financial system. There are, however, a number of specific measures that need to receive closer attention in order for the G20 leaders to declare their reform program a success. This paper discusses what policy makers and regulators should focus on in 2015 and why closer international cooperation in implementing regulatory reforms will be essential for success.

ABOUT CIGI

The Centre for International Governance Innovation is an independent, non-partisan think tank on international governance. Led by experienced practitioners and distinguished academics, CIGI supports research, forms networks, advances policy debate and generates ideas for multilateral governance improvements. Conducting an active agenda of research, events and publications, CIGI's interdisciplinary work includes collaboration with policy, business and academic communities around the world.

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CIGI was founded in 2001 by Jim Balsillie, then co-CEO of Research In Motion (BlackBerry), and collaborates with and gratefully acknowledges support from a number of strategic partners, in particular the Government of Canada and the Government of Ontario.

Le CIGI a été fondé en 2001 par Jim Balsillie, qui était alors co-chef de la direction de Research In Motion (BlackBerry). Il collabore avec de nombreux partenaires stratégiques et exprime sa reconnaissance du soutien reçu de ceux-ci, notamment de l'appui reçu du gouvernement du Canada et de celui du gouvernement de l'Ontario.

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