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The following conventions are used in this publication:

- An en dash (–) between years or months (for example, 2016–17) or January–June) indicates the years or months covered, including the beginning and ending years or months).
- n.a. means not available.
- Billion means a thousand million; "trillion" means a thousand billion.
- "Basis points" refers to hundredths of 1 percentage point (for example, 25 basis points are equivalent to ¼ of 1 percentage point.

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Preface

This book brings together nine papers that examine different aspects of the effectiveness of the IMF's engagement in Greece, Ireland, and Portugal during 2010–14. The crises in these countries, coming so soon after the global financial and economic crisis, and occurring in a common currency area comprising highly integrated economies, posed extraordinary challenges to European and world policymakers. The IMF was called upon to provide financing and technical expertise in the management of these crises. The IMF's role has been a subject of extensive commentary and scrutiny by experts around the world.

The papers were prepared as background material for the IEO evaluation *The IMF and the Crises in Greece, Ireland, and Portugal* (2016), which asked, among other questions, whether the IMF's crisis management was appropriate, given the exceptional circumstances; whether it compromised its best economic judgment because of the way it engaged the euro area; and what it could have done differently to achieve better outcomes. While the IEO used these background papers as inputs to help form judgments on these and other related questions, the views expressed herein remain those of the authors alone and do not necessarily represent those of the IEO, the IMF, or IMF policy.

The evaluation concluded that the Executive Board generally played a limited role in its supervisory function, and that the IMF's overall performance in surveillance and crisis lending was uneven. The IMF's handling of the euro area crisis raised issues of accountability and transparency, which helped create the perception that the IMF treated Europe differently. The IMF Executive Board, when it met to discuss the evaluation report in July 2016, gave full or qualified support to the recommendations drawn from the experience to improve the IMF's governance and operational effectiveness. The Chairman's Summing Up of this discussion, along with the statement by the Managing Director on the evaluation, are included in Part IV of this volume.

In March 2017, the Executive Board approved IMF management's plan to follow up on the IEO evaluation. It reaffirmed its commitment to accountability and transparency, as well as its strong support for the role of the IEO in fostering good governance in the IMF. Under the management implementation plan, IMF staff is preparing Board papers on program design in currency union members and on IMF cooperation with regional financing arrangements. These steps should help alleviate governance and reputational risks for the IMF. Staff is working with the IEO to develop a protocol for information sharing as part of a commitment to ensure smooth collaboration between the IEO and the IMF.

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Editors

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Washington, D.C.

Abbreviations

ABIB	Antigua and Barbuda Investment Bank
AQR	Asset Quality Review
ASEAN	Association of South East Asian Nations
BCEAO	Central Bank of West African States
BEAC	Bank of the Central African States
BOP	balance of payments
BRRD	Bank Recovery and Resolution Directive
BSRF	Banking Sector Reserve Fund
CAB	cyclically adjusted balance
CAPB	cyclically adjusted primary balance
CBI	Central Bank of Ireland
CARICOM	Caribbean Community
CDS	Credit Default Swap
CEMAC	Central African Economic and Monetary Community
CMA	common monetary area
COBAC	Central African Banking Commission
CUCB	currency union central bank
DSA	debt sustainability analysis
EA	exceptional access
EBA	European Banking Authority
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECA	European Court of Auditors
ECCA	East Caribbean Currency Authority
ECCB	Eastern Caribbean Central Bank
ECCU	Eastern Caribbean Currency Union
ECB	European Central Bank
ECF	Extended Credit Facility
ECJ	European Court of Justice
ECOFIN	Economic and Financial Affairs Council
ECOWAS	Economic Community of West African States
EDP	Excessive Deficit Procedure
EFC	Economic and Financial Committee
EFF	Extended Fund Facility
EFSF	European Financial Stability Facility
EFSM	European Financial Stabilization Mechanism
EIB	European Investment Bank
ELA	emergency liquidity assistance
EMS	European Monetary System
EMU	Economic and Monetary Union

EPE	ex post evaluation
ERM	Exchange Rate Mechanism
ESA	European System of Accounts
ESAF	Enhanced Structural Adjustment Facility
ESCB	European System of Central Banks
ESM	European Stability Mechanism
EU	European Union
EUR	European Department
EWG	European Working Group
FAD	Fiscal Affairs Department
FCC	forward-commitment capacity
FCL	flexible credit line
FSF	Financial Stability Fund
FSSA	Financial System Stability Assessment
FSAP	Financial Sector Assessment Program
G20	Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, United Kingdom, United States, and the European Union
GDP	gross domestic product
GGBs	Greek Government bonds
GFSR	*Global Financial Stability Report*
GLF	Greek Loan Facility
GRA	General Resources Account
HIPC	Heavily Indebted Poor Countries
ICT	information and communication technology
IFAC	Irish Fiscal Advisory Council
IFC	International Finance Corporation
IFSC	International Financial Services Centre
LEG	Legal Department
LOLR	lender of last resort
IMFC	International Monetary and Financial Committee
LOI	letter of intent
LTRO	long-term financing operation
MD	Managing Director
MCM	Monetary and Capital Markets Department
MEFP	Memorandum of Economic and Financial Policies
MNB	Hungarian Central Bank
MONA	Monitoring of Fund Arrangements
MOU	Memorandum of Understanding
MTFS	medium-term budget strategy
NGO	nongovernmental organization
NPL	non-performing loan
OCA	optimum currency area
OECD	Organisation for Economic Co-operation and Development

OMT	outright monetary transaction
PA	prior action
PCAR	Prudential Capital Asset Requirements
PEC	policy for early consultation
PIN	Public Information Notice
PLL	Precautionary and Liquidity Line
PPM	post-program monitoring
PPP	public-private partnership
PRGF	Poverty Reduction and Growth Facility
PSI	private sector involvement
PTSB	Permanent TSB
R&D	research and development
RAM	risk assessment matrix
RFAs	regional financing arrangements
RCF	Rapid Credit Facility
RFI	Rapid Financing Instrument
SAF	Structural Adjustment Facility
SB	structural benchmark
SBA	Stand-By Arrangement
SEEs	southeastern European economies
SGP	Stability and Growth Pact
SIP	Selected Issues Paper
SMP	Securities Markets Program
SOE	state-owned enterprise
SPR	Strategy, Policy, and Review Department
SRF	Supplemental Reserve Facility
STA	Statistics Department
TA	technical assistance
TFEU	Treaty on the Functioning of the European Union
TFGR	Task Force for Greece
TFP	total factor productivity
TOR	terms of reference
UFR	use of Fund resources
ULC	unit labor costs
UNCTAD	United Nations Conference on Trade and Development
VAT	value-added tax
WAEMU	West African Economic and Monetary Union
WB	World Bank
WEO	*World Economic Outlook*

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PART I

The Framework of IMF Decision Making

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CHAPTER 1

The IMF Executive Board and the Euro Area Crisis: Accountability, Legitimacy, and Governance

MIGUEL DE LAS CASAS

Introduction

In evaluating the performance of the IMF in the euro area crisis, it is important to consider the role played by the Executive Board. As the organ that represents all member countries in conducting the day-to-day business of the institution, it provides legitimacy to the Fund's decisions.[1] The Board is charged with the responsibility of making the vast majority of decisions, including those related to the formulation of IMF policies and its lending and surveillance operations. At the same time, it is the duty of the Board to direct the work of the management team in carrying out the ordinary business of the Fund. Did the Board adequately fulfill its fundamental duties during the euro crisis? Did management and the senior staff assist the Board sufficiently in executing these duties? Were decisions made according to the internal rules of the IMF? Was good governance exercised? These are the main overarching questions addressed by this chapter.

Under the existing governance structure of the IMF, there is a tension between the role of the Board as a decision-making body and the need of management and senior staff to undertake the technical work associated with IMF operations. The Board delegates sufficient latitude within the established policies, but it retains final authority. This tension is exacerbated during times of crisis, as program negotiations take place, usually, against a background of high uncertainty and urgency. In particular, when the Fund needs to make

[1] In June 2011, for example, Christine Lagarde remarked to the Board before assuming office as Managing Director: "I strongly believe in the value of a permanent resident Board. Without a Board representing the membership, there can be no global multilateral organization. I am convinced that the Board's work confers legitimacy to the Fund's action. A strong relationship between the Managing Director and the Board can only be built on trust and respect between us." (IMF, 2011a).

precedent-making decisions or assume unusual risks, the Board needs to be even more involved. That is the reason why, for example, the exceptional access policy has strengthened "procedures for decision-making to provide additional safeguards and enhance accountability." In this context, the conditions under which programs were designed for Greece, Ireland, and Portugal were undoubtedly exceptional. All three cases had potentially systemic implications, at the regional and global levels, required extraordinarily high access to IMF resources, and, importantly for the role of the Board, occurred in countries that are members of the euro area. This meant that (i) program negotiations were conducted jointly with the European institutions, (ii) IMF member countries holding more than one-third of the voting power at the Board were also the sole shareholders of those European institutions, and (iii) these countries had already committed, via public statements, to support the programs even before they were brought to the Board for consideration, and approved the parallel European lending, which also ensured that the IMF-supported program was fully financed.

Another crucial and related tension, long recognized in IMF activities (Rajan, 2005), is that between rules and discretion. While the Fund needs to have some discretion in deciding when and how much to lend, it is very difficult for the IMF to stand back when a member country is in trouble; indeed, the Articles of Agreement establish the right of any member to draw on Fund resources with adequate safeguards in order to prevent adoption of policies that are destructive of national and international prosperity. Rules clarify in advance the necessary conditions or safeguards and also help ensure even-handed, or comparable, treatment of members. Therefore, there is a strong case for adhering to established rules to ensure time and country consistency in the Fund's decisions, which helps preserve the best interest of the institution and its membership. The Fund's exceptional access policy and the Board's procedures, two sets of rules germane to the evaluation of the three euro area programs, seek to balance these important considerations.

This chapter analyzes the manner in which selected key decisions were made and the role played by the Board during the IMF's handling of the crises in these countries. Its focus is on the decision-making process and its implications for legitimacy, accountability, and governance rather than on the appropriateness of the decisions themselves. This chapter utilizes information gathered from interviews with relevant individuals and from internal documents.

The rest of the chapter is organized as follows. The second section explains the minimum legal and institutional background necessary to evaluate the involvement of the Board. The third and fourth sections analyze a number of key decisions in chronological order, as the sequence of events helps understand why and how they were made. The fifth section offers some findings and conclusions.

Legal and Institutional Background

Main Features of the IMF Executive Board

The Executive Board is the resident decision-making body of the IMF. Under its current configuration, 24 Executive Directors represent the same number of constituencies, covering all 189 member countries. The Managing Director serves as the Chairman of the Executive Board, and the Managing Director or one of the Deputy Managing Directors chair its meetings. Eight members enjoy their own single-country constituencies,[2] while the rest are part of multi-country constituencies (formed prior to biennial elections through the agreement of member countries who associate freely). Roughly, the geographical distribution of constituencies is as follows: one Chinese, one Central Asian, seven Europeans, one Japanese, one from the Middle East and North Africa, one Russian, one Saudi Arabian, one South American, one Southeast Asian, two from sub-Saharan Africa, one from the United States, and five are mixed groupings.[3]

According to Article XII, Section 3 of the Articles of Agreement of the IMF, the Executive Board is "responsible for conducting the business of the Fund," exercising all the powers delegated to it by the Board of Governors.[4] This "business" is defined broadly and includes lending operations and policy decisions. At the same time, the Board has the responsibility to direct the work of management,[5] since Section 4 of the same Article states that the Managing Director "shall conduct, under the direction of the Executive Board, the ordinary business of the Fund." Thus, the Board has two roles: (i) an executive one, given its decision-making responsibilities, and (ii) a

[2] China, France, Germany, Japan, Russia, Saudi Arabia, United Kingdom, and United States. http://www.imf.org/external/np/sec/memdir/eds.aspx. Following the entry into force of the Board Reform Amendment on January 26, 2016, and starting with the next regular election to be concluded by October 2016, all 24 Executive Directors are considered to be elected. The first election for an all-elected Board will take place in October 2016. Previously, the member countries holding the five largest quotas were each entitled to appoint an Executive Director, while 19 were elected by the remaining member countries. Three countries (China, Russia, and Saudi Arabia) held sufficient votes to have their own chair.

[3] Geographically mixed constituencies include: (i) Some Latin American countries and Spain, (ii) Canada, Ireland, and some Caribbean countries, (iii) some Latin American countries and some Caribbean countries plus Timor-Leste, (iv) some Asian countries and Oceania, and (v) some Middle Eastern countries and Ghana.

[4] The Board of Governors is the highest decision-making body of the IMF, but it has delegated most of its responsibilities to the Executive Board. The Board of Governors meets, normally, once a year and makes decisions by mail without a meeting. Each member country appoints one governor and one alternate governor, who are usually the minister of finance and the central bank governor.

[5] The term management refers, collectively, to the Managing Director and the Deputy Managing Directors.

supervisory and advisory one, as it is responsible for directing and monitoring the performance of management.

An important characteristic of the Board derives from the dual character of the Executive Director position. Directors are both IMF officials and representatives of the member countries that elect them. This means that they simultaneously defend national interests and those of the Fund as an institution. Directors, once elected, cannot be removed from office and continue in their office until their successor is elected biennially.

Votes are very rarely taken at the Board. Decisions are normally made by consensus, reflecting the cooperative nature of the Fund and the collegial character of the Board. This operating principle is incorporated in the Rules and Regulations of the IMF, which indicate that "The Chairman shall ordinarily ascertain the sense of the meeting in lieu of a formal vote" (Rule C-10). The "sense of the meeting" is understood as a position supported by Executive Directors having sufficient votes to carry the question if a vote were taken. However, any Director can always call a vote or express their contrary or abstaining position for the record on a particular issue.

When a vote is necessary, nearly all decisions, including those on the use of Fund resources, surveillance, and IMF policies, are made by a majority of the votes cast (Article XII, Section 5). Special majorities—either 70 percent or 85 percent of the total voting power—are specified under the Articles of Agreement and required only for decisions outside the "regular business." Each Director's voting power is determined by the voting power of the countries in his or her constituency.[6] The vote (or opinion) of Directors representing multi-country constituencies cannot be split, even if members forming a constituency disagree on a particular issue.

Executive Board Procedures[7]

The Compendium of Executive Board Procedures (the procedures) describes how Board meetings should be organized and held. The Chair of the Board calls the meetings according to the needs of the IMF or at the request of any Executive Director. Likewise, the Chair proposes an agenda of Board meetings, and Directors are entitled to request the inclusion of any item. Directors are to be notified of this agenda at least two days prior to the meeting, except in special circumstances. The procedures point out that a reasonable notice is especially important when a proposal implies a change of Fund

[6] Each member country of the IMF is assigned a quota, based broadly on its relative position in the world economy. Quotas not only determine a member's voting power (along with basic votes, which are distributed uniformly to all members), but also its maximum financial commitment to the IMF, and its access to IMF financing.

[7] This section refers to the Board procedures applicable during most of the euro area crisis. The Compendium of Executive Board Work Procedures, prepared in October 2001, was updated on May 13, 2010 and reviewed again in October 2015, simplifying and normalizing practices already in use during the euro area crisis (Annex 1.2).

practice or policy, or the establishment of exceptions to existing practice or policy. The majority of the Board may decide to postpone the discussion of an item.

There are two broad categories of Board meetings: formal and informal. The fundamental difference between the two is that the Board can only make decisions during formal meetings, while informal ones are used for informative and preparatory discussions.[8] Also importantly, the procedures require the preparation of supporting documents, summings up, and minutes for formal Board meetings, while informal ones are generally free from those requirements (Table 1.1). The procedures classify Board meetings into the following types:[9]

- Ordinary Meetings: these are formal meetings in which the Board may adopt decisions and reach understandings on the Fund's business.
- Executive Session: these are similar to ordinary meetings but restricted to Executive Directors and management. Attendance of the Secretary, Advisors, or essential staff may be permitted by the Executive Board.
- Informal Meetings: these meetings facilitate exchange of views on issues that are not yet at the stage at which a formal decision or understanding is sought, often on *individual* country matters. They may be called without the usual minimal advance notice.
- Informal Country Matters Sessions (restricted attendance): these are held semi-regularly and are intended to keep Executive Directors informed of developments in *several* countries on a strictly confidential basis.
- Seminars: these provide a format for discussion among Executive Directors on issues that may be considered formally by the Board at a later stage.
- Informal seminars: these are conceived for the discussion of subjects at a preparatory stage, both to brief Executive Directors or to gather their preliminary informal views or guidance.
- Executive Board Briefings by the Staff:[10] these are aimed at providing an opportunity for detailed question-and-answer sessions on country and policy issues.

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[8] The 2015 version of the Compendium explicitly acknowledges that informal sessions are meetings in which Executive Directors are not deliberating as a decision-making body of the Fund. Thus, they may present their own views or those of their authorities and no decisions are taken.

[9] Two additional categories "Informal Sessions on World Economic and Market Developments" and "Committees of the Whole" are omitted, as they are not relevant in the context of this evaluation.

[10] On May 13, 2010, the Compendium was revised to include the possibilities of (i) staff briefing a number of Executive Directors, not only the Board as a whole, and (ii) management, not just the staff, conducting the briefing. Thus, they became "Executive Board and Executive Directors' Briefings by the Staff and Management."

Table 1.1. Main Characteristics of Executive Board Meetings

	Formal Meetings	Informal Meetings				
	Ordinary and executive meetings	Informal meetings	Informal country matters sessions	Seminars	Informal seminars	Executive Board briefings by staff
Decision	Possible	No	No	No	No	No
Supporting documents	Yes	Possible	No	Possibly	Possible	No
Summing up/Concluding Remarks	Yes	No	No	Yes	No	No
Minutes	Yes	No	No	Yes[1]	No	No
Chaired by	Management	Management[2]	Management[2]	Management	Management/ staff	Management[2]

Sources: Compendium of Executive Board Work Procedures and author's elaboration.
[1] A disclaimer is included at the first page of the concluding remarks to ensure they are not misinterpreted as decisions of the Executive Board.
[2] The Compendium is not absolutely clear in this respect.

On the minimum circulation period, the procedures provide that documents for (formal) Board meetings on the use of Fund resources, including program requests and reviews, be circulated two weeks in advance. In the case of staff reports on Article IV consultations, the minimum circulation period is also two weeks, but for those countries considered to have important regional or systemic impact—a list that in May 2010 included Greece, Ireland, and Portugal—it is three weeks.[11] Waivers of the circulation periods can be granted at the request of the Executive Director representing the country, who should provide the rest of the Board with an explanation for the reasons why they could not be met. Any Director can object but Directors typically extend professional courtesy to each other.

IMF Access Policy

The IMF access policy regulates member countries' access to the Fund's resources relative to their quotas. Access varies depending, among other factors, on the needs of the member country and the facility used. When exceptional circumstances require financing above regular access limits (Box 1.1), the exceptional access framework comes into play with its own set of rules.

[11] The differentiation between countries that have a regional or systemic impact and those that do not was eliminated from the Compendium at the time of the May 13, 2010 review.

Box 1.1. Access Policy in May 2010: Thresholds and Criteria[1]

As a rule, access by member countries to the Fund's general resources is subject to (i) an annual limit of 200 percent of quota; and (ii) a cumulative limit of 600 percent of quota, net of scheduled repurchases.[2] However, the Fund may approve access beyond these limits, in exceptional circumstances, if the following four criteria are met:

(i) The member is experiencing or has the potential to experience exceptional balance of payments pressures on the current account or the capital account,[3] resulting in a need for Fund financing that cannot be met within the normal limits.

(ii) A rigorous and systematic analysis indicates that there is a high probability that the member's public debt is sustainable in the medium term. <u>However, in instances where there are significant uncertainties that make it difficult to state categorically that there is a high probability that the debt is sustainable over this period, exceptional access would be justified if there is a high risk of international systemic spillovers</u>.[4] Debt sustainability for these purposes will be evaluated on a forward-looking basis and may take into account, inter alia, the intended restructuring of debt to restore sustainability. This criterion applies only to public (domestic and external) debt. However, the analysis of such public debt sustainability will incorporate any potential contingent liabilities of the government, including those potentially arising from private external indebtedness.

(iii) The member has prospects of gaining or regaining access to private capital markets within the time frame when Fund resources are outstanding.

(iv) The policy program of the member provides a reasonably strong prospect of success, including not only the member's adjustment plans but also its institutional and political capacity to deliver that adjustment.

[1] Decision No. 14064-(08/18), February 22, 2008, as amended by Decision Nos. 14184-(08/93), October 29, 2008, 14284-(09/29), March 24, 2009, BUFF/10/56, May 9, 2010, 14716-(10/83), August 30, 2010, and 15017-(11/112), November 21, 2011.

[2] These limits, raised from 100 percent of quota and 300 percent of quota, respectively, in 2009 (IMF, 2009), were reduced again in February 2016 (IMF, 2016b), to 145 and 435 percent of quota, respectively, in reaction to the entry into effect of the Fourteenth General Review of Quotas.

[3] At the time of the 2009 review, the Board modified this criterion to allow exceptional access for potential and actual balance of payments needs stemming from both capital and current account crises.

[4] The underlined portion, known as the "systemic exemption clause," was introduced at the time of the approval of the Greek program (IMF, 2010b), and later removed in January 2016 (IMF, 2016a). See Annex 1.1.

The main elements of the framework, prior to the approval of the Stand-By Arrangement for Greece in May 2010, were adopted in September 2002 (IMF, 2002).[12] This adjustment of the framework took place in an environment where increasingly integrated financial markets had given rise to

[12] The framework has been subject to frequent revisions. Box 1.1 summarizes the most relevant ones.

sudden and disruptive capital account crises and the Fund had been faced with members' unprecedented financing needs. Thus, the Board approved arrangements granting levels of access, in terms of percentage of their respective quotas, never seen before; for example, 1,938 for Korea (1997), 1,560 and 1,330 for Turkey (2001, 2002), and 800 for Argentina (2001).

At the time of the design of the framework, it was felt that retaining the Fund's ability to lend above regular limits was crucial, but the policies available to do so—the exceptional circumstances clause and the "limits-free" facilities, that is, the Supplemental Reserve Facility and the Contingent Credit Lines—needed strengthening.[13] Concerns focused, among other issues, on the lack of clarity about the circumstances and scale in which exceptional access was granted and the degree of discretion in making these decisions. As staff explained in 2002, "the degree of discretion and flexibility in the present framework may make the Fund more vulnerable to pressures to provide exceptional access even when prospects for success are quite poor and debt burden of the sovereign is likely to be unsustainable." Greater involvement of the Board (and the capitals) was intended to counterbalance political pressures, particularly from major shareholders.

In response, the Board agreed on a framework with two main components: four criteria that need to be met to justify exceptional access (Box 1.1), and a set of strengthened decision-making procedures to be followed when exceptional access was considered appropriate. The objectives of the framework are fivefold (IMF, 2004a):

- To define more clearly and narrowly cases when exceptional access may be appropriate, with increasing constraints associated with higher access.
- To provide more clarity on the criteria used to determine when exceptional access is appropriate and when a restructuring of private claims is warranted.
- To provide a better basis for judgments on the appropriate scale of access in capital account crises.
- To put in place internal safeguards to ensure that these judgments are made carefully, risks are appropriately weighed, and the Board involved.
- To preserve the Fund's financial position and safeguard its resources.

During the discussions that led to the adoption of the criteria, the possibility of introducing another criterion based on contagion risk or potential systemic effects was explicitly considered, both as a necessary or sufficient condition for exceptional access. However, IMF staff advised against this option and, ultimately, the Board concurred with this view. The main rationale to

[13] The strengthening of the exceptional access policy was not the only measure discussed to improve the Fund's crisis resolution toolkit at the time. A Sovereign Debt Restructuring Mechanism, the introduction of Collective Action Clauses, and a review of the Fund's policy of Lending into Arrears were other possibilities explored in the context of the *Prague Framework for Private Sector Involvement*, endorsed by the International Monetary and Financial Committee in September 2000.

deny such a criterion was the concern that it would introduce a bias toward higher access for larger members and, therefore, would be incompatible with the principle of uniformity of treatment (IMF, 2002).[14] At the same time, Directors recognized that the Fund should be prepared to provide exceptional access "where the member's problems have regional or systemic implications, where the other criteria are met."

By strengthening the set of decision-making procedures, the Board sought to provide additional safeguards and to enhance accountability. Directors agreed to (i) raise the burden of proof in program documents, including a thorough discussion on the need and the appropriate level of access, a rigorous debt sustainability analysis (DSA), and an analysis of the derived risks to the Fund; (ii) formalize the requirements for early Board consultations regarding the status of negotiations, program strategy, and case for exceptional access; and (iii) mandate an ex post evaluation (EPE) by staff within a year after the end of the arrangement.

Several months later, in February 2003 (IMF, 2003), the Board saw "a more formal process for Executive Board consultation at the early stages of program discussions as helpful for reinforcing careful and systematic decision-making on exceptional access cases" and, in working out the modalities for these consultations, agreed on the policy for early consultation (PEC). The Board also stressed the importance of a consistent and rigorous application of the four criteria for exceptional access, while, at the same time, it recognized the need for management and staff to have sufficient flexibility and discretion in coming to agreement with country authorities in crisis situations without undue delay.

The PEC is based on the following six elements:[15]

#1. Once management decides that exceptional access to Fund resources may be appropriate,[16] it will consult with the Board promptly in an informal meeting that will provide the basis for consultation with capitals and help identify issues that would be addressed in a further informal session. Directors are to be provided with a concise note, circulated at least two hours prior to the meeting, that includes, as fully as possible:

(a) a tentative diagnosis of the problem;

(b) the outlines of the needed policy measures;

(c) the basis for a judgment that exceptional access may be necessary and appropriate, with a preliminary evaluation of the four substantive criteria applying in capital account crises,

[14] For more details, see the companion chapter on the application of the Fund´s framework for exceptional access in the Greek program (Schadler, 2017).

[15] The requirements of the PEC are closely aligned with those of the Emergency Financing Mechanism, agreed by the Board in 1995, and applied to the Greek, Irish, and Portuguese programs (IMF, 1995b).

[16] This decision is typically formalized by management's approval of a briefing paper or policy note from staff on the use of Fund resources.

and including a preliminary analysis of external and sovereign debt sustainability; and

(d) the likely timetable for discussions.

#2. Before the (formal) Board's consideration of the staff report, additional consultations will normally be expected, during which staff will aim to keep the Board abreast of program-financing parameters, including:

(a) assumed rollover rates,

(b) economic developments,

(c) progress in negotiations,

(d) any substantial changes in understandings, and

(e) any changes to the initially envisaged timetable for Board consultation.

#3. The staff will provide the Board with a separate tentative report evaluating the case for exceptional access based on further consideration of the four substantive criteria, including debt sustainability. Where time permits, this report will be provided to the Board in advance of the circulation of program documents. In all cases, this report will be included in the program documents.

#4. Management will consult with the Board specifically before concluding discussions on a program and before any public statement on a proposed level of access.

#5. Strict confidentiality will need to be maintained, and public statements by members, staff, and management should take special care not to prejudge the Board's exercise of its responsibility to take the final decision.

#6. The staff report for an arrangement proposing exceptional access will include:

(a) a consideration of each of the four substantive criteria for exceptional access in capital account crises (including a rigorous analysis of debt sustainability);

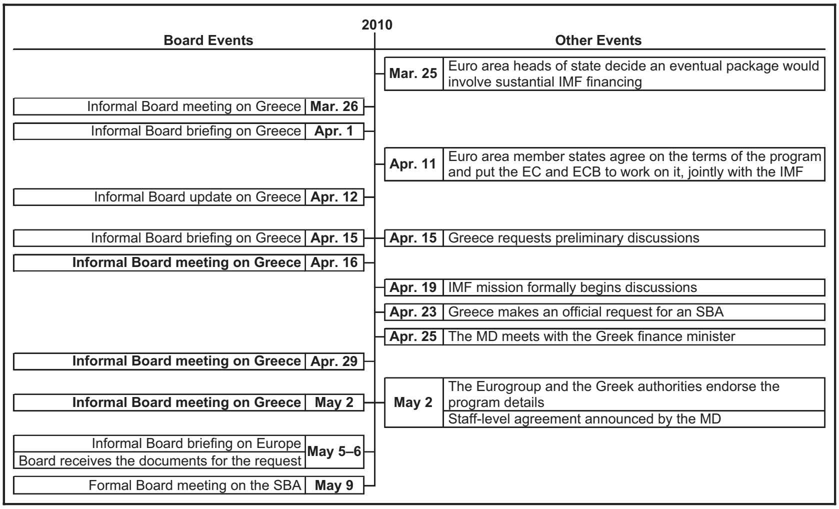
(b) a thorough discussion of need and the proposed level of access—including a standard table gauging proposed access levels against a broader set of metrics, and complement quota-based metrics;

(c) an assessment of the risks to the Fund arising from the exposure and its effect on liquidity;[17] and

(d) systematic and comprehensive information on the member's capacity to repay the Fund.

[17] At a later review, in April 2004 (IMF, 2004b), the Board added the requirement of an in-depth scenario analysis of the financial impact on the Fund and explicit recognition of the cost (to borrowers and creditors) of members incurring arrears to the Fund.

Figure 1.1. Greece: Timeline of Relevant Events



Note: Sources for Figures 1.1, 1.2, and 1.3 IMF Secretary's Department and press reports.

At the same meeting, Directors highlighted the unusual uncertainty and risk that is often associated with projections of private capital flows and the difficulty this poses for program design. They considered that it was especially important to be explicit and cautious about the assumptions underlying the projections for financing, and a number of Directors requested that additional information be provided to the Board discussing private sector involvement (PSI) in program financing. The Board agreed that discussions on PSI issues would be expected during the consultations with the Board for exceptional access cases.

The Role of the Board in Program Decisions

The Stand-By Arrangement for Greece

On May 9, 2010, the Executive Board approved a Stand-By Arrangement for Greece granting the highest access in the Fund´s history: €30 billion representing over 3,200 percent of the country's quota. Was this unprecedented decision consistent with the rules of the Fund? Was good governance practiced?

Eight informal meetings of the Board took place in the run-up to the May 9 formal meeting, three of them under the policy for early consultation in exceptional access (PEC) described above (Figure 1.1).[18] Other meetings, attended only by management and a subset of Directors, also took place. For

[18] In this chapter, "informal meetings" refer only to meetings of the Board as a whole. The term does not include meetings of management with a subset of the Board or meetings of Directors, with or without participation of staff.

example, the Managing Director called for meetings of European Directors, together with staff from various departments, on at least two occasions to report on the status of the program negotiations and his trips to Europe.

The decision to involve the Fund in an eventual financial assistance package to Greece was taken in Brussels as early as March 25, 2010 by the Heads of State and Government of the euro area. Later, on April 11, euro area member states announced their agreement for the European Commission and the European Central Bank (ECB) to begin working on a joint program, to be designed with and co-financed by the IMF. This announcement also detailed the duration of the program (three years) and the euro area member states' contribution for the first year (€30 billion), which later was revised upwards. Also at that early stage, despite having reiterated the absence of negotiations—other than those related to technical assistance (TA)—the Managing Director stated that it was obvious that a potential program would imply exceptional access (perhaps prejudging the Board's final decision).

On April 15, 2010, the Greek authorities requested the initiation of preliminary discussions on a potential program, and an IMF mission began operations in Athens on April 19. Four days later, on April 23, Greece made an official request for a SBA, and on April 25 the Managing Director met with the Greek finance minister. On May 2, the Eurogroup made public the details of the joint program with the IMF, which had already been endorsed by the finance ministers of the euro area and approved by the Greek Council of Ministers. The Managing Director and the EU Commissioner for Economic and Monetary Affairs issued a joint statement strongly supporting the program. The same day, the Managing Director also announced a "staff-level agreement" on a three-year and €30 billion Stand-By Arrangement for Greece (Box 1.2).

The staff note that the Board received and discussed on April 16, 2010 can be judged to satisfy element #1 of the policy for early consultation (PEC). It includes a tentative diagnosis of the problem and the policy measures needed, a preliminary evaluation of the appropriateness of exceptional access, and the anticipated timetable for negotiations. This note was very brief and prepared on the basis of preliminary discussions with the Greek authorities, the EC, and the ECB. It focused mainly on contagion risks and its assessment was that strong implementation of a program would allow Greece to meet all of the exceptional access criteria—a judgment later reconsidered. The note did not provide quantified estimates of the financing gap, expected access to IMF resources, or European financing; these estimates were however already available to management and staff and to the EC and the ECB. Nor was there a discussion of private sector involvement (PSI) approaches. While not explicitly required by the PEC, this lack of openness undermined the framework's intent to strengthen the decision-making process in exceptional access cases, reduced the information provided to Directors (and their capitals) and limited their ability to provide meaningful feedback. In fact, several Directors, at

Box 1.2. Staff-Level Agreements

Staff-level agreements are not binding. They are the manifestation of an understanding reached between the staff of the IMF and the authorities of a member country on a potential program. From the legal point of view these agreements are *ad referendum*. To become Fund arrangements in support of members' programs, they are subject, first, to clearance by management, and, second, to the final approval of the Executive Board.

However, markets and other external agents do not always pay attention to this distinction. From the public relations point of view, it is not always clear "who the Fund is" or "who speaks for the Fund" since, as the last review of the IMF's communication strategy recognized (IMF, 2014a), communication takes place at many levels. Typically, in IMF documents, "the Fund" refers to the Executive Board but, depending on the context, it may have different meanings (e.g., the Board of Governors, the Managing Director, or the institution as a whole). On who speaks for the Fund, the understanding is that each organ of the Fund does so within its own powers. In this regard, staff-level agreements are within the authority of management. The communication strategy establishes that public communications regarding these agreements must make very clear on whose behalf a communication is made: "Whenever relevant, where management/staff views are expressed, it should be clearly qualified by language explaining that the Fund's ultimate position would depend on the Executive Board (for example, completion of Article IV consultations and approval of use of Fund resources)."

this stage, expressed concerns over the lack of data provided to the Board and the absence of information on how the IMF was going to be involved in an eventual program, issues already being discussed by the press.

Between April 16 and May 2, 2010, the Board met informally three times under the PEC. According to the evidence reviewed by the IEO,[19] element #2 of the PEC was formally met. During interviews, however, several Board members were of the view that, while the parameters specified in this element were mentioned, the information provided by management and staff was too general and lacked crucial details (see below). With respect to element #3 of the PEC, it appears that the report on the case for exceptional access was made available to the Board together with the program request documents.

At the May 2, 2010 meeting, management and staff informed Directors that a staff-level agreement had been reached and provided them with the

[19] As noted in the section "Legal and Institutional Background," the Board procedures do not require the preparation of minutes for informal meetings. As a result, there was considerable uncertainty regarding what documents were available and accessible to the IEO. Gaps could only be filled, at least in part, with information gathered from interviews.

details on the contributions of the IMF and the European partners to the financing package. Prior to that meeting, the level of access to Fund resources required under the program had not been shared with the Board, either in writing or orally, despite repeated questions by several Directors. Neither were specific numbers presented to the European Directors during their meetings with management and staff. Although element #4 of the PEC was complied with, given that the Board met right before the program announcement in Brussels, Directors did not have time to carefully consider, let alone consult with their capitals, the key parameters of the arrangement that were going to be immediately announced.

Similarly, element #5 of the PEC was fulfilled, since management and staff did not make any public statement prejudging the Board's final decision. However, the way the process was handled resulted in the IMF Board to be the last decision-making body to be informed about the details of the program, as the Eurogroup and the Greek authorities were already endorsing it, and virtually at the same time they were released to the public.

The documents containing the full details of the program and the Greek request were sent to Directors between May 5 and 6 and the Board meeting was scheduled for Sunday, May 9, 2010. This left Directors only two days to study, and to consult with their capitals, a very complex program that involved the largest financing package in the history of the Fund.

The requirements applicable to staff reports on arrangements involving exceptional access (element #6 of the PEC) were formally met by the May 5 report. However, the background document on the risks to the Fund and its liquidity position did not include an in-depth scenario analysis of the financial impact or explicit recognition of the cost to other members of Greece falling into arrears. In terms of format, the three meetings that took place under the PEC were called as informal restricted meetings. According to Fund's law, no decisions could be taken during any of those meetings, and virtually no procedural requirements applied.

In general, the timeliness and content of the informal consultations was judged by many Directors to have been inadequate. They stated to the IEO team that these informal meetings took place too late, post factum, and that the media constituted a better source of information than management and staff. A case in point is the crucial decision to grant exceptional access financing to Greece without private sector involvement (PSI)—standstill or debt restructuring (Wyplosz and Sgherri, 2017). Despite the expectation in the framework that PSI would be discussed during early consultations with the Board, several Directors felt that management and staff had avoided the topic. Although the topic was raised by a few Directors, their questions were, in their view, never substantively answered, which led to the absence of an informed and open discussion and the subsequent perception that they were being presented with a fait accompli. For example, when asked about debt restructuring during one of the meetings, staff replied that debt restructuring had never been on the table and would never be under discussion.

The objectives of the exceptional access framework

In sum, as the foregoing discussion suggests, while the letter of the exceptional access framework was complied with, its objectives were not satisfied, particularly, those of the PEC. The lack of timely and relevant information to the Board had three main consequences. First, it created an important information asymmetry at the Board. Some Directors, including those representing European members, might have received more timely information from their capitals on the progress and details of the negotiations, but the rest were not adequately kept informed by management and staff.[20] While this asymmetry occurs in any program discussion, where the Director representing the borrowing country enjoys access to information not available to other Directors, this case was exceptional in that countries holding over 30 percent of the voting power at the Board had potential access to information on program negotiations via their participation in the European institutions.

Second, IEO interviews and the sequence of events suggest that the Executive Board's decision-making and advisory roles were undermined, rather than strengthened as intended under the exceptional access policy procedures. Information reached Directors practically at the same time as decisions were publicly announced by management and the IMF's European partners, leaving little room for the Board to provide real input or to influence decisions. On May 9, the Board had the legal prerogative to reject or postpone the approval of the program, since what was presented to them was a staff-level agreement *ad referendum*. But, was this a feasible option? Rejecting a program request is a difficult decision for the Board in any program case, as it implies acting against the advice of management and staff—potentially undermining their authority, and, ultimately, damaging the IMF's credibility—and denying assistance to a member country in difficulties.[21] Indeed, the early Board consultation procedures are intended to avoid this "nuclear option" by keeping Directors informed during program negotiations and allowing for timely consultations with their capitals. In this case, rejection was even more difficult, because of (i) the risk of regional and global contagion, and (ii) the fact that the capitals of member countries holding almost one-third of the voting power at the Board, and providing the non-IMF part of the program financing, had already publicly committed to the agreement.[22]

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[20] According to one interviewee, the frequent interactions of the Managing Director with European Finance Ministers during the negotiations distorted the usual channel of communication of capitals with the IMF, which takes place through the Executive Director. This may have reduced the information asymmetry between European and non-European Directors but may have also aggravated the general lack of information at the Board, thereby removing it further from the decision-making process.

[21] In fact, programs are hardly ever voted down by the Board.

[22] The consolidation of European voting power in the cases of Greece, Ireland, and Portugal triggered calls for adaptation of the voting rules at the Board. See, for example, the views of Jim

Third, delayed information and involvement deprived the Board of the ability to direct and monitor management and staff, making it difficult to hold them accountable. Thus, management's discretion and decision-making powers were left effectively unchecked.

These governance and accountability problems, which the PEC was designed to address, may have eroded the legitimacy and evenhandedness of the IMF. They are not new,[23] but the case of Greece is a particularly clear and striking example. These issues result in part from Directors' dual role as representatives of member countries and as IMF officials. Many Directors noted during interviews a conflict between their own views regarding the viability of the Greek program and those they were instructed to support by their authorities. Some of them even described the Board as a "theatrical exercise" in some instances, and considered it caught in a "governance trap."

Why did this happen? It would appear that four factors were at play. First, management was able to maximize its operational and decision-making powers by minimizing the involvement of the Board, and Directors may not have pushed back hard enough, demanding more information. Second, as foreseen by the exceptional access framework, decisions had to be made in a fast-evolving context, subject to a high degree of uncertainty. In the words of one Director interviewed, "the environment of risk and fear created around the negotiations" was such that it looked like "everything was permissible," which led to, at least, the perception of a more favorable treatment of Greece. Third, coordination with the European institutions introduced additional difficulties, as the process did not always operate smoothly. However, the Eurogroup seems to have been kept better informed by the EC and the ECB, than the IMF Executive Board by management and staff (Kincaid, 2017). Fourth, in an environment of extreme market sensitivity, potential leaks were considered a significant risk, especially given the history of recurring information leakage problems at the Board.

The process of informing the Board was seemingly approached as a box-ticking exercise, jeopardizing the credibility and legitimacy of the institution. Indeed, the consensus view among Directors interviewed was that the process could and should have been handled differently. They believed that a more timely, open, and transparent involvement of the Board would have prevented (i) the perception, internal and external, that the IMF gave Greece a more favorable treatment, and (ii) the sidelining of the Board that left a part of the membership largely out of the process. Even so, in their view, it would have had little or no impact on the final decisions.

Flaherty, Canadian Finance Minister at the time, proposing a double vote and approval; one by euro area members and another one by non-euro area members: http://www.reuters.com/article/g-idUSL2E8FJ2KJ20120420. This change would have required an amendment to the Fund's Articles of Agreement.

[23] See, for example, IEO (2008).

The Modification of the Exceptional Access Criteria

The approval of the Greek SBA required a modification of the second criterion of the exceptional access framework. Since Fund staff assessed Greece's debt not to be sustainable in the medium term with a high probability (Schadler, 2017) and after IMF management and the European institutions had already agreed and announced that Fund financing above the regular access limits was needed, IMF management decided that a modification of the criterion was the best way forward. The Board was not consulted on this question. In fact, Directors were not informed of staff's doubts regarding the sustainability of the Greek debt under the program, or notified of the proposal to modify the exceptional access criteria, until May 5, 2010, when the formal request document was sent to the Board.

In making this change, the rationale behind the Board's procedures was overlooked. First, Directors did not have enough time—just two days—for consideration of a decision that modified a crucial element of the lending framework of the IMF. Arguably, this could have been justified by the urgency of the situation at the time but, according to the evidence obtained by the IEO, management had been considering different alternatives for the modification to the exceptional access policy since, at least, end-April. Moreover, staff stated during the formal Board meeting on the Greek SBA request that they had been thinking about how to approach a change in policy for "a couple of weeks." Yet the Board was not consulted or informed during this period.

Second, and more importantly, neither management nor staff drew the attention of the Board to the proposed decision itself or to the fact that the exceptional access criteria would effectively be modified by approving the SBA. The policy change was embedded in the report requesting the Greek SBA and, therefore, was to be approved implicitly along with the formal and explicit request for Fund resources.[24] According to internal documents, concerns were raised during a meeting of management and staff that changing the policy might undermine the credibility of the IMF-supported program, especially with financial markets. It was noted by staff that this policy change could be done quietly by embedding the decision in the staff report. This is against the objectives of the Board procedures and normal Fund practice. In fact, according to interviews and the minutes of the meeting, several Directors expressed concerns about the modification being "hidden" in one sentence of the report, and stated they had not realized the magnitude and

[24] The report, in assessing the compliance with the exceptional access criteria, reads: "On balance, staff considers 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, 2010a, p. 19).

implications of this modification until one of them raised the issue during the meeting.

Once the issue was put in the spotlight during the Board meeting, several Board members expressed concern over how the modification was being presented and explored different alternatives. They proposed taking a decision applicable exclusively to Greece, but the Legal Counsel explained that the Board has no authority to make individual exceptions and, therefore, a modification of the criteria for Greece would apply to the whole membership. Some Directors also proposed to hold a separate meeting to deliberate such a far-reaching change or, at a minimum, to dedicate an entire paragraph of the report to discussing the modification, which is more in line with the regular practice. In the event, it was decided to go ahead with the language as proposed in the staff report, and to reflect it in the summing up.[25] The published IMF press release made no mention of this change in IMF policy.

The process for the inclusion of what became known as the systemic exemption clause went also against the objectives of the exceptional access framework, namely to limit discretion, ensure uniformity of treatment, safeguard Fund resources, and shape expectations of members and markets. Furthermore, the modification clearly was a reversal of the Board's judgment at the time of the introduction of the framework in 2002, when a systemic criterion was rejected (due, again, to concerns about its compatibility with the principle of uniformity of treatment). In coming to the decision to modify the criteria, the same four factors that led to the approach adopted during the approval of the SBA for Greece (see above) may have been at play. Moreover, as management, and the European partners, had already agreed on the design of the Greek program, a pragmatic and quick fix was needed. A senior IMF official interviewed by the IEO considered at the time that the exceptional access criteria were "bureaucratic rules" that should not stand in the way of putting out the fire facing the world and that their modification would not be a serious issue.

The way in which the modification of the exceptional access framework was handled raises the same governance, accountability, and evenhandedness issues posed by the departure from the framework itself (see the section "The Stand-By Arrangement for Greece" above).

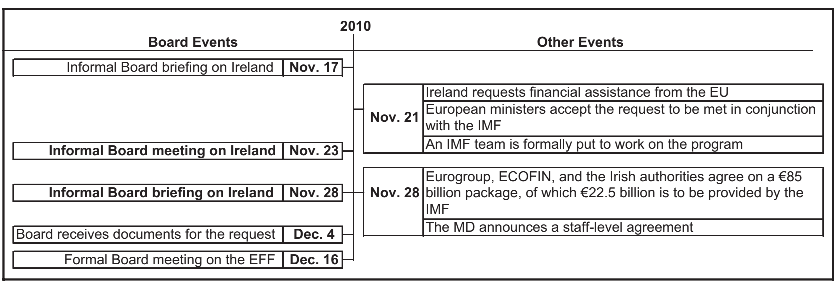
[25] The summing up states regarding the debt sustainability issue: "While Directors considered public debt to be sustainable over the medium term, they recognized that there are significant uncertainties that make it difficult to state categorically that there is a high probability that the debt is sustainable over this period as required under the exceptional access policy. Even so, on balance, Directors considered Fund exceptional access as justified given the high risk of international systemic spillovers. Going forward, to ensure the principle of uniformity of treatment, Directors recognized that the Fund would follow this approach regarding this criterion in similar cases with a high risk of systemic spillovers." (IMF, 2010b)

The Extended Arrangement for Ireland

On December 16, 2010, the Executive Board of the IMF approved a three-year and €22.5 billion arrangement under Extended Fund Facility (EFF) for Ireland, authorizing the second highest level of access in the history of the IMF: 2,322 percent of Ireland's quota. The Board held three informal meetings on Ireland before the approval of the extended arrangement (Figure 1.2), two of them under the policy for early consultation (PEC).

On November 17, 2010, management and staff communicated to the Board that the next day an IMF mission would begin a "technical engagement" with the Irish authorities on financial sector issues and on "preparation and discussion of program modalities" for a potential program. On November 21, the Irish government formally requested financial assistance from the European Union.[26] On the same date, EU ministers accepted the Irish request, to be met with a joint EU-IMF financial assistance package[27] and the Managing Director instructed an IMF team that was already in Dublin to work on the program, together with the other members of the troika. Also on November 21, a note prepared by staff was sent to the Board in preparation for the Board meeting to be held on November 23. This note presented (i) a preliminary analysis of the problems of the Irish economy, (ii) the recommended policy measures, (iii) a positive assessment of the fulfillment of the criteria for exceptional access, justified by the high risk of international systemic spillovers, and (iv) the anticipated next steps. Thus, it met the requirements contained in element #1 of the PEC. However, as in the case of Greece, this note did not provide estimates of financing requirement, IMF support, and European contribution, all of which was available to management and staff at the time. Moreover, during the November 23 meeting, staff explained that it was still too early to provide estimates on the size of the financing requirements—although it was foreseen that the IMF would cover approximately one-third of them—or to discuss in depth PSI approaches. As in the Greek case, while complying with the letter of the exceptional access framework, the approach of management and staff departed from its objectives.

Figure 1.2. Ireland: Timeline of Relevant Events



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[26] http://money.cnn.com/2010/11/21/news/international/ireland_banks_bailout/index.htm.
[27] http://ec.europa.eu/economy_finance/crisis/2010-11_en.htm.

On November 28, the Eurogroup and ECOFIN met and unanimously agreed, with the Irish government, on a financial package of €85 billion, of which €22.5 billion was to be provided by the IMF. An informal Board meeting took place simultaneously, during which Directors were provided with the details of the IMF's financial contribution to the program, in compliance with element #4 of the PEC. The EU Commissioner and the Managing Director announced the agreement immediately after in a joint statement. At the same time, the Managing Director announced separately a staff-level agreement for a three-year arrangement under the EFF and for €22.5 billion.

Thus, requirements under element #2 of the PEC were formally satisfied, although Directors felt that key information was not shared with the Board. The Board did not receive a note on the case for exceptional access until the staff report for the program request was circulated, which is consistent with element #3 of the PEC. The Board received the program documents recommending the approval of exceptional access on December 4,[28] with a discussion to be held on December 10.[29] These documents complied with element #6 of the PEC.

Overall, the letter of the PEC was complied with during the decision-making process. The rationale and objectives of the exceptional access framework, however, were somewhat set aside. For example, Executive Directors could have been provided with key information in a more timely manner, allowing for more meaningful consultations with their capitals and a more proactive role of the Board at an early stage. The Board was again notified of the IMF's share of the financing under the program as the other members of the troika and the Irish authorities were already giving their agreement and practically at the same time that details were made public. When the Board was faced with a proposed decision to approve the arrangement, the European authorities and institutions, with the tacit approval of IMF management, had publicly committed to the program for more than two weeks. The nuclear option was the only one left to Directors in case of disagreement. In this respect, the process that led to the approval of the Irish arrangement is subject to analogous criticisms to the process used for Greek SBA, with a similar impact on accountability, legitimacy, and governance.

The Irish case also highlights another element of the exceptional access framework: the expectation that the Board would discuss PSI issues during the consultations preceding the approval of an arrangement. During those consultations, despite several questions by Directors, they were not discussed in depth. While during the formal meeting on December 16, some Directors put on the table again the question of alternative approaches to PSI—more specifically asking staff about the possibility of bailing in senior bondholders

[28] Ireland did not make the formal request until the previous day.

[29] The later decision by the Irish government to table a motion on the program before the Parliament forced the postponement of the Board's discussion until December 16.

of Irish banks—the issue had been settled some time earlier. After initial consideration by the Irish authorities and IMF staff, the troika had collectively ruled out this possibility in the last week of November, following a teleconference held by the finance ministers of the G7, the president of the European Central Bank, and the Managing Director of the IMF (Donovan, 2017). This issue had not been discussed at informal Board meetings prior to that decision, depriving Directors of an opportunity to provide guidance for negotiations to management and staff and raising again questions of information asymmetry, accountability, and governance more generally.

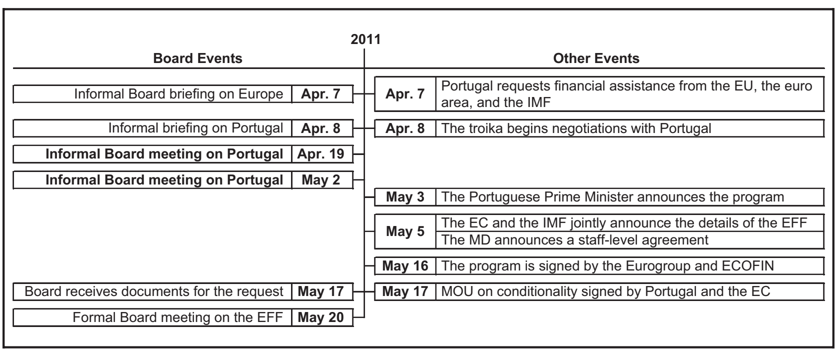
The Extended Arrangement for Portugal

The Board approved Portugal's three-year arrangement under the Extended Fund Facility involving financing for €26 billion or 2,306 percent of its quota (the third highest access in the Fund's history)—on May 20, 2011 (Eichenbaum, Rebelo, and de Resende, 2017). The Board met informally four times, beginning April 7, to discuss issues related to Portugal (Figure 1.3).[30] Two of these four informal Board meetings took place under the policy for early consultation (PEC).

On April 7, 2011, the Portuguese authorities requested, formally and simultaneously, financial assistance from the EU, the euro area member states, and the IMF. The Board met informally on the same date to discuss the situation in Europe, including Portugal. On April 8, the Eurogroup and ECOFIN acknowledged the request and invited the EC, the ECB, and the IMF to start program negotiations with Portugal. On the same day, an informal Board meeting was called to inform Directors of the Portuguese request.

On April 19, the Board met informally again, for the first time under the PEC, to consider the concise note prepared by staff. This note, circulated to Directors the previous day, met the formal requirements in element #1 of the PEC, including a preliminary evaluation of the criteria for exceptional access

Figure 1.3. Portugal: Timeline of Relevant Events



[30] The 2011 IMF Spring meetings took place between April 15 and 17, and the Managing Director resigned on May 18.

in which staff assessed the second criterion to be met given the "high risk of international systemic contagion." Yet, as in the other two cases, quantification of the financing requirement, expected IMF access, and European financial support were not provided to the Board in this note even though this information was available to management and staff. Moreover, in response to Directors' questions at the informal meeting, staff explained that it was still too early to provide such information.

There was another informal Board meeting on Portugal on May 2. During that meeting, management and staff shared with the Board a preliminary financing gap estimate of €70 billion, of which one-third was to be covered by the IMF. Therefore, in the Portuguese case, the Board was informed of the (preliminary) level of access before the public announcements and before the program was approved by the European institutions, satisfying elements #4 and #5 of the PEC. Other elements of the PEC were also complied with, since (i) information given to Directors broadly complied with the requirements of element #2, and (ii) the Board received a report on the case for exceptional access with the documents supporting the Portuguese request, which is sufficient under element #3. However, PSI issues were not discussed as expected in the exceptional access framework.

The Portuguese Prime Minister announced the program on May 3,[31] but it was only on May 5 that the EC and the IMF jointly released the details of their financial assistance. The Managing Director announced a €26 billion staff-level agreement under the EFF on the same day. Subsequently, on May 16, finance ministers signed the agreement during the meetings of the Eurogroup and ECOFIN. The Memorandum of Understanding that specified the conditionality was signed by the EC and Portugal on May 17. The formal Board meeting was held on May 20. The staff report for the request, specifying the details of the arrangement in full, was sent to Directors two days earlier and was compliant with the requirements of element #6 of the PEC.

In general terms, the Board was informed in a more timely manner during the Portuguese negotiations than in the other two cases. However, Directors were still not able to provide guidance during the first stages of the process and could have been provided with information earlier. The Portuguese case is, moreover, the only one in which, at the time of writing, an ex post evaluation (EPE) has not been discussed by the Board, even though almost two years have elapsed since the expiration of the arrangement in June 2014.

The Role of the Board in other Selected Decisions

"Enhanced Surveillance" for Italy

Italy committed to a series of structural reforms and to a fiscal consolidation strategy during the Euro Summit on October 26, 2011. The leaders'

[31] http://www.reuters.com/article/us-portugal-bailout-idUSTRE7425UP20110503.

statement invited the European Commission to assess in detail the proposed measures and to monitor their implementation. The G20, during the November 4 summit in Cannes, supported these measures and welcomed in its statement "Italy's decision to invite the IMF to carry out a public verification on its policy implementation on a quarterly basis." The Managing Director, who attended the G20 summit, confirmed immediately afterwards Italy's request to the Fund and stated that she expected to have a team on the ground before the end of the month. She also explained that the plan was to benefit from the expertise, know-how, and independence of the IMF to verify and certify the implementation of Italy's commitments, in order to overcome their "lack of credibility."

This monitoring of Italy's policy implementation, sometimes referred to by the Fund's spokespersons and the media as "enhanced surveillance,"[32] never occurred. According to IEO interviews, as the new Prime Minister of Italy took office and the measures agreed with the EC were implemented, coupled with the ECB's purchases of Italian bonds, market pressures eased, and the Italian government and its European partners no longer considered formal IMF involvement as necessary.[33]

What was the involvement of the Board in the considerations of this enhanced surveillance engagement? Some members of the Board recalled being informed about the Managing Director's discussions in Europe, but the issue and the alternative ways in which the Fund could engage with Italy were never presented in written form or discussed informally with the Board, according to evidence available to the IEO. This episode is another example of decisions being taken in Europe with no meaningful involvement of the IMF's Executive Board. It also contributed to solidifying the perception among some Directors that European countries were treated differently.

The Provision of Technical Assistance to Spain

In 2012, the IMF conducted a Financial System Stability Assessment (FSSA) for Spain under the Financial Sector Assessment Program (FSAP), updating the one completed in 2006. On April 25, the preliminary conclusions were made public by the Fund mission. On June 8, the Board formally

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[32] Formally, "enhanced surveillance" is a special instrument in the IMF toolkit used as a signaling device and does not imply IMF endorsement of the member's economic program. Created in 1985, it has not been used since the early 1990s (IMF, 2007). It is unclear whether references to "enhanced surveillance" in the context of Italy's monitoring referred to this instrument in particular or generically to an intensified form of surveillance. Had this monitoring been implemented, this differentiation would have been important, as the required involvement of the Board would have been different.

[33] Mario Monti replaced Silvio Berlusconi as Prime Minister on November 16, 2011. The media reported, at the beginning of February 2012, that discussions between Italy and the IMF were being held on the possibility of bringing the format of the planned monitoring closer to the Fund's regular surveillance, as market pressures eased. (See http://www.reuters.com/article/italy-imf-idUSL5E8D32KH20120203.)

discussed the Spanish FSSA,[34] and the next day the Eurogroup made public a statement announcing predisposition to respond favorably to an eventual request for financial assistance by the Spanish authorities. In the same statement, the Eurogroup indicated that the IMF would be involved in the conduct of an initial assessment and designing financial sector conditionality to be attached to the program. It also invited the Fund "to support the implementation and monitoring of the financial assistance with regular reporting." The Managing Director strongly welcomed this preliminary agreement and signaled the IMF's readiness to accept the invitation of the Eurogroup. Six weeks later,[35] on July 20, the Eurogroup approved the financial assistance and the Fund made public the "Terms of Reference for Fund Staff Monitoring in the Context of European Financial Assistance for Bank Recapitalization." This terms of reference, agreed with the Spanish authorities and the EC, clearly specified that (i) the Fund was not responsible for the conditionality or implementation of the financial assistance, and (ii) the Fund's monitoring was to be conducted as a form of technical assistance.

Focusing exclusively on the involvement of the Board, management and staff made a series of decisions that effectively left the Board out of the decision-making process on this Spanish TA. According to information available to the IEO, different alternatives were internally considered and a different course of action could have been chosen. First, the Fund's monitoring could have been conceived as a form of surveillance under Article IV, which would have implied formal involvement of the Board. However, it was decided to shape it as TA, under Article V, Section 2(*b*), which can be approved and conducted without the authorization of the Board.[36] Second, the Spanish authorities, not a European institution,[37] made the request for TA. If the request had been made by a nonmember, including an international organization, it would have required Board consent. Third, responsibility for conditionality design and implementation was not assumed, as this would have gone beyond the boundaries of TA, requiring Board approval. Fourth, despite the absence of legal requirements, management could have decided to engage Directors more actively, but, in the event, the Board was not involved except

[34] FSSAs are normally discussed by the Board together with the Article IV report for the country in question. However, in this case, the Board considered the FSSA for Spain on stand-alone basis (the Article IV report was presented to the Board on July 25), which was regarded by several Directors at that time as an example of exceptionalism.

[35] In the interim, on June 14, the Article IV mission to Spain ended and a concluding statement was published.

[36] The functions of the Executive Board in the area of capacity development, including technical assistance, are limited to strategic direction and oversight through (i) regular reviews of, and policy guidance for, the Fund's capacity development policies and activities; and (ii) the budget process. It is management responsibility to approve individual members' requests, conduct operations, and establish policies in this area (IMF, 2014b).

[37] Financial assistance was provided through the ESM, while the EC was in charge of conditionality and monitoring.

to receive, for information only, the TOR and the staff periodic monitoring reviews.

According to Board members interviewed for this evaluation, the Board was never consulted on the possible modalities of IMF engagement with Spain, nor was it formally involved in the implementation of the monitoring. This was a managerial decision, taken in accordance with internal rules and practices, but was it an example of good governance? In the view of some Directors, management effectively excluded the Board and allowed an exceptional treatment to Spain, giving rise to concerns about evenhandedness, legitimacy, and accountability. Directors also noted that a higher degree of transparency and candor in the communication between management and Directors would likely have led to the same outcome but without raising governance-related concerns.

The Interaction with European Institutions

The Eurogroup created the troika in 2010 as the vehicle for negotiations of joint IMF-EC programs with Greece, and continued on for the Irish and Portuguese crises. The rationale behind this setup, and the important implications that followed, are beyond the scope of this chapter (see Kincaid, 2017 for a detailed analysis). However, the troika arrangement was not the only way in which the IMF could have engaged in these programs, both in terms of process and substance. For example, the IMF could have (i) acted more independently, (ii) participated with a larger or smaller financing share, perhaps even within regular access limits, or (iii) assisted in the design and implementation of the program without the provision of financing, as it did in Spain. These and other alternative modalities of engagement could have been explored, but according to the information available to the IEO, the Board was never consulted by staff or management on how to proceed nor were the implications presented to the Board in 2010.

The IMF's Role in the ESM Treaty

The treaty establishing the European Stability Mechanism (ESM) refers to the IMF in a number of places. Some of these simply refer to the Fund as a model or standard for operations (e.g., consideration of PSI in exceptional cases, or provision of financial assistance when access to regular market financing is impaired), but some other references specify a role for the IMF in the operations of the ESM. In particular, the Treaty stipulates that:

- "The ESM will cooperate very closely with the IMF in providing stability support. The active participation of the IMF will be sought, both at technical and financial level. A euro area member state requesting financial assistance from the ESM is expected to address, whenever possible, a similar request to the IMF." The framework agreement of the European Financial Stability Facility (EFSF), the predecessor of the ESM, also contained a provision to this effect.

- The assessment of debt sustainability "is expected to be conducted together with the IMF" wherever appropriate and possible.
- MOUs detailing the conditionality attached to the ESM financial assistance will be negotiated by the EC in liaison with the ECB and "wherever possible, together with the IMF," a provision, again, originally introduced in the framework agreement of the EFSF.
- The EC, in liaison with the ECB and "wherever possible, together with the IMF" will monitor the compliance with ESM's conditionality.

While these provisions are not binding on the IMF, they frame its relationship with European institutions and define coordination expectations. While IMF staff commented on a draft of the Treaty, the issue was never brought before the Board, preventing an open debate on its implications. This is another example of poor governance practices. This lack of an open discussion magnified the perception of European exceptionalism, according to interviewees.

The Pari Passu Clause

The financial assistance agreements of Greece, Ireland, and Portugal with the EFSF included a pari passu clause,[38] by virtue of which any early repayments made by program countries to the IMF would make a proportional amount of the loans under the agreement with the EFSF (and the other lenders) "immediately due and repayable." This means that the regular individual interaction between the IMF and its members, more concretely the freedom of program countries to repay the Fund at any point during the program, was constrained. This had financial implications for the program country, as fees and interests must be paid for longer periods, and affected the revolving nature of IMF resources, by constraining the availability of financing to other members. It has also been argued—rightly or wrongly—that these clauses affect the preferred creditor status of the IMF.

[38] Greece's Master Financial Assistance Facility Agreement contains the following clause (a similar one can be found in the other two programs): "If financing granted to the Beneficiary Member State under the IMF Arrangement, any of the facilities provided by the Financial Support Providers, the IMF or the European Union (or any body or institution thereof) or any of the facilities provided by EFSF as described in Preamble (6) is repaid by the Beneficiary Member State in advance in whole or in part on a voluntary or mandatory basis, a proportional amount of the Financial Assistance Amounts of the Financial Assistance provided under this Agreement together with accrued interest and all other amounts due in respect thereof shall become immediately due and repayable in a proportionate amount established by reference to the proportion which the principal sum repaid in advance in respect of the IMF Arrangement or the relevant facility represents to the aggregate principal amount outstanding in respect of the IMF Arrangement or such facility immediately prior to such repayment in advance." A similar clause was also included in the agreements of Ireland with its bilateral lenders (United Kingdom, Denmark, and Sweden).

In the event, Ireland decided to make an early repayment to the Fund and the proportional payment was waived by the other creditors on the basis of a note prepared jointly by the ECB, EC, ESM, and the IMF for consideration by euro area creditors.[39] This note was not circulated to the Executive Board. According to IEO interviews, some Directors felt the Board was sidelined again. During the approval of the programs, the pari passu clause was not brought to the attention of Directors (although it was included in the addendum on EU conditionality attached to the requests) and its implications were not discussed.

Main Findings and Conclusions

The role of the Executive Board, in any substantive sense, was minimal in decision-making and providing guidance for the handling of the euro area crisis. The Board, as the IMF's day-to-day governing body, played largely a nominal role, sanctioning decisions that had already been made by management, in some cases jointly with the other members of the troika, or adopted in other fora like the Eurogroup or the G7. Such anemic involvement of the Executive Board stands in contrast to the expectations under the exceptional access policy that strengthened and clear processes would provide additional safeguards and accountability by reinforcing careful and systematic decision-making by the Board. The unprecedented access levels and unique nature of IMF involvement with the euro-area institutions should have demanded, from a good governance perspective, consultation with the Board and capitals that went beyond the legal minimum.

This sidelining of the Board was allowed to occur, in part, by a departure from the original objectives of the IMF internal rules and procedures. The purpose of the Fund's framework for exceptional access was compromised during the process leading to the approval of the Greek, Irish, and, to a lesser extent, the Portuguese arrangements. The Board lacked the timely and substantive information it needed to play a more active and influential role.

The manner in which the exceptional access criteria were modified, in order to allow for approval of the Greek SBA, also went against the rationale behind the established Executive Board procedures. First, Directors did not have sufficient time to consider such an important modification. Second, and more importantly, neither management and staff nor the program document presented to the Board alerted Directors about the proposed decision itself or about its implications: a major change in the IMF lending policy. The proposed decision was buried in the report that supported the Greek request and crafted as a pragmatic solution that allowed the launching of a program already agreed upon. At the same time, this decision went against the key

[39] http://www.finance.gov.ie/ga/what-we-do/eu-international/publications/reports-research/early-repayment-imf-credit-letters-lenders.

objectives of the exceptional access policy and reversed an explicit decision made by the Board at the time it adopted the framework.

The Executive Board was not involved in other important decisions. It was never consulted on how best to cooperate with the European institutions in the troika, on the role the IMF was to play in the enhanced surveillance agreed for Italy, or on the technical assistance provided to Spain. The Board did not discuss either the implications of the roles attributed to the Fund in the founding treaty of the ESM, or of the pari passu clauses included in the master financial agreements between Greece, Ireland, and Portugal and their European lenders. The exclusion of the Board from decisions on these issues, though not a breach of any rules, magnified the perception of secrecy and obscurity associated with the way these programs were managed, with considerable cost to the Fund's reputation.

Three immediate consequences resulted from the way the process was handled. First, a deep information asymmetry was introduced in the Board, as European Directors could benefit from advice by their capitals that was based upon more timely and relevant information through the European institutions, while the rest of the Board (and their capitals) had no direct source of information. Second, the Board was largely removed from the decision-making process and had little chance to provide any inputs or guidance, since it was not meaningfully consulted early in the process as intended under the exceptional access policy. Third, the Board's ability to fulfill its responsibility to supervise management and staff and hold them accountable was undermined.

Beyond these immediate consequences, the approach to decision-making adopted had substantial implications for the legitimacy, accountability, and governance of the institution. Regarding legitimacy, a significant part of the membership felt excluded and thought European countries were treated more favorably, as exceptions mounted up. Some of these may have been justified, given the exceptional circumstances, but their rationale was not discussed a priori with Directors. When the program requests were presented to the Board, Directors had the legal capacity to reject or postpone their approval, but this would have been a difficult and virtually unfeasible decision. It would have meant denying assistance to member countries in trouble going against the recommendations of management and staff, in a context of huge uncertainty and possible regional and global contagion. Avoiding this "nuclear option" was precisely the intention of the early and substantive consultations with the Board as envisaged in the exceptional access framework. Such an option was also politically unpalatable, given that the capitals of member countries holding almost one-third of the voting power at the Board had already publicly committed to the agreements. The Board's consultative and oversight functions were also undermined, magnifying management discretion in critically important decisions and minimizing its accountability to the membership. Effectively, the Board was rendered ineffective regarding several major decisions. These governance problems are not new, but they were aggravated by the special circumstances surrounding the participation of the IMF in the euro area crisis.

A more open and transparent communication by management and staff with the Board might not have changed the final decisions. The measures adopted had ample political support and the context of extreme uncertainty and urgency at the time did not leave much room for careful consideration of alternatives. However, a more candid debate would have helped preserve the legitimacy of the IMF and avoid the perception of European exceptionalism.

The uncertain and risky environment in which the IMF operates, especially when fulfilling its role as crisis manager, requires agility and flexibility. This, in turn, means that management and staff need some room for maneuver and a certain degree of discretion in making decisions and conducting negotiations. Nevertheless, as implicitly recognized in the exceptional access policy and the Board procedures, higher degrees of management and staff leeway, sometimes demanded by exceptional circumstances, must be matched with increased openness and transparency in their relationship with the Board. Otherwise, the Board's roles are undermined and the institution's legitimacy is eroded.

While the IMF already has policies and rules designed to prevent these kind of problems, they may need to be reexamined and improved. For example, since informal meetings are an important part of the exceptional access framework, minutes or transcripts of those meetings should be kept in order to allow for later review and evaluation. Other areas that deserve attention are (i) how to prevent information leaks, (i) exploring the possibility and feasibility of adjusting voting rules in certain circumstances, and (iii) how to communicate the Board's views, distinctively from those of management and staff to the public. More generally, consideration should be given to adopting measures aimed at reinforcing the implementation of rules and strengthening accountability, with the ultimate objective of preserving the representativeness and the effectiveness of the Board by keeping it adequately informed. These issues continue to have a significant impact on the legitimacy and reliability of the institution in the eyes of the membership, and underscore the need for a more general debate on how to improve the governance of the IMF.

Annex 1.1. Modifications to the Exceptional Access Criteria in January 2016 Review (IMF, 2016a)

"(a) The member is experiencing <u>or has the potential to experience</u> exceptional balance of payments pressures on <u>the current account or</u> the capital account, resulting in a need for Fund financing that cannot be met within the normal limits;

(b) A rigorous and systematic analysis indicates that there is a high probability that the member's public debt is sustainable in the medium term. Where the member's debt is assessed to be unsustainable ex ante, exceptional access will only be made available where the financing being provided from sources other than the Fund restores debt sustainability with a high probability. Where the member's debt is considered sustainable but not with a high probability, exceptional access would be justified if financing provided from sources other than the Fund, although it may not restore sustainability with high probability, improves debt sustainability and sufficiently enhances the safeguards for Fund resources. For purposes of this criterion, financing provided from sources other than the Fund may include, inter alia, financing obtained through any intended debt restructuring. ~~However, in instances where there are significant uncertainties that make it difficult to state categorically that there is a high probability that the debt is sustainable over this period, exceptional access would be justified if there is a high risk of international systemic spillovers. Debt sustainability for these purposes will be evaluated on a forward-looking basis and may take into account, inter alia, the intended restructuring of debt to restore sustainability.~~ This criterion applies only to public (domestic and external) debt. However, the analysis of such public debt sustainability will incorporate any ~~potential~~ relevant contingent liabilities ~~of the government~~, including those potentially arising from private external indebtedness.

(c) The member has prospects of gaining or regaining access to private capital markets within ~~the~~ a timeframe ~~when Fund resources are outstanding~~ and on a scale that would enable the member to meet its obligations falling due to the Fund.

(d) The policy program of the member ~~country~~ provides a reasonably strong prospect of success, including not only the member's adjustment plans but also its institutional and political capacity to deliver that adjustment."

Annex 1.2. Main Characteristics of Executive Board Meetings, October 2015

	Formal Meeting	Informal Session to Brief	Informal Session to Engage
Chaired by	Management	Management/staff	Management
Supporting documents	Yes	Possible	Yes
Directors' statement	Yes	Rarely	Rarely
Directors' prepared views	Yes	Possible	Yes
Executive Board decision	Possible	No	No
Summing up/Chair's statement	Yes	No	No
Minutes	Yes	No	No

Source: Compendium of Executive Board Work Procedures.

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CHAPTER 2

Living with Rules: The IMF's Exceptional Access Framework and the 2010 Stand-By Arrangement with Greece

SUSAN SCHADLER

Introduction

The handling of the IMF's framework governing exceptional access to crisis countries will be one of the most important legacies of the euro debt crisis.[1] The framework has as its objective to set procedures and substantive standards to guide IMF decisions on providing exceptionally large financing, typically in capital account crises. The initial framework was adopted in 2002. Its purpose was to distill best practices for resolving crises efficiently and to steer decisions away from mistakes made in previous crises. However, as the crisis in Greece loomed in early 2010, the substantive part of the framework—four criteria that had to be met for the IMF to provide exceptional access—was seen by some as preventing the optimal response to the crisis. Accordingly, the criteria were changed, and the amended version was applied to the IMF's decisions first in Greece and later in Ireland and Portugal. This evaluation will focus on the amendment and its application during the 2010 Stand-By Arrangement (SBA) with Greece.

Evaluating the role of the framework for exceptional access is integral to understanding one of the most controversial aspects of the Greek program—the decision to proceed in 2010 and 2011 without restructuring privately held debt. Views remain deeply divided on whether that decision was a good one: some argue that it saved the euro area from intolerable stress, while others argue that, by delaying the resolution of a fundamental sustainability problem, it set Greece and possibly the euro area more broadly on a path of excessive uncertainty and escalating problems. The purpose of this chapter is

[1] Access is termed "exceptional" when it exceeds the Fund's normal access limits. Although exceptional access can occur in any circumstances—i.e., in traditional current account crises or in capital account crises—it is more typically necessary in capital account crises, the very definition of which is the loss of market access (usually when a government or banks have been borrowing heavily) and accordingly inability to roll over debt (which is usually large) coming due.

not to judge that debate. Nor is the purpose to judge whether the IMF needs a constraining framework for exceptional access decisions.[2] Rather the purpose is to consider whether the framework for exceptional access fulfilled its objective of facilitating a decision-making process in the IMF that is effective, clear, predictable, and protected from undue political influences. To this end the chapter examines two issues:

- The thoroughness of the considerations that went into the amendment of the four criteria in the context of the approval of the 2010 SBA with Greece.
- The thoroughness of the assessment of the four criteria during the 2010 SBA with Greece.

The remainder of this chapter is structured as follows. The second section briefly reviews the history of the framework for exceptional access. The third section examines the considerations behind the 2010 amendment to the framework and the process of gaining Executive Board approval. The fourth section considers the rigor of the application of the amended framework to decisions on the SBA for Greece. A final section states key findings and remaining issues.

The Framework for Exceptional Access—A Brief Summary of Its Inception and Evolution

The Fund's policies on exceptional access evolved slowly and deliberately. With very few precedents of exceptional access, policies in the capital account crises of the 1990s (the 1994 Mexico crisis, Asian crises in the late 1990s, Russia and Brazil crises in 1998–99) drew on the "exceptional circumstances" clause formalized in 1983. That clause stated that access in excess of normal limits could be provided when a case was made that a member was experiencing "exceptional circumstances," a term that "was left deliberately unspecified, reflecting what was seen as the inherent uncertainty of 'exceptional circumstances'."[3]

Eleven arrangements during 1995–2002 with countries experiencing "exceptional circumstances" focused attention on their terms and modalities. The Supplemental Reserve Facility (SRF) was put in place during the Korea crisis in 1997 as a channel for, in principle, unlimited exceptional access in capital account crises.[4] Disbursements through the SRF were differentiated

[2] See Schadler (2013) for an in-depth review and assessment of the range of views on this topic.
[3] IMF (2001), p. 54.
[4] Although the notion of setting exceptional terms for exceptional access in capital account crises had been debated for several years, it is fair to say that the Asia crisis (and the Korea crisis in particular) accelerated consideration. The Executive Board approved the establishment of the SRF on December 17, 1997. The following day it was activated for the Korea SBA, which had been approved on December 4, 1997.

from those under pure SBAs or the Extended Fund Facility (EFF) by short repayment periods (reflecting the presumption that programs would restore investor confidence quickly and thereby catalyze private financing) and a surcharge on top of the General Resources Account (GRA) rate of charge. SRF resources were meant to support programs also backed by a SBA or EFF.[5]

The case for a *formal framework* (as opposed to a separate facility) for exceptional access emerged from a three-four-year period of reflection about the IMF's role in the capital account crises of the late 1990s. Specifically, by 1999, concern had become strong about risks stemming from the absence of a clear and transparent framework for exceptional access. This concern surfaced in the IMF *Annual Report* for 1999 (IMF, 1999), a staff review (discussed in a Board seminar) of the experience during the Asian crisis (IMF, 2000a), and the Prague Framework for Private Sector Involvement endorsed by the International Monetary and Financial Committee at the 2000 Annual Meetings (IMF, 2000b). A dominant theme in these early documents was the need to delineate circumstances when it would be necessary to have private creditors bear some portion of the losses associated with the crisis—so-called private sector involvement (PSI). A chapter entitled "Strengthening the Architecture of the International Financial System" in the 1999 Annual Report captured the sense of this theme:

> The effort to better involve the private sector in crisis prevention and resolution is seen as critical in bringing about a more orderly adjustment process, limiting moral hazard, strengthening market discipline, and helping emerging market borrowers protect themselves against volatility and contagion. . . (IMF, 1999, p. 47).

At the end of this multi-year period of reflection, the Executive Board discussed and then approved a framework to guide exceptional access decisions. The framework had both procedural and "substantive" components. On the former, several requirements for exceptional access were put in place: a process for early and regular consultation with the Executive Board on the progress in reaching agreement on a program; the presumption that staff reports for exceptional access arrangements would be published; an assessment of the risks to the Fund of high and/or concentrated exposure; and an ex post evaluation one year after the completion of exceptional access arrangements. These were all relatively uncontroversial. The substantive component—the four criteria for exceptional access—was the subject of several subsequent reviews, deliberations, and some minor revisions during 2002–09. Box 2.1 shows the Four Criteria as of end-2009.

[5] For a concise description of the SRF, see IMF (2003a). The SRF was modified on several occasions as experience was gained. It was eliminated in 2009 when the Fund's "toolkit" was overhauled (IMF, 2009b).

Box 2.1. The Four Criteria for Exceptional Access as of End-2009[1]

The following text is taken from IMF (2009b), pp. 30–31.

> The Fund may approve access in excess of the limits set forth in this Decision in exceptional circumstances, provided the following four substantive criteria are met:
>
> (a) The member is experiencing or has the potential to experience exceptional balance of payments pressures on the current account or the capital account, resulting in a need for Fund financing that cannot be met within the normal limits.
>
> (b) A rigorous and systematic analysis indicates that there is a high probability that the member's public debt is sustainable in the medium term. Debt sustainability for these purposes will be evaluated on a forward-looking basis and may take into account, inter alia, the intended restructuring of debt to restore sustainability. This criterion applies only to public (domestic and external) debt. However, the analysis of such public debt sustainability will incorporate any potential contingent liabilities of the government, including those potentially arising from private external indebtedness.
>
> (c) The member has prospects of gaining or regaining access to private capital markets within the timeframe when Fund resources are outstanding.
>
> (d) The policy program of the member provides a reasonably strong prospect of success, including not only the member's adjustment plans but also its institutional and political capacity to deliver that adjustment.

[1] This version of the four criteria reflects the cumulative changes to the criteria during 2003–09.

There were two recurring concerns in the establishment of the four criteria and in reviews during 2003–09. Though they took different directions, they both spun off the initial objective of putting in place a formal framework—to ensure that there is as clear an ex ante understanding as possible of when the private sector should assume a share of the burden of a country's excessive accumulation of debt.

- *The first concern centered on how best to provide clarity, transparency, and predictability on the IMF's exceptional access policy*. This objective is a rather generic desideratum of most, if not all, IMF policies. But in the context of exceptional access, it is specifically seen as key to preventing the moral hazard that would exist if private creditors believe that they will in almost any circumstances be repaid and to reducing any tendency for the IMF to contribute to market uncertainty. More broadly, private creditors should be fully apprised that the IMF would not substitute official for private credit to heavily indebted countries if that involved imposing an excessive adjustment burden on the crisis country and worsening the chances for a successful recovery.

- *The second concern has been to protect the Fund's decision-making process in exceptional access cases from undue political influence*. Such protection is always seen as essential to ensuring uniformity of treatment among members. But a broader concern about political influence was also articulated. In the words of the 2002 staff paper proposing the four criteria, "the degree of discretion and flexibility in the [less formal pre-2002] framework may make the Fund more vulnerable to pressure to provide exceptional access even when prospects for success are quite poor and the debt burden of the sovereign is likely to be unsustainable."[6]

Both of these objectives complement two other (and more generally applicable) features of IMF lending decisions: to safeguard IMF resources and to be aware of risks from excessive concentration of the IMF credits.

During some deliberations, questions arose about how risks of contagion during crises should influence exceptional access decisions. The 2002 staff paper proposing the four criteria directly addressed this question. It stated that "Regional and systemic implications [of severe debt crises] have often been cited as potential justification for exceptional access." After a short discussion, the paper concluded that "it would be inappropriate to make the systemic criterion a necessary or a sufficient condition for providing exceptional access."

Directors appear also to have taken a clear negative view on special consideration for contagion. The question about contagion during these deliberations was whether the risk of contagion should be a criterion in addition to the other four criteria. In other words, should exceptional access cases have to meet each of the four criteria *and* a fifth criterion that contagion was a significant risk (IMF, 2002)? The Public Information Notice (PIN) on the Board meetings establishing the four criteria states "a few Directors suggested further narrowing the definition of capital account crises that could warrant exceptional access by establishing a formal criterion relating to problems of contagion or the potential for systemic effects."[7] The PIN goes on to say:

> Many other Directors, however, considered that such a criterion could create a bias toward higher access for larger members, which could not be reconciled with the principle of uniformity of treatment. Directors recognized that the Fund should be prepared to provide access above the normal limits in cases where the member's problems have regional or systemic implications, *when the other criteria are met* [emphasis added]" (IMF, 2003b).

In short, the introduction of a specific consideration of contagion was rejected by both staff and Executive Directors.

Although the conclusion on contagion was well-reasoned, the term "contagion" was used rather loosely in the 2002 staff paper. No effort was made

[6] IMF (2002), p. 7.
[7] IMF (2003b).

to define contagion, suggest ways to measure contagion, assess the implications of contagion or address whether there is a trade-off between actions that might be advocated to reduce contagion (including, for example, official bailing outs of the private sector) and actions that might most directly help the crisis country (for example, PSI).

In 2010, the Executive Board approved a major revision to the exceptional access framework. It introduced the option of granting an exemption to the second criterion (on debt sustainability) if it were judged that a debt restructuring needed to ensure a high probability of debt sustainability would have "adverse international spillover effects." The following sentence was added to criterion 2:

> However, in cases where there are significant uncertainties that make it difficult to state categorically that there is a high probability that the debt is sustainable over this period, exceptional access would be justified if there is a high risk of international systemic spillovers.[8]

Without formal discussion dedicated to this significant policy change, the Executive Board adopted this amendment as part of the approval of the SBA for Greece.

Despite concerns of some Executive Directors about the unusual process of changing this Fund policy, a long delay occurred before the Board revisited the issue. In 2013 in a Board seminar touched on the topic. A formal Board discussion that included issues related to the framework for exceptional access took place in 2014. In January 2016, the Executive Board approved an amendment to the four criteria.

Changing the Four Criteria: The Debate and the Process

The justification for seeking the 2010 amendment to the four criteria was that the criteria did not allow the optimal response to the circumstances in Greece and the euro area more broadly. This conclusion was not reached lightly. In contrast, the process of gaining Board approval of the change departed sharply from established practices.

The Debate Before Seeking Executive Board Approval

The amendment was made in the heat of the emergency of dealing with the Greek crisis. Many questions of substance about how to manage the crisis required rapid decisions simultaneously: how an IMF lending arrangement with the member of a currency union should be handled, how much fiscal adjustment could and should be undertaken, how to mesh the fiscal

[8] IMF (2010d).

adjustment and structural reform components of the program, how to provide adequate financing, to name a few. With formal IMF involvement starting only in mid-April, 2010 and a deadline for decisions on the strategy of mid-May when a large debt-service payment was due, the time for debating any one of these issues was compressed.

Interviews of senior staff and management indicate that debate within those groups was fairly open and encompassed a reasonable spectrum of differences of view. It appears that positions ranged from the view that, in the absence of restructuring, debt was unsustainable (and therefore that the constraint imposed by the four criteria on proceeding without a restructuring was appropriate) to the view that debt would be sustainable if the right policies and sufficient financial support were put in place.

Those interviews also indicate that three considerations drove the decision on the way to characterize the sustainability of Greek debt.

- The case for IMF involvement stemmed in large part from a conviction that the IMF was the best-equipped institution for the technical rigors of negotiating and monitoring the program. IMF participation was highly controversial among officials in Europe. By late March, however, the European debate had swung in favor, a position which, according to some interviewees, was supported by some large non-euro area members. IMF management was also eager to be involved.
- Key European officials were resolutely opposed to debt restructuring by a euro area member. The commitment to this view was already deep by the time the IMF was formally invited into the inner circle of the crisis resolution process. While it is unclear whether an earlier IMF presence would have given the IMF a more influential voice on sustainability, it was clear that by April 2010, European opponents of restructuring had secured acceptance of their position. As one IMF staff member said on the issue of whether management could have insisted that Greece restructure, "the train had already left the station."
- The position within the IMF staff and management remained divided even after intense debate. The compromise position was that Greek debt would be deemed sustainable but not with a high probability. Interestingly, most interviewees were on either end of the sustainable/unsustainable spectrum. In other words, positions were rather polarized, and it is questionable whether many involved staff would have supported the formal compromise position that debt was sustainable but not with a high probability.

Given these three defining features, the only way to square the circle was to provide an exemption for Greece from at least the second criterion. In this context, the options were to make a special exception for Greece alone or to introduce a permanent exemption into the criteria. A one-off exception would have had the advantage of not changing, without due process, a Fund policy born of careful reflection on the IMF's involvement in capital account crises since the mid-1990s. However, Legal Counsel was firmly of the view that the Executive Board did not have the authority to make a one-off exception to an approved Fund policy. Beyond that legal consideration, a permanent change was seen as having the advantage of even-handedness (vis-à-vis members that might one day seek exceptional access) and transparency.

In short, the decision to amend the four criteria was the result of debate within Fund staff and management. There is no evidence that any government officials played a direct role. In fact, many government officials interviewed were not fully aware of the framework for exceptional access, nor therefore, of the constraint it formally posed on IMF lending decisions. That said, the debate within staff and management about sustainability specifically was certainly influenced by the strong opposition especially of some European officials to restructuring. At this level, it is impossible to disentangle the possible roles in the formation of European views (and in turn pressure on staff and management) of hard analysis of sustainability and/or risks of contagion, pressure from private creditors, or personal self-interest.

The Role of the Executive Board

Executive Directors entered the meeting to approve the SBA for Greece with no preparation for addressing the proposal to amend the four criteria. As described above, the concept of introducing an exemption to the requirement of a high probability of debt sustainability had not been raised or discussed in any prior Board consideration of the exceptional access framework. Executive Directors interviewed had no recollection of any mention that Greek debt would not be considered sustainable with a high probability or that management would propose an amendment to the exceptional access framework. In short, decision to amend the four criteria was made without the usual consideration by the Executive Board of intended and unintended consequences that the vast majority of other IMF policies receive.

The staff paper for the Board meeting did not give any prominence to the proposal to amend the criteria. The paper stated staff's final (compromise) position on the sustainability of Greek debt, but it did not provide any explanation of why a permanent change in Fund policy was effectively being put to the Board for approval. Rather, the proposal was embedded in the standard assessment of the exceptional access criteria. Specifically, the following three sentences appeared in the assessment of the criterion on debt sustainability.

> On balance, staff considers 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, 2010b).

Several Directors commented that staff's position on the sustainability of debt was clear, but the necessity of a permanent policy change was not clear from the report. When a few Directors expressed a preference for making a one-off exception to the criteria for Greece, Legal Counsel clarified that a permanent amendment to the four criteria was necessary. Moreover, approval of the SBA carried with it approval of the amendment. In other words, votes on the two issues could not be separated. In the event, there were no votes against and no abstentions. In an interview, one Director stated that he felt "cornered" by the process.

Directors raised several questions at the Board meeting.

- To proceed with the arrangement with Greece, was it necessary to make the systemic risk exemption a permanent change or could a once-off exception to the second criterion be made for Greece? Legal Counsel explained that the Executive Board does not have authority to make ad hoc exemptions to general Fund policy. The staff representative from the Strategy, Policy, and Review Department said that granting a once-off exemption would violate the IMF's commitment to uniformity of treatment.
- Were the four criteria meant to be simply guidance for Executive Board decisions, not an actual constraint? If so, the arrangement with Greece could be approved without a change in policy or specific exception made for Greece. Legal Counsel confirmed that the four criteria were an actual constraint.
- If a permanent policy change were approved, one Director noted, and "spillover risks in a sense take priority over criterion 2, then we will in future cases have to have some assessment about the spillover risks." He requested an update from the Director of the Monetary and Capital Markets Department (MCM) on "broader regional implications," but no comment was provided.

Once it was understood that staff and management were proposing a permanent policy change, several Directors suggested that the Board return to the issue soon. Immediate follow-up would have moved the process closer to the normal standard of scrutiny (albeit almost without exception ex ante) that changes in Fund policy receive. However, no follow-up meeting was held. In fact, there was no mention of the issue in a staff paper on the closely related topic of the Fund's mandate (IMF, 2010d) nor in the Board discussion of that paper the following month. Instead, appeal to the systemic exemption, without review, was again made in approving the arrangements with Ireland and Portugal and all subsequent reviews of the arrangements for Greece, Ireland, and Portugal.

Three years passed between the decision to amend the four criteria and the first discussion at the Executive Board of the amended policy. In mid-2013, a staff paper reviewing options for the framework was discussed in a Board seminar. A follow-up paper, sent to the Board and discussed in mid-2014, contained proposals for eliminating the systemic risk exemption and introducing other ways to deal with crisis countries where debt was assessed to be sustainable but not with a high probability. No Board decision was proposed. A third paper, sent to the Board in June 2015, built on the 2014 paper with farther-reaching proposals for addressing the risk of contagion when a country is assessed as having debt that is sustainable but not with a high probability. In January 2016, the Executive Board discussed the paper and approved the recommended elimination of the systemic spillover waiver. The resulting version of the four criteria is reproduced in an annex to this chapter.

Assessment of the Amended Four Criteria for Greece

Reviewing the analysis that supported approval of the SBA with Greece against the four criteria brings into focus many of the critical issues that were, and continue to be, debated with respect to the Fund's role. Dominant among them are whether the framework for assessing debt sustainability was broad enough, whether the projections underpinning the Debt Sustainability Analysis (DSA) were rigorously constructed, whether prospects for market access were assessed against reasonable metrics, and whether prospects for contagion were adequately assessed.[9] *This review identifies concerns about how each of these issues was handled.*

Debt Sustainability, Market Access, and Program's Prospects for Success

Ex post, Greek sovereign debt proved to be unsustainable. The baseline projection in the May 2010 staff report had gross public debt stabilizing at about 150 percent of GDP in 2012, beginning to fall in 2014, and reaching 120 percent of GDP in 2020. Market access was expected to resume in mid-2012. In fact, gross public debt reached 177 percent of GDP in 2014 (even after the unanticipated 2012 restructuring of privately held debt) and, in the October 2015 *World Economic Outlook (WEO)*, was projected to rise above 200 percent of GDP in 2016 before starting to fall. Except for a brief period in 2014, Greece has not had market access. Forecasting errors (at times even startlingly large ones) are common in IMF-supported programs. They cannot be the standard for assessing a judgment at the inception of the program that public debt was sustainable. Rather, that standard should be the rigor of the analytics underlying the original judgment.

The assessment of public debt sustainability was based on a very narrow definition of sustainability in close to ideal circumstances. The central question in judging sustainability was whether in the medium term the baseline

[9] Outside the IMF understanding of the four criteria, or even knowledge that the four criteria exist, is mostly confined to country officials that follow IMF developments very closely. Most market participants interviewed were unfamiliar with them. Nevertheless, most interviewees, whether inside or outside the IMF, were focused on the issues underlying the four criteria even if they were not explicitly knowledgeable about the framework.

projection for the debt ratio would stabilize and then start on a downward trend. The baseline was constructed using assumptions of full implementation of the program policies (including large proceeds from privatization), realization of staff's projections for the main endogenous variables—real GDP, the GDP deflator, government revenue and expenditure, and other influences on the primary government balance—and the opening of market access at "favorable terms" by mid-2012. The possibilities for worse-than-programmed policy implementation, progress toward market access, and developments in key macroeconomic variables were highlighted. But the staff report states that these risks prevented only the assessment of debt sustainability with a high probability, not the assessment that debt was sustainable.[10] Questions of rigor, therefore, center on the definition of sustainability and the projections underlying the baseline DSA.

The definition of debt sustainability was narrow. Although a sine qua non of sustainability is the stabilization of the debt ratio, several other factors have important influences on debt sustainability: the level at which debt stabilizes and the known vulnerabilities associated with that level; the rollover rates in the country's debt structure and, relatedly, the gross financing need; the analytical underpinnings of the assessment of when market access can plausibly be regained; and as criterion 4 notes, the prospects for success of the program "including not only the member's adjustment plans but also its institutional and political capacity to deliver that adjustment." The assessment with respect to market access and likelihood of success of the program were mere assertions without supporting argumentation.

A broader and more rigorous view of sustainability would have probed the overall characteristics of Greek debt, Greece's financing needs, and specific risks to the outlook. Within the narrow definition of sustainability actually used, the DSA drove the assessment. The DSA conformed to the technical template provided in the then-prevailing staff guidance. It covered 2010–20 and included a baseline projection for the debt ratio, six shock scenarios, projections of gross financing needs, projections for the debt ratio with all variables set at their "historical averages" (no time frame is provided), and projections for the debt ratio in a no-policy change scenario (a primary surplus of 0.9 percent of GDP, although it is not clear how this surplus would have come about with no policy change). A debt stabilizing primary surplus (1.9 percent of GDP) was calculated for the period after 2020. At least two parts of this template—the projections based on historical averages and those based on no policy change—were meaningless for a country in a major debt crisis. They therefore at best cluttered, and at worst undermined, the credibility of the exercise.

[10] The May 2010 staff report states, "on balance, staff considers debt to be sustainable over the medium term but the significant uncertainties . . . make it difficult to state categorically that this is the case with a high probability."

The staff report repeatedly qualified the baseline scenario as subject to serious downside risks. As such, the baseline was by construction not a central scenario; it rather characterized an outcome if program execution was complete, and a V-shaped recovery took place. As early as the 2002 introduction of a DSA template, the likelihood that DSAs would have such a bias was recognized. As long as baseline scenarios assumed full implementation of agreed policies—rather than assigning some probability of full policy implementation—baseline scenarios would be biased. A further bias would result if projections for other macroeconomic variables that are influenced by any shortfalls in program implementation—for example, GDP growth, inflation, terms of market access—erred on the optimistic side.

Guidance notes for the DSA therefore saw the sensitivity analyses as a critical tool for evaluating the debt paths under less optimistic assumptions. Informally, this could be seen as establishing an upper path for the debt ratio which would capture a plausible range of worse outcomes, though not extreme tail events. Sensitivity tests for Greece fell far short of this standard: the shocks were relatively mild;[11] no explanation was provided for how the shocks were chosen or therefore why they were considered to capture most adverse outcomes; and there was no effort to consider interactions or feedback loops among the shocks. The debt ratio stabilized or fell in all scenarios (albeit peaking anywhere from 155–180 percent of GDP) except in the combined adverse shocks scenario. There was no country-tailored sensitivity analysis even though earlier guidance papers had encouraged staff teams to devise them.

The conclusion that debt was sustainable had immediate credibility problems. Initially, skepticism took three broad tacks.

- The first centered on doubts about the feasibility of the fiscal adjustment program. Such doubts implicitly concerned whether Greece met the fourth criterion. The program entailed an improvement in the primary fiscal balance by some 9½ percentage points of GDP over three years through a combination of revenue and expenditure measures.[12] In addition, privatization revenues, though not large, were important to reduce reliance on debt-creating financing. To a large extent, the division within the staff between those who saw debt as sustainable and those that did not appears to have hinged on the credibility/sustainability of the fiscal

[11] The shocks comprised one positive shock (GDP growth higher than the baseline by 1 percentage point each year) and five negative shocks (GDP growth below the baseline by 1 percentage point each year, inflation below the baseline by 3 percentage points cumulatively during 2010–12, a permanent 200 basis points higher spread over German bund rates on new market debt, a once-off shortfall in the primary balance of 1 percent of GDP relative to the baseline, and realization of implicit or contingent claims of about 10 percent of GDP in 2010. A scenario showing combined adverse effects was also included.

[12] A further increasing the primary deficit relative to GDP of 5 percentage points was projected for 2012–15.

program. Some outside bloggers who challenged the debt sustainability assessment also pointed to the credibility of the fiscal program.[13] Several Executive Directors explicitly questioned whether the fiscal adjustment proposed was realistic from a social point of view.

- The second concerned the assumption that Greece would regain market access at favorable interest rates by mid-2012. Staff consistently emphasized that the market access assumption was critical not only to financing the program (including repaying the Fund) but also to the resumption of growth. Yet at least three bloggers (Kirkegaard, 2010; Mussa, 2010; and Schadler, 2010) questioned its plausibility when even in the baseline scenario debt would have just peaked but not yet started to fall and would still be exceptionally high. Staff's conclusion that market access would return in 2012 was based solely on the projection that the debt ratio would peak in that year.

  Relatedly, some bankers interviewed asserted that they had had severe doubts that Greece could meet its medium-term amortization schedule. These concerns were not discussed or recorded in public. However, that they were serious is confirmed by reports that at least two banks reached out to major European governments and senior management of the IMF with proposals for maturity extension and/or coupon write-downs. These efforts were undoubtedly self-serving, but they indicate skepticism that the program or its financing would be adequate to restore stability without a debt operation. Some bankers saw these early proposals as direct precursors to the aborted July 2011 debt-reprofiling agreement.

- The third broad concern was whether Greece could avoid a severe and prolonged output contraction, especially without devaluation. Lachman (2010), for example, argued that without a devaluation, the path to stronger competitiveness and therefore a resumption of growth would be extremely difficult. He expected that Greece would eventually leave the euro area in order to devalue. This would be highly disruptive to the Greek economy in the short term and in that context threaten sustainability. Several Executive Directors strongly questioned the growth projections.

In the event, divergences from projections of activity and prices have been far larger than divergences from the fiscal projections. In terms of the pure mechanics of the path of the debt ratio, the continuing drop in GDP is by far the most important factor behind the massive overshoot relative to the initial DSA. A falling GDP deflator—reflecting an internal devaluation accomplished more through wage and price cuts than productivity increases—is a

[13] For example, Wyplosz (2010) and Lachman (2010). Eichengreen (2010) also questioned whether Greek residents would tolerate severe fiscal adjustment when at least part of it was dictated by the need to repay foreign banks.

distant second factor. The fiscal adjustment has been only slightly less than originally agreed, although privatization revenues have disappointed and costs associated with a weaker than expected banking sector have been higher than anticipated. These facts suggest (with the benefit of hindsight) that the rigor of the DSA (and the conclusion that debt was sustainable) should be considered against the rigor of projections for GDP growth and the design of the related sensitivity analysis.

What can be said about the growth projections *from the perspective of the data and information available at the time they were made*? Two observations stand out.

First, though favorable precedents for the inputs to the projections existed, Greece combined the most difficult conditions of any recent capital account crisis countries. For example, the timing of the projected V-shaped recovery in real GDP starting three years after the previous peak (2008), was not out of line with other large capital account crises since 1995. The examples of Turkey in 2001 (which had a very large primary balance adjustment but devalued substantially) and Latvia in 2007–08 (which had maintained its fixed exchange rate but had relatively little fiscal adjustment) were held up by proponents of the projections. However, Greece faced an exceptionally large fiscal adjustment without a devaluation and in a weak external environment, so comparisons with these relatively favorable previous crisis outcomes were a false comfort. The credibility of the projections suffered from the absence of explicit accounting for the deep differences between the circumstances for Greece and those for other crisis countries.

Second, the case in the staff report for a sharp but short drop in real GDP is not well developed. The scant explanation of the basis for the GDP projection is not out of line with common practice in staff reports. Most reports refer only qualitatively to some influences on GDP growth and provide little analytical or quantitative detail. But the absence of analytical underpinnings proved a particularly serious problem for Greece: it weakened the quality of the projections at the time and also left staff's projections open to serious criticism, as outside commentators focused increasingly on the massive forecasting gap.

Without transparency about the analytical framework in which GDP projections in particular were made, the Fund invited questions from many angles.

- What was the assumed fiscal multiplier?[14]
- Was account taken of a possible credit crunch?

[14] In interviews, staff stated that a multiplier of 0.5 was used in the baseline. This was reportedly the Organisation for Economic Co-operation and Development's central estimate for the multiplier in its member countries. This information was not provided in the staff report.

- Was a low Okun's law assumption (relating employment growth to GDP growth) used?
- Was account taken of likely impacts of an unusually severe crisis on conventional rules of thumb—such as fiscal multipliers and Okun's law?
- Was account taken of the lagged effects of a decade of falling competitiveness?
- What was the basis for assumptions about the flexibility of domestic prices and (especially wage) costs?
- Through what channels were the structural reforms expected to support growth and how quickly could they be expected to have an impact?
- What were the projections for foreign demand?

None of these issues was addressed with any specificity or rigor in the staff report. A short paragraph in the May 2010 staff report mentioned some of them qualitatively. Specifically, it stated that the needed internal devaluation was likely to be a "long and painful process," in a "relatively closed economy, the fiscal multipliers are bound to be large," and that the "external environment is expected to remain weak." But there was no indicative quantification provided and other factors were not mentioned. Growth, following a V-shaped pattern, was expected to return by 2012 on the basis of "confidence effects, regained market access, and comprehensive structural reforms."

A second forecasting error with significant effects on the DSA was that for the GDP deflator. Fundamentally this came down to the fact that the internal devaluation that was achieved—though most data suggest it was less than originally planned—came about not through productivity increases but through falling wages, which in turn had a more-depressing-than-expected effect on the GDP deflator. The analytics behind projections of the GDP deflator are also scant.

In sum, Fund-wide standards for assessing debt sustainability and, accordingly, the actual assessment in May 2010 for Greece had serious shortcomings. The lack of specificity on the analytical underpinnings of staff projections for developments ranging from market access to GDP and prices adversely affected both the IMF's strategy in Greece and its plausibility. Together these left a great deal of room for low contemporaneous credibility and ex post criticism.

Contagion: Was There Sufficient Analytical Evidence for Invoking the Exemption?

The 2010 amendment introduced contagion (or systemic spillover effects) into decisions on exceptional access.[15] With no clear definition of contagion and no existing template or precedent for assessing it, staff analyses were in

[15] The remainder of this chapter will use the terms "adverse systemic spillover effects" and "contagion" interchangeably.

uncharted territory. Evaluating how thorough and convincing the assessments of contagion were must rely on the clarity of the framework created in real time and the transparency of the analysis.

As of May 2010, the analysis of contagion in the Greek crisis was developing, though it was to a large extent backward-looking.[16] Several internal communications from staff to management (mostly from MCM, but one from an interdepartmental group) appear to have constituted the argumentation of the group within IMF staff and management that favored the European—and especially the European Central Bank—view that contagion was serious enough to trump concerns about insufficient confidence in debt sustainability in Greece. For the most part these characterized the possible channels of contagion and examined recent developments in Credit Default Swap (CDS) and Sovereign Swap Rates. Spillovers from sovereign spreads to banking sector spreads were prominently reported. The identification of channels of contagion analyses were thorough in the sense of calling attention to apparent channels for contagion, but they were mainly qualitative without indicating with much, if any, quantification which channels were likely to be important. Detail was greatest on the channels from Greek sovereign risk to the banking sectors in Greece and in other European countries. The main variables for which quantification was provided were various banks' (domestic and foreign) exposure to Greek sovereign bonds and recent changes in banks' CDS spreads, deposit outflows, and bank funding costs.

A more sophisticated analysis examined recent data and searched for changes in the degree of distress dependence. One internal memorandum in December 2009 reports computations of "conditional probabilities of distress" of European and Greek banks and a number of sovereigns in the event of distress (defined as a CDS event or an event that triggers activation of CDS) of the Greek government or major Greek banks.[17] Staff describes the CDS event considered (a Greek government default on 80 percent of its foreign liabilities with a loss given default at 100 percent) as "very severe." This is a forward-looking exercise in the sense that it is based on prices of financial assets that reflect market expectations of future developments.

The staff report for approval of the SBA for Greece has only a generic comment on contagion. This leaves unclear the extent to which the above-mentioned analyses fed into the design of the program and particularly to what degree there was coordination within the troika on a strategy to mitigate contagion. In a one-paragraph feature, the staff report states that "a worsening of the economic crisis in Greece could precipitate powerful spillovers to other

[16] Assessing this material was made difficult by the fact that too often terms are not defined, tables and charts are not fully labeled, and little effort is made to make the material accessible to non-technicians. It was also clear during interviews that some of the analyses were not well-understood by staff members who were not the ones actually carrying out the analysis.

[17] Interdepartmental memo to the Managing Director and Deputy Managing Directors, December 18, 2009.

countries." It lists three channels of contagion: to sovereign debt and financial markets of other euro zone countries with relatively weak fiscal finances; to foreign financial institutions with substantial exposures to Greek paper; and to southeastern European economies (SEEs). There is neither quantification nor analysis to establish the potential importance of these channels. It is not even clear whether the passage relates to contagion from the adverse developments in Greece generally or from some form of possible default, restructuring, or exit from the euro area.

To the extent that analyses of contagion were forward-looking the event on which they focused differed. Most of the MCM analyses focused on a CDS or credit event that took the form, as noted above, of a severe default. A memo from the Research Department considered the implications, including for contagion, of a Greek exit from the euro area with a default. It is not apparent that any analysis considered an orderly restructuring of the type advocated by restructuring experts outside or inside the Fund. This apparent concentration on the extremes without recognition of more controlled modalities of PSI meant that the discussion of those extreme events might have crowded out discussion of orderly restructuring scenarios.

There is no written record to indicate that contagion counterfactuals were examined. The work described above presented evidence of correlations of spreads and conditional distress probabilities in the event of a credit event (variously defined). There was, however, no analysis of contagion that might stem from markets viewing large-scale official support as simply delaying restructuring (and raising the burden of a future restructuring on private creditors with long maturities). A question from a Board member during the May 9, 2010 Executive Board meeting crystallized the problem.

> There is concern that default/restructuring is inevitable—even with the announcement of the program, bond spreads have risen. It is argued that trying to avoid default with the program simply increases the debt load and actually increases the probability of the default. On the other hand, it is argued that Greece is the sovereign version of Lehman Brothers and, therefore, it is advisable to put off restructuring for some time. We look forward to staff comments.[18]

In short, the staff report had not addressed the implicit question critical to the use of the newly-approved systemic risk exemption: even if one accepted that the risk of contagion in the event of a restructuring of Greek debt was substantial, was the counterfactual—proceeding aggressively (for example with an early restructuring of Greek debt)—likely to result in a better or worse outcome than a full bailout of creditors? The staff report did not address this issue, and the question raised at the Executive Board meeting was not answered.

[18] As recorded in the minutes of the meeting (IMF, 2010c).

Outside the IMF, some practitioners and academics proposed ways to restructure Greek debt adapting methods used in previous emerging market countries. The most widely circulated of these was Buchheit and Gulati (2010). While recognizing that restructuring in a currency union presented special challenges, they proposed concrete procedures based on their understanding of the legal structure of debt outstanding. They argued that the operation could be done within five-six months ("less if necessary") with high creditor participation.

There appears to have been little if any dialogue within senior levels of the troika about options for restructuring and how disruptive they would be. Several interviewees expressed doubt about how well senior officials outside the IMF understood the possibilities for and technicalities of a debt restructuring in an emerging market or advanced country. In effect, the discussion of restructuring—of adhering to the need for a high probability of debt sustainability and not invoking the systemic risk waiver—was closed down in the lead-up to the May 2010 approval of the Greek program.

The overall picture of the contagion debate suggests a serious anomaly. As some officials persisted in the view that contagion from restructuring could be catastrophic, the market and especially the largest holders of Greek government bonds (GGBs) were actively discussing and developing proposals for a restructuring. These proposals almost definitely would not have been adequate to render debt sustainable (even with full program implementation), but they had two potential attributes: they would have been a basis for starting discussion on restructuring at an earlier point than actually occurred, and they might have prevented banks from reducing their positions in GGBs.

In sum, staff work on contagion made available to the IEO team was rather thin and did not address the counterfactual issues essential to assessing contagion. Moreover, accepting that restructuring would be excessively risky took the Fund out of potentially useful dialogue with restructuring experts and market participants.

2010–11 Reviews of the SBA: How Quickly Did the Fund Analysis Evolve?

The decision on whether to extend exceptional access to Greece in 2010 without a restructuring was by any standard extremely difficult. A major debt crisis (albeit in a small country) was roiling a relatively new and globally important currency area when the Lehman crisis was fresh in the memory of officials and markets. Time to assess the relative risks of differing strategies for dealing with the crisis was virtually nonexistent. Thus, at least as important as the rigor of the assessments behind the decision to invoke the systemic risk exemption in May 2010 was the rigor of continuing reviews. This section considers the reviews of the SBA (and by extension the ongoing assessment of debt sustainability) and the continuing reliance on the systemic risk exemption.

Developments in real GDP were the largest and most important divergence between the original program projections and actual outcomes. Notwithstanding considerable skepticism about the GDP projections among Executive Directors at the May 2010 Board meeting and, subsequently, growing doubts of outside commentators about growth prospects, the projected trajectory for GDP was revised in a substantive way only in the fifth review (December 2011), over 18 months into the arrangement. In interviews, staff involved noted that undertaking substantive revisions to the projections proved very difficult in the absence of a clear event or other decisive piece of news that would have necessitated a significant revision. Instead, disappointing news as well as historical data revisions dribbled in, and changes to the GDP projections were small.

There is no publicly available detailed reexamination during the actual course of the SBA of the underlying framework that informed the initial projections.[19] For example, staff might have undertaken and reported on a deeper analysis of the fiscal multiplier, Okun's law relationships, and speed of adjustment of prices, productivity, and wages. Such a reexamination would have addressed questions raised at the May 2010 Board meeting and growing public skepticism about the basis of the projections for GDP and the debt ratio. The absence of such an effort was reflected in the almost unchanged description of the GDP projections in the staff reports for the second–fourth reviews and the fact that cumulative real GDP growth between 2009 and 2020 was revised only by 0.7 percentage points between May 2010 and July 2011. In the fifth review (December 2011) the projection for cumulative growth between 2009 and 2020 was revised down by over 10 percentage points (Table 2.1). In other words, large revisions to the projections took place only after the decision within the troika to restructure debt. GDP deflator projections were also small but in the upward direction. This suggests that the deflationary effect of the program was still not internalized in the projections.

The October 2010 *WEO* (IMF, 2010e) included a special topic chapter on fiscal multipliers. This chapter was not focused on Greece, but the analysis was clearly relevant to the projections for Greece. Indeed, the multipliers assumed for Greece would eventually generate vigorous public controversy about the IMF's role in Greece. Broadly, the *WEO* analysis can be summarized as follows: fiscal multipliers for advanced countries have historically averaged about 0.5; expansionary effects of a fiscal contraction occur mainly in the long term (and in the short term in only very specific circumstances); and fiscal multipliers are likely to be at least twice the historical average when interest rates cannot be lowered or interest rate cuts cannot be taken simultaneously by several countries (effectively preventing a nominal depreciation). Though a link to the program projections for GDP in Greece is not drawn, it would seem likely that had it been, the *WEO* analysis would have seriously challenged them.

[19] The exceptional access framework mandated that an ex post evaluation be carried out within a year of the end of arrangements with exceptional access. A comprehensive evaluation was published in June 2013 for Greece.

Table 2.1. Selected Macroeconomic Projections

	2009	2010	2011	2012
2009 data and cumulative changes from 2009 to-date indicated at top, projection as of date in left column (in percent)				
Real GDP				
May 2010	−2.0	4	6.5	−5.5
December 2010	−2.6	−4.2	−7.1	−6.1
July 2011	−2.0	−4.4	−8	−7.5
December 2011	−3.3	−3.5	−9	−12
October 2015 *WEO*	−4.4	−5.4	−13.9	−17.8
GDP deflator				
May 2010	0.7	1.2	0.7	1.7
December 2010	1.5	3	4.5	5
July 2011	1.3	2.5	4	4.8
December 2011	2.8	1.7	3.6	3.8
October 2015 *WEO*	2.6	1.0	1.5	1.6
Level projections as of date at left of sheet for date listed at top of sheet				
Primary balance/GDP (in percent)				
May 2010	−8.6	−2.4	−0.9	1
December 2010	−10.1	−3.3	−0.8	. . .
July 2011	−10.3	−4.9	−0.8	1.5
December 2011	−10.4	−5	−2.3	0.2
October 2015 *WEO*	−10.3	−5.2	−3.0	−1.4
Primary balance (euro billions)				
May 2010	−20.4	−5.6	−2.1	2.4
December 2010	−23.7	−7.6	−1.8	. . .
July 2011	−24.1	−11.4	−1.9	3.3
December 2011	−24.1	−11.4	−4.9	0.4
October 2015 *WEO*	−24.4	−11.9	−6.2	−2.7

Notes:
(i) 2009 column shows 2009 values.
(ii) Euro stat fiscal and GDP data revisions completed November 2010.
(iii) December 2010 SR says program primary balance/GDP for 2010 was −2.2.
(iv) December 2010 SR says program primary balance for 2010 was −5.3.

Analysis of the risks of contagion was not carried out in any detail until the fourth review (July 2011). That review included a box entitled “Greece: Spillover and Contagion Risks,” which concluded: “The direct spillovers of a Greek debt operation can remain manageable, provided that necessary safeguards (liquidity and capital backstops) and an effective communication strategy are put in place.” The conclusion was supported by data on banking and trade links between Greece and SEE countries and on foreign bank holdings of GGBs. The box speculated that “risks could escalate dramatically under a poorly implemented debt operation without adequate safeguards or under a disorderly default scenario. These instances could threaten stability in the euro area with substantial spillovers to the global financial system.”

Analyses related indirectly, or to a lesser extent directly, to the questions of fiscal and debt sustainability and contagion took place outside of the program reviews. The *Global Financial Stability Reports (GFSRs)* in October 2010

(IMF, 2010f) and April 2011 (IMF, 2011a) had several special mentions of the four euro area countries with the highest fiscal and/or banking vulnerabilities (Greece, Ireland, Portugal, and Spain). Though these were mostly embedded in more general analyses of vulnerabilities in advanced countries, they introduced several recurring concerns directly or indirectly pertaining to Greece. The most prominent such themes were the scope for transmission of stress from sovereigns to banks (the strongest channel being from the Greek sovereign to domestic banks rather than foreign banks) with feedback loops to the fiscal accounts, rising bank holdings of sovereign debt, and rising interest bills relative to fiscal revenue. Between the April and October 2010 *GFSR's* concern about contagion seems to have diminished slightly in large part because the escalation of sovereign swap spreads in the middle of 2010 had ceased at least partly as a result of European policy initiatives and national fiscal adjustments. However, the concern rose again in the April 2011 *GFSR* as many volatility and spread measures had worsened during the preceding six months. The section includes an explicit admonition for the European crisis facilities to lend on "sufficient scale and [with] flexibility, and should lend at interest rates low enough to support debt affordability, subject to strict conditionality."[20]

In mid-2011, the IMF published, in its debut Euro Area Spillover Report (IMF, 2011b), its most trenchant examination of the risks and nature of contagion from a "credit event" in Greece, Ireland, or Portugal.[21] The report has quantitative and qualitative assessments of the main channels and potential sizes of transmission of shocks from the three crisis countries to other euro area countries and to other economies. Three quantitative exercises examining financial sector spillovers (using financial market prices from 2007–11) dominate the analysis.

Broadly these exercises led to similar conclusions: if any increase in stress, including a "credit event" that triggered CDS contracts, were confined to the periphery, it would most likely have "modest spillover effects." To the extent that stress were initiated in the core euro area (or presumably if periphery stress were to spread to the core euro area to a greater extent than the exercises indicated) the likelihood of contagion to non-euro area economies and financial systems would be far larger.

Despite the apparent fluctuation in concerns about contagion risks, staff assessments of the four criteria (when they were explicitly reexamined) were unchanged[22]: (i) public debt was assessed to be sustainable but not with a high

[20] IMF (2011a).

[21] Spillover reports, introduced in 2011, had their origins in the concerns about global imbalances earlier in the 2000s. They are issued once a year for each of the five systemically important countries/currency areas (China, euro area, Japan, the United Kingdom, and the United States).

[22] The four criteria are supposed to be assessed in all staff reports initiating exceptional access arrangements and in all reviews. However, for Greece the criteria were not assessed in the second and third reviews. The first time they were assessed after May 2010 was in July 2011.

probability; (ii) the systemic risk exemption was invoked; (iii) it was expected that Greece would regain market access within the period IMF resources were outstanding; and (iv) the program was expected to be successful. Perhaps the most puzzling part of the ongoing application of the four criteria to Greece is that the systemic risk waiver continued to be invoked in the fourth and fifth review of the SBA (July 2011 and December 2011, respectively) even though agreement had been reached that a restructuring of debt was needed. A possible explanation is that the exact terms of the rescheduling agreement and the extent of creditor participation were still uncertain, so invoking the exemption could have been seen as a precaution. This explanation, however, would not cover a larger puzzle: the systemic risk exemption was again invoked for the approval of the Extended Arrangement in March 2012 after the agreement on and high commitment of participation to a large rescheduling of private debt and two changes in the terms of the EU financial support that eased terms substantially.

In sum, refinement of the analysis and review of the strategy adopted in the heat of the outbreak of the crisis were slow and piecemeal after May 2010. In the first 14 months after approval of the Greek SBA (during which time four reviews took place), the analysis underlying staff projections was little deepened or adjusted. The assessment of contagion was elaborated somewhat, but it was not put in a counterfactual context. The staff's assessment against the amended criteria accordingly remained unchanged.

Key Findings and Recommendations

The decision to amend the four criteria in order to extend exceptional access to Greece in 2010 was made in extremely difficult conditions; a large, imminent amortization payment threatened to lead Greece to default. The dominant European officials were adamant that an orderly restructuring could not take place in the context of euro area institutions at the time, while a decision had been made at the political level to involve the IMF in managing the Greek crisis. In these circumstances, the motivation that drove the decision to amend the criteria is clear.

The amendment, however, was not a small change and did not receive appropriate ex ante or ex post Board consideration. Rather it was a significant and substantive change to a policy framework that had resulted from careful deliberation and debate lasting for over a decade. An important strength of the IMF is that decisions of such import receive careful review so that intended and unintended consequences as well as implications for the future work of the IMF are clearly understood. Even if this process of deliberation could not be observed before the amendment decision was taken, it should have been undertaken as soon as possible afterwards (as some Directors requested at the May 2010 Board meeting). Instead, the first staff paper on the issue was circulated and discussed at an Executive Board seminar in mid-2013. In a revamping of the four criteria in 2016, the Executive

Board eliminated the systemic risk exemption, but still retained an option for discussion in situations where debt is considered sustainable but not with a high probability.

The assessment of the (amended) four criteria in the approval of the 2010 SBA with Greece was not convincing. A large body of external commentary on the assessment questioned the conclusion that debt was sustainable and that market access could be restored within the period that IMF resources were outstanding. Fewer, but still a significant number, doubted that with reliance only on fiscal adjustment and structural reform, the program provided reasonably strong prospects of success that the growth projections were realistic. The low level of credibility of the projections harmed both the Fund's reputation and any possible catalytic role that the Fund might hope to play. Whether this problem was the result of political influence (staff responding to the requirement to meet the amended criteria so that the Fund could participate in the lending arrangement with Greece) or true differences between the views of staff and those of outsiders can be debated, but probably not resolved. In any event, shortcomings were apparent in four areas:

- *The debt sustainability analysis*. In the 2010 assessment, debt sustainability was equated with the stabilization of the ratio of debt to GDP, notwithstanding the fact that that ratio stabilized at a high 150 percent of GDP and rollover needs after the disbursement of IMF and European funds would remain exceptionally large. The baseline scenario—which many would expect to be a central scenario—was biased to the optimist side because any risk of incomplete policy implementation was precluded. The sensitivity analysis was not grounded in the types of uncertainties and shocks that a country in the midst of a major debt crisis was likely to face.

  A process of overhauling the DSA template started with a staff paper in mid-2011 and a more thorough staff paper in 2013. Many of the problems noted here have been addressed. Nevertheless, the DSA template should remain under close review, efforts to align the baseline with a central scenario should be deepened, and tailored shock scenarios should be actively encouraged.

- *Assessments of prospects for market access*. The assessment in 2010 was essentially a statement of faith; it was assumed that as soon as the debt ratio reached the level at which staff projected it would stabilize, markets would reopen to Greece, even though debt would be some 150 percent of GDP. This assessment was possible because at the time there was virtually no agreed framework to provide guidance on how to assess prospects for market access.

  Staff guidance on indicators for assessing prospects for market access were issued in 2013. These have substantially improved the analytical basis for assessments. The approach to these assessments, however, is not based in firm *theory. Refining the assessment of prospects for market access should be a continuing priority.*

- *Contagion*. According to all evidence provided to the IEO, both internal staff evaluations of contagion and staff work made available to the public during 2010 and the early months of 2011 were paltry. Much effort was devoted to describing the channels of contagion and reporting relationships between recent developments in prices of financial assets across countries. The more sophisticated of these examined cross probabilities of default with rather extreme assumptions on shocks. There is no written evidence that the relative risks, costs, and course of contagion in a restructuring scenario were compared to those in the no restructuring/full bail-out scenario. In short, as mentioned in point 3, there was no clear analytical framework for judgments.

  The elimination of contagion as a consideration in the four criteria makes better measurements of contagion less urgent for the exceptional access framework per se. But the Fund would benefit more generally from work on measures of contagion in counterfactual conditions.

- *Macroeconomic projections.* Staff reports for the initial program request and for subsequent reviews had scant elaboration of the underpinning of the central macroeconomic projections. This problem had the widest ramifications for the credibility of the IMF and the DSA when it came to projections for real GDP and the GDP deflator, both of which play a determining role in the DSA. Staff reports presented at best brief verbal comments on the projections and did not address the controversies that grew as time went by.

  Staff reports in general, but especially for requests for Fund assistance or reviews thereof, should provide a rigorous elaboration of the analytical underpinnings of the projections for key variables especially real GDP and GDP deflators. This is essential to ensure the analytical rigor of the projections and in turn their credibility.

The Fund was slow to revise its analysis and approach in subsequent reviews. Many of the shortcomings in the Fund's initial assessment of sustainability and its components are understandable in view of the emergency conditions in which the program and projections were prepared. But lack of time cannot be used to explain why a reexamination of the macroeconomic projections did not start immediately after approval of the arrangement. Understandably, it is hard to change high profile projections which would require revision of a program that was just agreed. Moreover, news in the first few months of the arrangement was not unduly negative. However, the strong controversy surrounding the approval of the program—starting with several Executive Directors expressing doubts about the basis of the GDP projections, but extending to outside critics where commentary only became more negative—constituted a strong reason to review the projections in a fundamental way immediately.

Although early revision to program projections is difficult and costly, the IMF must have the resolve to undertake early and thorough revisions especially when the initial projections are made in haste, possibly under political pressure. It may therefore be desirable in exceptional access cases to require a more detailed and explicitly analytical review of exceptional access programs within six months of approval. This would include an exceptional review akin in terms of documentation, analysis, and projections to program approval with no presumption that changes must be small.

The disconnect between the perspective of several large banks pursuing reprofiling proposals on the one hand and the staff's assessment that Greek debt was sustainable on the other is puzzling. First, it is difficult to understand how the Fund was taking the position that contagion from a restructuring was a major risk when banks were increasingly anticipating it. Second, communication between staff and management on the one hand and banks on the other appears to have been scanty. It may be that banks were highly focused on their communications with large euro area governments to the exclusion of the IMF. Yet, in view of the fact that significant numbers of Fund management and staff had come or were coming to the view that debt was not sustainable, it would seem that more intensive communication would have helped inform the Fund's perspective on options for earlier rescheduling.

Annex 2.1. Four Criteria for Exceptional Access (Revised January 2016)[1]

(a) The member is experiencing or has the potential to experience exceptional balance of payments pressures on the current account or the capital account, resulting in a need for Fund financing that cannot be met within the normal limits;

(b) A rigorous and systematic analysis indicates that there is a high probability that the member's public debt is sustainable in the medium term. Where the member's debt is assessed to be unsustainable ex ante, exceptional access will only be made available where the financing being provided from sources other than the Fund restores debt sustainability with a high probability. Where the member's debt is considered sustainable but not with a high probability, exceptional access would be justified if financing provided from sources other than the Fund, although it may not restore sustainability with high probability, improves debt sustainability and sufficiently enhances the safeguards for Fund resources. For purposes of this criterion, financing provided from sources other than the Fund may include,

[1] Reproduced from IMF (2016).

inter alia, financing obtained through any intended debt restructuring. This criterion applies only to public (domestic and external) debt. However, the analysis of such public debt sustainability will incorporate any potential relevant contingent liabilities of the government, including those potentially arising from private external indebtedness.

(c) The member has prospects of gaining or regaining access to private capital markets within a timeframe and on a scale that would enable the member to meet its obligations falling due to the Fund.

(d) The policy program of the member provides a reasonably strong prospect of success, including not only the member's adjustment plans but also its institutional and political capacity to deliver that adjustment.

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CHAPTER 3

IMF Engagement with the Euro Area Versus Other Currency Unions

LING HUI TAN

Introduction

The euro area crisis was considered special in several respects, in part because it involved economies within a currency union. But the euro area is not the only currency union, and the IMF has assisted members of other currency unions over at least four decades. This chapter takes a closer look at the Fund's engagement with other currency unions.

Currency unions are characterized by a common central bank that issues a common regional currency. The IMF's *Balance of Payments and International Investment Position Manual* (sixth edition) defines a currency union as "a union to which two or more economies belong and that has a regional central decision-making body, commonly a currency union central bank (CUCB), endowed with the legal authority to conduct a single monetary policy and issue the single currency of the union" (IMF, 2009).[1] Under this definition, currency unions may be distinguished from dollarization or dual legal tender arrangements where one country adopts another country's currency without a say in how that currency will be managed or a share of the seigniorage revenues.[2] A currency union may, and often does, coexist or overlap with other forms of regional integration such as a customs union, common market, or economic union. For example, the euro area is a currency union that is part of an economic union, the European Union (EU), where member countries have a common external trade policy, free movement of goods, services, and

[1] A currency union may be characterized by a single central bank only or a union central bank together with national central banks at the individual member level.

[2] For example, the Common Monetary Area (CMA) comprising South Africa, Lesotho, Namibia, and Swaziland is not considered a currency union under this definition. Lesotho, Namibia, and Swaziland have their own currencies that are pegged at par to the South African rand. The South African rand is legal tender within the CMA but the validity of the three other currencies as legal tender is limited to their own country. There is no common central bank conducting monetary policy for the region as a whole although all CMA countries effectively share the same monetary policy (i.e., that of South Africa).

factors of production, and common policies in other areas such as product regulation.

Besides the euro area, there are presently three other currency unions in the world: the Central African Economic and Monetary Community (CEMAC), the West African Economic and Monetary Union (WAEMU), and the Eastern Caribbean Currency Union (ECCU). These three currency unions have existed for much longer than the euro area.

What makes currency unions special for the IMF? The IMF is a country-based institution. Fund membership is only open to individual countries and no provision is made in the Articles of Agreement for the joint membership of two or more countries that remain distinct political entities as countries (IMF, 1997b). As a result, IMF surveillance over members of currency unions involves a complexity absent in Article IV consultations with non-currency-union members, and IMF lending to currency union members involves factors not normally encountered in lending to non-currency union members.

- *Surveillance.* The IMF has the mandate, under Article IV, Section 3, to exercise firm surveillance over members' exchange rate policies. However, IMF members of currency unions have devolved responsibility for monetary and exchange rate policies to their regional central banks. As a result, these policy areas would not be covered in Article IV consultations with individual currency union members.
- *Lending.* The IMF can lend only to individual members and not to a currency union as a whole. In order to make use of the Fund's general resources, Fund members must represent a balance of payments need.[3] Typically, a country would represent such a need by virtue of its overall balance of payments position or by the level of or developments in its reserves. However, these may not be appropriate or meaningful indicators of balance of payments need in currency union members, where scope for official action on the foreign exchange or monetary front is generally limited. Even when the need for a Fund-supported program can be identified, there are issues regarding program conditionality: like the gap in Article IV surveillance of currency union members, there is a potential gap in conditionality that can be applied in IMF-supported programs with currency union members because certain policies are under the control of the regional central bank (or other supranational institution within the currency union) and not the national authorities.

The purpose of this chapter is to identify areas of similarities and differences in the Fund's engagement with the euro area and the other currency unions in order to provide some background against which to assess claims

[3] This chapter does not consider issues pertaining to use of concessional Fund resources (which are different from those relating to use of the Fund's general resources) since no euro area member is eligible for concessional assistance under the Extended Credit Facility (ECF) or its predecessor, the Poverty Reduction and Growth Facility (PRGF).

that the IMF treated the euro area "differently."[4] It is not an evaluation of the IMF's engagement with currency unions in general. The analysis is based on a desk review of IMF documents and interviews with relevant staff and regional/country authorities.

The chapter is organized as follows. The second section outlines the essential features of the ECCU, WAEMU, and CEMAC as compared to the euro area. The third and fourth sections discuss IMF regional surveillance and lending, respectively, in the three currency unions, highlighting the main similarities and differences vis-à-vis its engagement with the euro area. The comparison will focus on the modalities and broad contours of Fund engagement and not on its quality and effectiveness, which would be outside the scope of the present evaluation. The final section concludes.

The Basics

The euro area is a large union of advanced economies—some systemically important—with a common currency that is also a major reserve currency. The 19 members of the euro area collectively account for around 13 percent of global purchasing-power-parity-adjusted GDP and have a voting share of 21.7 percent in the IMF.[5] The euro area is a subset of the EU: while all 28 EU members are part of the Economic and Monetary Union (EMU) and coordinate their economic policymaking to support the economic aims of the EU, the euro area countries took integration further and adopted a single currency, transferring responsibility for monetary policy from their national central banks to the European Central Bank (ECB), a supranational institution.[6] The national central banks were not abolished; they coexist with the ECB as part of the so-called Eurosystem. The ECB conducts monetary policy for the euro area as a whole with the primary objective of maintaining price stability. The exchange rate regime of the euro area is free floating.

[4] For example, Pisani-Ferry, Sapir, and Wolf (2011) found that: "Rather than fully exploiting its comparative advantage based on its international experience in crisis-prone countries, the IMF fell victim to a 'Europe is different' mindset" in conducting surveillance of the euro area. According to one former senior IMF official: "Many countries interpret the IMF's actions in Europe as confirmation that they are members of an institution that speaks about uniformity of treatment but makes large exceptions for its historic masters" (El-Erian, 2011).

[5] The voting share in this and the next paragraph refers to votes taken by the IMF Board of Governors (which consists of one governor and one alternate governor for each of the Fund's 189 member countries) and not to votes taken by the IMF Executive Board (which consists of 24 Directors, who are appointed or elected by member countries or by groups of countries, and the Managing Director, who serves as its Chairman).

[6] When the euro area was created in 1999, it consisted of 11 EU member states. Greece joined in 2001, followed by Slovenia in 2007, Cyprus and Malta in 2008, the Slovak Republic in 2009, Estonia in 2011, Latvia in 2014, and Lithuania in 2015. Of the 9 non-euro area EU members, Denmark and the United Kingdom have "opt-outs" from joining; the others have not yet qualified to be part of the euro area.

The ECCU, WAEMU, and CEMAC are much smaller currency unions, in terms of both membership and economic size.

- The ECCU comprises eight Caribbean island economies—Anguilla, Antigua and Barbuda, Dominica, Grenada, Montserrat, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines—that share a common currency called the East Caribbean dollar. Six of them are IMF members; Anguilla and Montserrat are dependent territories of the United Kingdom. The ECCU accounts for less than 0.01 percent of global purchasing-power-parity-adjusted GDP and has a voting share of 0.2 percent in the IMF.
- The WAEMU comprises eight West African countries—Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, and Togo—that share a common currency called the CFA franc.[7] All except Guinea-Bissau are former French colonies that formed the West African Monetary Union in 1962 after gaining independence.[8] The WAEMU accounts for less than 0.2 percent of global purchasing-power-parity-adjusted GDP and has a voting share of 0.6 percent in the IMF.
- The CEMAC comprises six Central African countries—Cameroon, the Central African Republic, Chad, Equatorial Guinea, Gabon, and the Republic of Congo—that share a common currency, also called the CFA franc.[9] The CEMAC and the WAEMU, together with Comoros, comprise the CFA franc zone. All CEMAC members except for Equatorial Guinea are former French colonies that gained independence in 1960 and formed the Central African Monetary Area.[10] The CEMAC accounts for less than 0.2 percent of global purchasing-power-parity-adjusted GDP and has a voting share of 0.4 percent in the IMF.

The three currency unions have existed for much longer than the euro area.

- The East Caribbean dollar was created in 1965, with sole right of issue granted to East Caribbean Currency Authority (ECCA). In 1983, the Eastern Caribbean Central Bank (ECCB) was established to replace the ECCA as the regional central bank of the ECCU.
- The CFA franc was created in 1945 and two "issuance houses" were established to issue the currency for France's African colonies. After

[7] CFA here stands for Communauté Financière Africaine (Financial Community of Africa).
[8] The West African Monetary Union initially consisted of Benin (then Dahomey), Burkina Faso (then Upper Volta), Côte d'Ivoire, Mali, Mauritania, Niger, and Senegal. Mali withdrew in 1962 and rejoined in 1984; Togo joined the union in 1963; Mauritania left in 1972. Guinea-Bissau, a former Portuguese colony, is the only non-Francophone member of the WAEMU and the most recent—it joined the WAEMU in May 1997.
[9] CFA here stands for Cooperation Financière Africaine (African Financial Cooperation).
[10] Equatorial Guinea, a former Spanish colony and the only non-Francophone member, joined later in 1985.

independence, these institutions were converted to formal central banks: the Central Bank of West African States (BCEAO) was established in 1962 as the common central bank of the West African Monetary Union, the predecessor of the WAEMU; and the Bank of the Central African States (BEAC) was established in 1972 as the common central bank for the Central African Monetary Area, the predecessor of the CEMAC. The BCEAO is responsible issuing West African CFA francs and the BEAC is responsible for issuing Central African CFA francs.

There is no system of national central banks in the three currency unions. The ECCB is headquartered in St. Kitts, with an agency office run by a resident representative in each of the other seven members. The BCEAO is headquartered in Dakar, Senegal, and the BEAC is headquartered in Yaoundé, Cameroon. The BCEAO and the BEAC are represented in each member country by a national directorate that handles day-to-day operations at the national level.

The three currency unions have maintained a fixed exchange rate since their inception.

- The East Caribbean dollar was pegged to the British pound from 1965 to 1976, and has been pegged to the U.S. dollar since 1976 at the exchange rate of EC$2.70 = US$1. The parity of the East Caribbean dollar can only be modified by unanimous consent of the member countries.
- The CFA franc was pegged to the French franc from 1945 to 1999, during which time the exchange rate was changed only twice: in 1948 (revaluation) and in 1994 (devaluation). Since January 1999, the CFA franc (both West and Central) has been pegged to the euro at the exchange rate of CFAF 656 = €1.[11]

Monetary policy in the three currency unions is subordinated to the exchange rate peg.

- The ECCB maintains the U.S. dollar peg through a quasi-currency-board arrangement. Under this arrangement, ECCU member countries surrender their foreign exchange to a common reserves pool managed by the ECCB, which must maintain the level of pooled official reserves at no less than 60 percent of its demand liabilities. The ECCB's Monetary Council, comprising the finance ministers of all eight member governments, is responsible for providing guidance on monetary and credit policy, including the determination of monetary targets.
- In the WAEMU and the CEMAC, the currency peg is supported by a monetary cooperation agreement with France, which guarantees the

[11] The West African and Central African CFA francs are independent of each other—each is nominally convertible into the euro but they are not directly convertible into each other.

convertibility of the CFA franc.[12] WAEMU (CEMAC) countries pool their foreign exchange reserves in the BCEAO (BEAC). A certain share of the reserves must be deposited in an operations account with the French Treasury through which all purchases or sales of foreign currencies or euros against CFA francs are settled.[13] The French Treasury provides an unlimited overdraft facility through this account, albeit with some institutional safeguards and restrictions; for instance, the BCEAO and BEAC are required to maintain a stock of reserves of at least 20 percent of base money. Within the fixed exchange rate regime, limited external capital mobility—capital transactions within each union and with France are unrestricted but there are controls on capital transactions with non-union countries—provides some room for independent monetary policy. The BCEAO and the BEAC operate a framework of monetary programming, with broad objectives set at the regional level and detailed programming at the national level to ensure compatibility with these regional objectives.[14]

Unlike the ECB, the regional central banks of the three currency unions may extend, and have extended, credit to member governments when needed.

- In practice, the ECCB has maintained a reserve cover of close to 100 percent, leaving it some room to lend to member governments in pressing circumstances such as natural disasters. Credit allocations are based on each member government's share of total regional recurrent revenue. To date, member countries have financed their (at times sizable) fiscal deficits largely without recourse to ECCB credit, by borrowing from domestic and external creditors, including the IMF.[15]
- BEAC statutes allow each member country to draw central bank credit up to a limit of 20 percent of the country's fiscal revenue in the previous

[12] The monetary cooperation agreement between France and the CFA franc zone remained unchanged after the introduction of the euro, by a November 1998 decision of the Economic and Financial Council of the EU.

[13] At least 50 percent of the BCEAO's foreign exchange reserves must be deposited in the operations account. For the BEAC, the minimum was originally 65 percent but the share was often exceeded in practice because the interest rate on the operations account was attractive and the central bank's reserve management capacity was not well developed. In 2009, the 65 percent minimum was changed to a cap of 50 percent, net of the foreign exchange counterpart of remunerated country-specific accounts held at the BEAC and the BEAC reserve position at the IMF.

[14] Historically, monetary policy in the WAEMU (CEMAC) was determined by the BCEAO's (BEAC's) Board of Directors, assisted at the national level by National Credit Committees (National Monetary Committees) chaired by the finance ministers of the member countries. Under a new institutional framework introduced in 2008 in the CEMAC and 2010 in the WAEMU, responsibility for setting monetary policy in each union now rests with a Monetary Policy Committee chaired by the respective central bank governor and including members from all member countries plus France.

[15] There is a functioning regional government securities market in the ECCU, which was established in 2002.

year, although these statutory advances to governments are being phased out.

- The BCEAO has not been permitted to engage in direct monetary financing of government debt since 2003 but it can (and does) refinance member government treasury bills.[16] Since 2010, the BCEAO's refinancing exposure to government securities has been limited to at most 35 percent of the fiscal revenues of the preceding year.

Lender of last resort arrangements vary across the three currency unions and the euro area. In the euro area, the national central banks—and not the ECB—may provide emergency liquidity assistance (ELA) to illiquid but solvent banks under their jurisdiction in a financial crisis. The provision of ELA is vetted by the ECB governing council which may restrict the assistance if it decides, with a two-thirds majority, that such support is at odds with the objectives and tasks of the Eurosystem. In the ECCU, the ECCB has some room to act as lender of last resort to the banking system using its excess international reserve holdings. The BCEAO and the BEAC, on the other hand, do not have an explicit mandate to provide ELA.

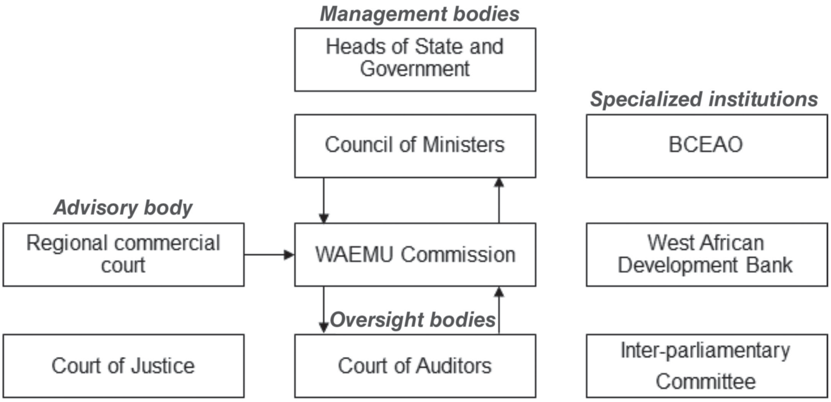
Bank supervision is conducted at the regional level in the three currency unions, unlike in the euro area (until recently); however, bank resolution involves coordination with the national authorities concerned. In the ECCU, the ECCB is responsible for banking sector regulation and supervision; decisions such as granting and withdrawal of bank licenses are made by the respective Ministries of Finance after consultation with or on recommendation from the ECCB. In the WAEMU, responsibility for bank supervision lies with the WAEMU Banking Commission, which was set up in 1990, and in the CEMAC, with the Central African Banking Commission (COBAC), which was set up in 1993. Bank resolution in the WAEMU involves both the Banking Commission, which takes the decision to close down a bank, and the concerned national government, which can appeal to the WAEMU Council of Ministers to reverse it. In the CEMAC, while the COBAC has the power to withdraw bank licenses, it relies on the cooperation of national authorities to be effective in dealing with troubled banks.

Unlike the euro area, which is a currency union formed from within an economic union, the WAEMU, CEMAC, and ECCU were currency unions first and moved towards economic union much later.

- The WAEMU Treaty of 1994 created the framework to extend the process of economic integration beyond the West African Monetary Union. It established the Conference of Heads of State and Government (to determine the broad policy orientations of the union), the Council

[16] Previously, the limit on BCEAO advances to national treasuries was 20 percent of the fiscal revenues of the preceding year, just as for the BEAC. Central bank statutory advances to member governments were abolished in 2003 in order to foster a regional market for government securities.

Figure 3.1. WAEMU: Operating Framework



Source: Banque de France (2010).

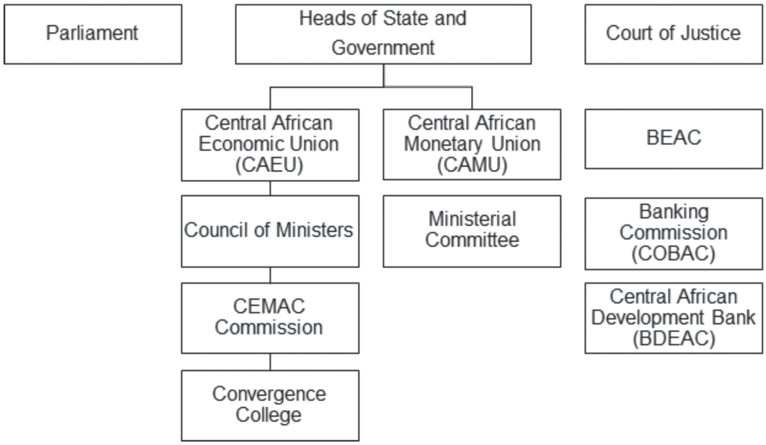
of Ministers (responsible for implementing the decisions of the Conference of the Heads of States and Governments), and the WAEMU Commission (to prepare and implement the decisions of the Council of Ministers) (Figure 3.1).[17] The treaty envisaged the creation of a single domestic market through the establishment of a customs union, the harmonization of legal systems, the implementation of common sectoral policies, and the convergence of fiscal policies in support of the common monetary policy. However, regional integration within the WAEMU remains low—intra-regional trade has increased only marginally since the customs union was created and continues to be hampered by nontariff barriers; and financial integration within the WAEMU remains limited notwithstanding the free movement of capital within the region. The WAEMU is also part of the broader 15-member Economic Community of West African States (ECOWAS), which was founded in 1975, and has long had the ambition to create a larger West African monetary union.[18]

- The CEMAC Treaty, which entered into force in 1999, created a monetary union (the Central African Monetary Union) and an economic union (the Central African Economic Union). It established the institutional framework for the community including the Conference of Heads of State (which determines the broad policy orientation of the community), the Council of Ministers of the Central African

[17] The WAEMU Commission has eight commissioners—one from each member country—who are in charge of macroeconomic and sectoral policies.

[18] In 2000, five non-WAEMU members of ECOWAS formed the West African Monetary Zone (WAMZ) as an intermediate step towards the larger monetary union of all ECOWAS countries. An interim institution, the West African Monetary Institute (WAMI), was established in 2001 to oversee the convergence process among the countries of the WAMZ.

Figure 3.2. CEMAC: Operating Framework



Source: Banque de France (2010).

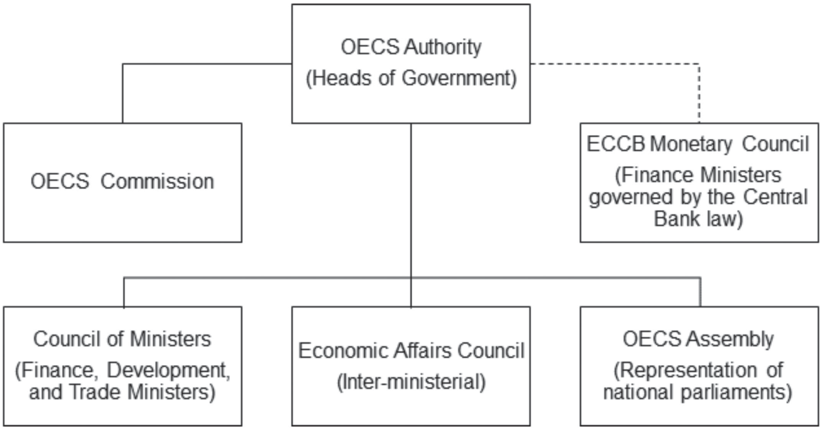
Economic Union and the Ministerial Committee of the Central African Monetary Union (which implement the decisions of the Conference of the Heads of State), and the CEMAC Commission (previously the Executive Secretariat, the main management and administrative body) (Figure 3.2).[19] Like the WAEMU Treaty, the CEMAC Treaty envisaged the creation of a single domestic market through the establishment of a full customs union, harmonization of legal and regulatory systems, implementation of common sectoral policies, and convergence of fiscal policies in support of the common monetary policy. Like the WAEMU, regional integration remains limited in the CEMAC, with intra-regional trade accounting for only around 3 percent of member countries' total trade and financial integration at a very rudimentary level.

- The ECCU moved towards deeper integration in 2011 when it ratified the revised Treaty of Basseterre establishing the Organization of Eastern Caribbean States (OECS) economic union.[20] The Treaty designated legislative authority in a number of areas (including monetary policy and trade policy) directly to the OECS Authority, which is made up of member state heads of government, and it established the OECS

[19] Following the example of the EU, the CEMAC Commission is composed of an equal number of commissioners from each member country.

[20] The original Treaty of Basseterre establishing the OECS was signed in 1981. All eight ECCU countries are part of the OECS, which also includes the British Virgin Islands (a U.K. territory that uses the U.S. dollar as its de facto currency) and Martinique (a French territory that uses the euro).

Figure 3.3. OECS/ECCU Institutional Structure



Source: Nassar, McIntyre, and Schipke (2013).

Assembly, which functions as the regional parliament (Figure 3.3).[21] It envisaged the creation of a single financial and economic space within which goods, people, and capital move freely, monetary and fiscal policies are harmonized, and members adopt a common approach to trade, health, education, the environment, and the development of critical sectors such as agriculture, tourism, and energy. Within the ECCU, the financial sector is well integrated and trade policies are fully aligned with those of the Caribbean Community (CARICOM), of which the ECCU is a part.[22]

Fiscal policy remains the responsibility of national governments in the three currency unions, as in the euro area. Within the euro area, national governments must coordinate their respective fiscal policies in order to attain the common objectives of stability, growth, and employment. This is enforced through institutional arrangements, key among them being the Stability and Growth Pact, which contains rules for fiscal discipline and sanctions for noncompliance by euro area members. In the WAEMU and the CEMAC, fiscal policy is subject to regional surveillance by the respective Commissions. WAEMU countries introduced a Convergence, Stability, Growth, and Solidarity Pact in 1999, following the example of the euro area, with a view

[21] The OECS Assembly was inaugurated in August 2012. For more on the institutional setup of the ECCU/OECS, see Nassar, McIntyre, and Schipke (2013).

[22] CARICOM, which includes 12 countries/territories outside the ECCU, is also pursuing deeper regional integration—free movement of goods and services, capital, and labor, supported by a common trade policy and the right to establish businesses in any member state without restriction—through the CARICOM Single Market and Economy initiative, although progress has been more limited compared to the OECS.

to achieving the gradual convergence of macroeconomic policies and performance.[23] Under the pact, member states committed to meet four primary and four secondary convergence criteria by 2002 (subsequently delayed to 2005 and then 2008).[24] The corrective procedure in cases of non-compliance with the fiscal balance criterion has some similarities with the euro area's Excessive Deficit Procedure (see Hitaj and Onder, 2013). However, the WAEMU Treaty allows the Council of Ministers, by a unanimous vote, to exempt a member country from meeting some or all of the convergence criteria if the country is experiencing economic distress or is susceptible to such distress because of exceptional circumstances. CEMAC rules also set limits on key macroeconomic indicators to promote national policies consistent with the common currency.[25] Members with policies inconsistent with the union's objectives are required to adopt adjustment programs, although there are no sanctions for non-compliance.

Regional Surveillance and Policy Advice

Prior to 1998, the Fund had no formal modalities for surveillance over currency unions. IMF staff apprised the Executive Board of developments in the ECCU and the CFA franc zone through occasional informal discussions—see, for example, IMF (1982, 1990, and 1994).[26] Starting around 1990, staff conducted semiannual meetings with the BCEAO and the BEAC which were focused mainly on the consistency between monetary objectives at the regional level and individual country programs; these meetings did not give

[23] The pact defined (i) a convergence phase ending in the target year, at which time member countries were expected to have been in compliance with all primary and secondary convergence criteria, and (ii) a stability phase beginning after the target year.

[24] The primary criteria relate to: the basic fiscal balance (non-negative); public sector debt (not to exceed 70 percent of GDP); inflation (annual average not to exceed 3 percent); and non-accumulation of domestic and external payment arrears. The secondary criteria relate to: the wage bill (not to exceed 35 percent of tax revenue); domestically financed public investment (not to exceed 20 percent of tax revenue); the tax-to-GDP ratio (higher than 17 percent); and the external current account deficit (excluding grants, not to exceed 5 percent of GDP). In January 2015, the WAEMU Heads of States revised the criteria—replacing the basic fiscal balance ceiling with a ceiling on the overall balance and eliminating the criteria on arrears, the current account deficit, and investment expenditure—and moved the target date for convergence to 2019.

[25] The convergence criteria (set in 1994, refined in 2001, and augmented in 2008) are: (i) non-negative basic fiscal balance, basic structural balance, and non-oil basic fiscal balance; (ii) average annual inflation and average annual underlying inflation not higher than 3 percent; (iii) public debt less than 70 percent of GDP; and (iv) non-accumulation of government arrears.

[26] As early as 1984, during a Board discussion in the context of Mali's re-entry into the West African Monetary Union, one Executive Director raised the question of whether the regular procedure for Article IV consultations was the most appropriate or useful one for countries belonging to monetary unions. However, there is no evidence that the issue was seriously considered until 1998.

rise to a subsequent Executive Board discussion. The first periodic regional consultation with a currency union was conducted for WAEMU institutions in 1997–98; however, staff were careful to distinguish it from an Article IV consultation.[27]

In 1998, the IMF, in anticipation of EMU and the euro, formalized modalities for regional discussions in the context of surveillance over individual euro area members. The rationale for new modalities was twofold. First, because euro area members of the Fund would no longer be in unilateral control of the policies identified in Article IV (i.e., exchange rate and monetary policies), the Fund would need to complement its regular bilateral discussions with national authorities with discussions with the institutions of the euro area. Second, and more importantly, the euro area was considered unique in terms of its potential systemic influence and its single market for goods, services, labor, and capital. The new procedures included semi-annual discussions with EU institutions responsible for common policies in the euro area in addition to annual Article IV consultations with individual member countries (see Table 3.1). At that time, some Directors also called for strengthened regional surveillance elsewhere in the world (IMF, 1997a) and a few Directors called for similar systematic arrangements to be adopted for discussions with regional institutions of the ECCU, WAEMU, and CEMAC (IMF, 2000). However, this issue was not picked up for several years.

Reflecting the systemic importance of the euro area, the IMF Executive Board granted the ECB observer status from January 1, 1999 (Box 3.1).[28] In making this decision, the Board considered that effective representation of the ECB's views in Board discussions would enhance the Fund's surveillance over the euro area—within the Fund's Executive Board, the euro area countries are spread out over eight constituencies (with France and Germany each having their own seat). As an observer, the ECB representative may address the Board when invited to do so, but does not have voting rights.[29] In Board discussions on euro area policies, the euro area is represented by one Executive

[27] During the Board discussion of this report in May 1998, a European Executive Director raised questions about the nature of the exercise and called for further discussions to clarify how the Fund's surveillance functions, especially the Article IV process, would relate to currency unions such as the WAEMU and the euro area.

[28] The ECB and the European Commission also participate as observers in meetings of the International Monetary and Financial Committee (IMFC), which provides strategic direction to the work and policies of the Fund. The IMFC has 24 members who are central bank governors, ministers, or others of comparable rank; the size and composition of the IMFC mirror that of the Executive Board. None of the other currency unions' institutions have observership in the IMFC.

[29] Two euro area countries—France and Germany—appoint Directors to the Executive Board, totaling 10 percent of the Board's vote. The remaining euro area members are distributed among 6 different constituencies, of which 5 have rules that allow the euro area member to be elected Executive Director; if all five constituencies elect a euro area member as Executive Director, the euro area would fill 7 of the 24 chairs and its voting share in the Board would reach 32 percent.

Table 3.1. Regional Surveillance Modalities

	Euro Area	ECCB, WAEMU, and CEMAC
Frequency	Twice-yearly staff discussions with EU institutions responsible for common policies, held separately from Article IV discussions with individual members.	Annual discussions with regional institutions responsible for common policies, held separately from Article IV discussions with individual members. Second round of discussions during the year if considered necessary by the Managing Director.
Timing	Discussions with individual members are clustered, to the extent possible, around the discussions with EU institutions.	Discussions with individual members are clustered, to the extent possible, around the discussions with regional institutions.
Staff report and Board discussion	Annual staff report and Board discussion on common policies, considered as part of Article IV consultation with each member. Informal reporting to the Board by staff on second round of discussions with EU institutions.	Annual staff report and Board discussion of common policies, considered as part of Article IV consultation with each member.
Coverage	Monetary and exchange rate policies, and—from a regional perspective—other economic policies relevant for Fund surveillance.	Monetary and exchange rate policies, and—from a regional perspective—other economic policies relevant for Fund surveillance.
Summing up	Summing up of the conclusion of the Board's annual discussion on common policies, incorporated by reference into summings-up for Article IV consultations with individual members that take place before the next Board discussion of common policies.	Summing up of the conclusion of the Board's annual discussion on common policies, incorporated by reference into summings up for Article IV consultations with individual members that take place before the next annual Board discussion of common policies.
Communication	Standing arrangements for attendance at selected Executive Board meetings by the ECB. The Fund communicates to the ECB the agenda for all Board meetings and documents for Board meetings to which the ECB has been invited. The ECB representative may address the Board and may circulate written statements that become part of the record of the Board meeting.	Staff reports and related documents pertaining to Article IV surveillance over (i) common policies and (ii) policies of each individual member are communicated to the ECCB/BCEAO/BEAC at the same time the relevant staff report is made available to the Executive Board.

Sources: DEC/12899, December 5, 2002; DEC/13654, DEC/13654, and DEC/13656, January 9, 2006; DEC/14059, DEC/14060, DEC/14061, and DEC/14062, February 13, 2008.

Box 3.1. The ECB's Observer Status in the IMF

The IMF Executive Board adopted a Decision at the end of 1998 to grant observer status to the ECB after a long and spirited debate. Besides the ECB, standing arrangements for attendance at IMF Board meetings exist only for the World Bank and the World Trade Organization.

Initially, it was agreed that the ECB would be invited to send a representative to Board meetings on: Article IV surveillance over euro area policies and over individual euro area members; the role of the euro in the international monetary system; and the *World Economic Outlook*, *Global Financial Stability Report* (formerly *International Capital Markets Report*), and World Economic and Market Developments. In addition, it was agreed that the ECB would be invited to send a representative to Board meetings on items recognized by the ECB and the Fund to be of mutual interest for the performance of their respective mandates. Over time, the following items were included in the Decision: Article IV surveillance over the United States and Japan; and Article IV surveillance over, and use of Fund resources by, non-euro area member countries of the EU and candidate countries to the EU.

Executive Board approval is required for the ECB to send a representative to attend Board meetings not listed in the Decision. In practice, the ECB representative has been approved to attend Board meetings and informal Board seminars on diverse policy items including IEO evaluation reports and management briefings on recent travels. In 2006, one Executive Director observed that the expansion in the number and type of meetings that the ECB observer had been invited to attend raised questions of evenhandedness vis-à-vis other regional institutions that may also consider such policy discussions and decisions to be relevant to them. However, there was no further discussion of the issue. After 2007, reviews of the ECB observer status Decision were changed from annual to as needed. The last review was done in December 2009. At that time, European Directors declined to include in the Decision Board meetings on use of Fund resources by euro area members for fear that the change could trigger an adverse market reaction if made public. In the event, the ECB observer attended most Board meetings on use of Fund resources by euro area members.

Director who is responsible for reflecting the common view of the euro area member states and the relevant EU institutions in their respective fields of competence—initially, this was the Director from the country holding the (annual rotating) presidency of the European Council; since 2007, it has been the Executive Director heading the so-called EURIMF, an informal group of EU member state representatives in the Fund.

Around the same time, regular discussions also began to be held with regional institutions in the ECCU, WAEMU, and CEMAC.

- In the ECCU, IMF staff began experimenting with different ways to introduce a regional dimension to Article IV consultations with individual members. In 1999–2001, Fund staff held discussions with the

ECCB and prepared papers covering institutional arrangements, recent developments, and policy issues in the currency union as background for Article IV consultations with individual members. In 2002–05, staff conducted discussions with the ECCB and other ECCU regional institutions (the OECS Secretariat and the Caribbean Development Bank) twice a year; the first discussion was followed by a formal Board meeting, with a staff report and summing up, and the second discussion was followed by an informal Board meeting involving only an oral presentation by staff. Starting in 2004, staff would visit each of the ECCU's Fund members—separately from their individual Article IV consultations—as part of their regional surveillance of the ECCU.[30]

- In the WAEMU and the CEMAC, staff held stand-alone discussions every one or two years with the regional central bank and other regional institutions including the WAEMU Commission and the Banking Commission in the WAEMU and the CEMAC Commission (and the Executive Secretariat before that) and the COBAC in the CEMAC.[31] Following each discussion, a staff report was presented to the Board and there is a summing up of the conclusion of the Board discussion.

In 2006, those discussions were formalized as constituting an integral part of Article IV surveillance on the individual currency union members, after staff argued, and the Board agreed, that establishing an appropriate framework for policy discussions with regional institutions in the ECCU, WAEMU, and CEMAC would be "desirable" (IMF, 2004a). The surveillance modalities are similar to those established for regional discussions with the euro area except that: (i) they provide for annual discussions with regional institutions rather than twice-yearly discussions as in the case of the euro area; and (ii) they do not include observer status for the central bank at IMF Board meetings (Table 3.1). In addition to the formal modalities, Fund staff hold discussions with the BCEAO and BEAC roughly every quarter (via videoconference) on macroeconomic developments in their member countries; and in the ECCU, Fund staff continue to visit each individual member in the course of conducting regional discussions on ECCU policies.[32]

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[30] ECCB and Caribbean Development Bank representatives often participated as observers in Article IV missions to individual IMF members of the ECCU, a practice dating back to the mid-1990s. The ECCB representatives played a dual role in the Article IV missions because they represented the authorities as the central bank on one hand, but on the other hand they were also there to learn about the country's macroeconomic situation.

[31] In the WAEMU, staff occasionally met with other institutions including the Regional Securities Commission and the West African Development Bank, as well as the ECOWAS and the West African Monetary Institute. In the CEMAC, staff occasionally met with other institutions including the Central African Development Bank, Economic Union of Central African States, the Anti-Money Laundering Group, and the Financial Markets' Supervisor.

[32] Since 2009, discussions on ECCU common policies have been held with all eight ECCU members including Anguilla and Montserrat.

None of the three central banks has observer status at the Fund. Although some Directors had expressed a preference for developing criteria to assure uniform treatment of institutions similar to the ECB (i.e., the ECCB, BCEAO, and BEAC) in 1998, their preference was not met (IMF, 1998c). At Board discussions on common policies of ECCU countries, the ECCU is represented by the Canadian Executive Director, to whose constituency the six IMF members of the currency union belong. At Board discussions on WAEMU and CEMAC policies, the unions are represented by the Executive Director for Francophone Africa. The World Bank has sent observers to these meetings but the ECCB, BCEAO, and BEAC have not.

In 2009, the Surveillance Guidance Note for staff for the first time set out the scope and focus of surveillance for currency union members. Essentially the guidelines specify that staff should assess the real effective exchange rate and economic and financial policies both at the level of the union (i.e., to what extent union-level policies are promoting the union's domestic and balance of payments stability and global stability, as the case may be, and what policy adjustments are necessary for this purpose) and at the level of the individual member (i.e., to what extent individual member-level policies are promoting the member's domestic and balance of payments stability and contributing to the stability of the union as a whole).

A constant theme of IMF regional surveillance of the ECCU, WAEMU, and CEMAC was the importance of regional coordination to ensure the consistency of national fiscal policies with the currency union.

- The ECCU was considered to be behind the curve in this respect relative to the euro area. Although the ECCB Monetary Council adopted a set of fiscal benchmarks similar to those in the EU's Stability and Growth Pact in 1998—including a 3 percent limit on the overall government budget deficit relative to GDP and a 60 percent limit on total central government debt outstanding relative to GDP—no formal monitoring and enforcement mechanisms were set up and compliance ultimately was low. In 2006, a new system of fiscal benchmarks was approved that placed greater emphasis on integrating annual budget objectives with the medium-term goal of reducing public debt to 60 percent of GDP by 2020, but member authorities rejected IMF staff's arguments for a formal enforcement mechanism "which they considered had been ineffective in the European Union" (IMF, 2007).
- In the WAEMU, every IMF staff report on regional discussions with WAEMU institutions since 1998 included an assessment of members' compliance with the convergence criteria. The Fund (staff and the Board) time and again bemoaned the repeated failure by WAEMU countries to meet their target date for convergence and called for "stronger political commitment and peer pressure" (IMF, 2004a), "a robust process of peer review and increased budget transparency" (IMF, 2011a),

and "[i]mproving country ownership of the new [fiscal] rules" (IMF, 2015a). This contrasts with the approach in the euro area, where Kopits (2017) notes that the Fund was not sufficiently forceful in highlighting inconsistencies in the application of Maastricht Treaty obligations, including the failure to levy sanctions on governments that flouted the Excessive Deficit Procedure (particularly France and Germany in 2004).

- Likewise, every IMF staff report on regional discussions with the CEMAC included a table assessing members' compliance with the convergence criteria. Successive Fund missions pushed for modifications to the convergence criteria to better reflect the oil-dominant structure of the economies and to limit pro-cyclical fiscal policies. The IMF staff and Board repeatedly called for greater ownership of the internal surveillance framework by member states and strengthened enforcement of the framework by the regional institutions.

The Fund was outspoken in calling attention to longer-term risks to the currency unions. For example:

- The Fund repeatedly criticized CEMAC countries for not complying with the reserves pooling requirement. As fiscal surpluses in oil-exporting members grew, so did the tension between those countries' interest in saving and investing part of their oil-related inflows and the need for adequate common reserves held in the BEAC. Successive Fund missions called for a reform of the oil savings management framework that would maintain an adequate level of regional reserves, allow more effective and transparent management of the member states' fiscal savings, and ensure adherence to regional rules.
- The Fund repeatedly expressed reservations about the future enlargement of the WAEMU. A 2008 Selected Issues Paper evaluated the economic benefits and costs of and outlined the conditions and institutional requirements for a West African monetary union, and concluded that: "Under current economic conditions, a rapid move to a West African monetary union would be unlikely to provide net economic benefits and in fact could be economically costly" (IMF, 2008). This is in contrast to the euro area, where Kopits (2017) and Dhar and Takagi (2017) find that the Fund was reticent in expressing its views on enlargement.

Lending

Unlike the euro area, almost all members of the other three currency unions are eligible to use the Fund's concessional financing facilities. In the ECCU, Dominica, Grenada, St. Lucia, and St. Vincent and the Grenadines are eligible, even as middle-income states, in view of their assessed vulnerabilities. All WAEMU countries and all CEMAC countries except for Gabon and Equatorial Guinea are eligible to use the Fund's concessional financing facilities and for assistance under the Heavily Indebted Poor Countries (HIPC) Initiative.[33]

All members of the three currency unions have received financial assistance from the Fund at one time or another.

- ECCU countries are highly vulnerable to external shocks and natural disasters such as hurricanes and almost all of them have received some form of emergency assistance from the Fund (which is disbursed rapidly and without the need for program-based conditionality).[34] Fund-supported programs have been less common except in Dominica and Grenada (Table 3.2). IMF staff noted that "[w]hile some of the countries have repeatedly accessed the Fund emergency facilities in recent years . . . there is generally hesitation among the authorities to engage in Fund-supported programs," reflecting lingering stigma from experiences with the Fund in the region (IMF, 2011b).
- Every WAEMU and CEMAC country has had several, often consecutive, arrangements under the IMF's facilities for low-income countries (Tables 3.3 and 3.4). Some countries have also had Stand-By Arrangements (SBAs), typically of a year's duration; some—like Côte d'Ivoire, Niger, Senegal, and Togo in the WAEMU and Cameroon, the Central African Republic, the Republic of Congo, and Gabon in the CEMAC—had a series of SBAs over a number of years. For much of the period from the late 1980s to the late 1990s, there were Fund-supported programs in all eight (six) WAEMU (CEMAC) countries at the same time. Fund lending to CEMAC and WAEMU countries has been primarily for alleviating temporary terms of trade shocks, assisting in post-conflict recovery, and reducing poverty and promoting growth in the longer term.

Compared to the Fund's financial assistance to Greece, Ireland, and Portugal, the size of IMF loans to ECCU, WAEMU, and CEMAC members has usually been small, reflecting the IMF's intended catalytic role for debt

[33] All eight WAEMU countries are receiving full debt relief from the IMF and other creditors after reaching their HIPC completion points. In the CEMAC, Cameroon, the Central African Republic, and the Republic of Congo have qualified for comprehensive debt reduction from the IMF and the World Bank under the enhanced HIPC Initiative, while Chad is in the interim phase of the initiative. Equatorial Guinea was deemed no longer eligible for Fund concessional lending in 2001.

[34] IMF emergency assistance—to help countries with urgent balance of payments financing needs in the wake of natural disasters or armed conflicts—is provided to all members through the Rapid Financing Instrument (RFI) and to low-income members through the Rapid Credit Facility (RCF). Such assistance takes the form of outright disbursements without the need for a full-fledged program. The RCF and RFI replaced the Emergency Natural Disaster Assistance, Emergency Post-Conflict Assistance, and the rapid access component of the Exogenous Shocks Facility.

Table 3.2. ECCU Countries: Lending Arrangements, 1983–2015

Country	IMF Facility[1]	Year(s)	Amount Approved: SDR millions	Amount Approved: Percent of quota
Antigua and Barbuda	Stand-By	2010–13	67.5	500
Dominica	Stand-By	1984–85	1.4	35
	SAF*	1986–89	2.8	70
	Stand-By	2002–04	3.3	40
	PRGF*	2003–06	7.7	94
Grenada	EFF	1983–84	13.5	300
	PRGF*	2006–10	16.4	140
	ECF*	2010–13	8.8	75
	ECF*	2014–17	14.0	120
St. Kitts and Nevis	Stand-By	2011–14	52.5	590

* indicates concessional facility.

Note: ECF = Extended Credit Facility; EFF = Extended Fund Facility; PRGF= Poverty Reduction and Growth Facility (replaced by ECF); and SAF = Structural Adjustment Facility (replaced by PRGF).

[1] Does not include: Emergency Natural Disaster Assistance (Dominica—2008, Grenada—2003 and 2004, St. Lucia—2011; St. Kitts and Nevis—1998 and 2009); Exogenous Shocks Facility (Dominica—2009, Saint Lucia—2009, St. Vincent and the Grenadines—2009); Rapid Credit Facility (Dominica—2012, St. Lucia—2011, St. Vincent and the Grenadines—2011 and 2014).

Table 3.3. WAEMU Countries: Lending Arrangements, 1962–2015

Country	IMF Facility[1]	Year(s)	Amount Approved: SDR millions	Amount Approved: Percent of quota
Benin	SAF*	1989–92	21.9	70
	ESAF*	1993–96	51.9	115
	ESAF*	1996–2000	27.2	60
	PRGF*	2000–04	27.0	44
	PRGF*	2005–09	24.8	40
	ECF*	2010–14	74.3	120
Burkina Faso	SAF*	1991–93	22.1	70
	ESAF*	1993–96	53.0	120
	ESAF*	1996–99	39.8	90
	ESAF*/PRGF*	1999–2002	39.1	65
	PRGF*	2003–06	30.1	50
	PRGF*	2007–10	48.2	80
	ECF*	2010–13	82.3	137
	ECF*	2013–16	51.2	85
Côte d'Ivoire	EFF	1981–84	484.5	485
	Stand-By	1984–85	82.8	50
	Stand-By	1985–86	66.2	40
	Stand-By	1986–88	100.0	60
	Stand-By	1988–89	94.0	57
	Stand-By	1989–91	146.5	89
	Stand-By	1991–92	82.8	50
	ESAF*	1994–97	333.5	140
	ESAF*/PRGF*	1998–2001	285.8	120
	PRGF*	2002–05	292.7	90
	PRGF*	2009–11	374.0	115
	ECF*	2011–15	520.3	160
Guinea-Bissau[2]	ESAF*	1995–98	10.5	100
	PRGF*	2000–03	14.2	100
	ECF*	2010–13	22.4	158
	ECF*	2015–18	17.0	60

(*Continued*)

Table 3.3. (Continued)

			Amount Approved	
Country	IMF Facility[1]	Year(s)	SDR millions	Percent of quota
Mali[3]	Stand-By	1985–87	22.9	45
	Stand-By	1988–89	12.7	25
	SAF*	1988–91	35.6	70
	ESAF*	1992–96	79.2	115
	ESAF*	1996–99	62.0	90
	ESAF*/PRGF*	1999–2003	51.3	55
	PRGF*	2004–07	9.3	10
	PRGF*	2008–11	53.0	57
	ECF*	2011–13	30.0	32
	ECF*	2013–16	30.0	32
Niger	Stand-By	1983–84	18.0	75
	Stand-By	1984–85	16.0	47
	Stand-By	1985–86	13.5	40
	Stand-By	1986–87	10.1	30
	SAF*	1986–88	21.4	64
	ESAF*	1988–91	47.2	140
	Stand-By	1994–95	18.6	39
	ESAF*	1996–99	58.0	120
	PRGF*	2000–04	59.2	90
	PRGF*	2005–08	26.3	40
	PRGF*	2008–11	23.0	35
	ECF*	2012–16	79.0	120
Senegal	Stand-By	1979–80	10.5	25
	EFF	1980–81	184.8	440
	Stand-By	1981–82	63.0	100
	Stand-By	1982–83	47.3	75
	Stand-By	1983–84	63.0	100
	Stand-By	1985–86	76.6	90
	SAF*	1986–88	54.0	64
	Stand-By	1986–87	34.0	40
	Stand-By	1987–88	21.3	25
	ESAF*	1988–92	144.7	170
	Stand-By	1994	47.6	40
	ESAF*	1994–98	130.8	110
	ESAF*/PRGF*	1998–2002	107.0	90
	PRGF*	2003–06	24.3	15
Togo	Stand-By	1979–80	15.0	79
	Stand-By	1981–83	47.5	167
	Stand-By	1983–84	21.4	75
	Stand-By	1984–85	19.0	49
	Stand-By	1985–86	15.4	40
	Stand-By	1986–88	23.0	60
	Stand-By	1988–89	13.0	34
	SAF*	1988–89	26.9	70
	ESAF*	1989–93	46.1	120
	ESAF*	1994–98	65.2	120
	PRGF*/ECF*	2008–11	95.4	130

* indicates concessional facility.

Note: ECF = Extended Credit Facility; EFF = Extended Fund Facility; ESAF = Enhanced Structural Adjustment Facility (replaced by PRGF); PRGF = Poverty Reduction and Growth Facility (replaced by ECF); and SAF = Structural Adjustment Facility (replaced by PRGF).

[1] Does not include Compensatory Financing Facility (Côte d'Ivoire—1976, 1981, 1983, 1988, and 1990, Niger—1983, Senegal—1978 and 1981; Republic of Congo—1977; Gabon--1994); Emergency Post Conflict Assistance (Côte d'Ivoire—2007 and 2008, Guinea-Bissau—1999, 2000, 2008, and 2009); Exogenous Shocks Facility (Senegal—2008-10); Rapid Credit Facility (Guinea-Bissau—2014; Mali—2013).

[2] Guinea-Bissau adopted the CFA franc in 1997.

[3] Mali (re)adopted the CFA franc in 1984.

Table 3.4. CEMAC Countries: Lending Arrangements, 1972–2015

Country	IMF Facility[1]	Year(s)	Amount Approved: SDR millions	Amount Approved: Percent of quota
Cameroon	Stand-By	1988–90	61.8	67
	Stand-By	1991–92	28.0	30
	Stand-By	1994–95	81.1	60
	Stand-By	1995–96	67.6	50
	ESAF*	1997–2000	162.1	120
	PRGF*	2000–04	111.4	60
	PRGF*	2005–09	18.6	10
Central African Republic	Stand-By	1980–81	4.0	25
	Stand-By	1981	10.4	43
	Stand-By	1983–84	18.0	75
	Stand-By	1984–85	15.0	49
	Stand-By	1985–87	15.0	49
	Stand-By and SAF*	1987–88	8.0	26
	SAF*	1987–90	21.3	70
	Stand-By	1994–95	16.5	40
	ESAF*	1998–2002	49.4	120
	PRGF*	2006–10	69.6	125
	ECF*	2012–14	41.8	75
Chad	SAF*	1987–90	21.4	70
	Stand-By	1994–95	16.5	40
	ESAF*	1995–99	49.6	120
	PRGF*	2000–04	47.6	85
	PRGF*	2005–08	25.2	45
	ECF*	2014–17	106.6	160
Republic of Congo	Stand-By	1977–78	4.7	36
	Stand-By	1979–80	4.0	24
	Stand-By	1986–88	22.4	60
	Stand-By	1990–92	28.0	75
	Stand-By	1994–95	23.2	40
	ESAF*	1996–99	69.5	120
	PRGF*	2004–08	55.0	65
	PRGF*	2008–11	8.5	10
Equatorial Guinea[2]	Stand-By	1985–86	9.2	50
	SAF*	1988–91	12.9	70
	ESAF*	1993–96	12.9	53
Gabon	Stand-By	1978–79	15.0	50
	EFF (precautionary)	1980–82	34.0	113
	Stand-By	1986–88	98.7	135
	Stand-By	1989–91	43.0	59
	Stand-By	1991–93	28.0	38
	Stand-By	1994–95	38.6	35
	EFF	1995–99	110.3	100
	Stand-By	2000–02	92.6	60
	Stand-By	2004–05	69.4	45
	Stand-By (precautionary)	2007–10	77.2	50

* indicates concessional facility.

[1] Does not include Compensatory Financing Facility (Cameroon—1976 and 1978, Central African Republic—1996 and 1981, Chad—1976, 1981, and 1985; Republic of Congo—1977; Gabon—1994); Emergency Post Conflict Assistance (Central African Republic—2004 and 2006, Republic of Congo—1998 and 2000); Rapid Credit Facility (Central African Republic—2014).

[2] Equatorial Guinea adopted the CFA franc in 1985.

restructuring and/or for budgetary support from other lenders and bilateral donors.

- There were no capital account crises and no exceptional access programs in the WAEMU and the CEMAC, due to limited financial integration both within the currency union and between the currency union and outside countries. The largest IMF financing packages approved in the WAEMU were the Extended Fund Facility (EFF) arrangements in Côte d'Ivoire (425 percent of quota) and Senegal (440 percent of quota) in the early 1980s. No CEMAC country has borrowed more than 160 percent of its quota from the Fund.
- Two exceptions in the ECCU were the 2010 SBA in Antigua and Barbuda (with initial access of 600 percent of quota, just shy of the exceptional limit)[35] and the 2011 SBA in St. Kitts and Nevis (with access of 590 percent of quota but considered exceptional because of the need for heavily frontloaded disbursements). Both of those programs took place contemporaneously with, and had similar underlying issues as, the euro area programs—IMF staff called the ECCU "a microcosm of the euro area and its difficulties" (Schipke, Cebotari, and Thacker, 2013).

In contrast to surveillance, relatively less attention was given by the Fund to a systematic consideration of issues related to lending to currency union members. An exploratory effort in 1998 focused mainly on how to assess need for use of Fund resources in a euro area country, noting that the experience to date in the other currency unions was not very relevant (Box 3.2). Directors agreed that circumstances could arise where a balance of payments need could be discerned in an individual euro area country based on indicators such as exceptional financing and movements in interest rate premia (IMF, 1998c); they agreed to return to the issue at a later date but there is no evidence that any further discussion took place. In contrast to the approach to surveillance, the 1998 Board discussion did not consider special modalities for lending to euro area members or a framework for incorporating currency-union considerations in program design and modalities.

Importantly, there was no discussion of how to design conditionality in Fund-supported programs in currency union members. The 2002 Guidelines on Conditionality stipulated that conditions be established only on the basis of those variables or measures that were reasonably within the member's direct or indirect control. This was stated as a general principle and could be taken to imply that IMF-supported programs in individual currency union member countries were expected to eschew conditionality on union-level policies which were beyond the national authorities' control. In 2012, Fund staff suggested to management that the conditionality guidelines could possibly be

[35] A rephrasing of purchases at the combined fourth, fifth, and sixth reviews in 2012 reduced total access for Antigua and Barbuda's SBA to 500 percent of quota.

Box 3.2. Considerations on the Use of Fund Resources by Euro Area Countries

The 1998 Board paper on *EMU and the Fund* (IMF, 1998b) set out some considerations relating to possible use of Fund resources by an EMU member (i.e., euro area country). In the past, the IMF had been able to deduce a balance of payments need in a currency union member from the existence of arrears and/or debt rescheduling. However, the paper noted that the tendency to look to fiscal needs as evidence of balance of payments needs in a currency union reflected the fact that the existing currency unions comprised mostly lower-income countries that had limited market access and were not vulnerable to sudden stops. It presumed that in the euro area, "an incipient balance of payments need in an individual member [would] almost invariably be met by the union-wide financial system, since both public and private sectors [would] be able to attract capital inflows from other union members, reflecting the absence of exchange risk in addition to free capital movements." However, if the financial system were to become segmented—for example, if financial markets perceived that a member might exit the union or that there was significant country-specific risk—an individual euro area country could lose, or come close to losing, access to international capital markets. Absent union-wide external weakness, therefore, need for an individual euro area country would have to be evidenced by developments in its own balance of payments, through indicators such as exceptional financing or official inducements for residents to borrow (e.g., ECB liquidity support). In such circumstances, a request for use of the Fund's general resources would be warranted. It was not known at that time if the EU would regard use of Fund resources by euro area members as consistent with the "no bailout" clause of the Maastricht Treaty.

revised to explicitly address the option of imposing program conditionality at the union level, but no revision took place. Subsequently, the 2015 Board paper, "Crisis Programs Review," stated that the Fund's Articles of Agreement allowed for the establishment of conditions for the financing of member countries, including those to be implemented at the union level, and outlined some possible approaches to designing programs with currency union members (IMF, 2015b). During the Board discussion of that paper, some Directors agreed that the Fund should seek commitments on union-level policies if necessary for program success or financing assurances but others considered that Fund should only provide advice on union-level policies through surveillance (IMF, 2015c).

There were no formal conditions on union-wide policies in IMF-supported programs in the ECCU, WAEMU, and CEMAC.

- ECCB officials interviewed for this evaluation were clear that the ECCB, as a regional institution, could not be subject to IMF conditionality on monetary and exchange rate policies, which would effectively also apply to and impact members that did not have a Fund program. They cited the example of Dominica in the 1980s, where IMF-supported programs had to accept that exchange rate policy was off the table.[36] Similarly, while the IMF could discuss with the ECCB its credit allocations in a program context, the Fund could not specify that the ECCB change its credit allocation formula as part of program conditionality.

- A form of implicit union-level conditionality (and lending) occurred in the context of the January 1994 CFA franc devaluation. Beginning in the mid-1980s, the countries of the CFA franc zone experienced a substantial and protracted loss of competitiveness. Internal adjustment policies were unsuccessful and led to a significant erosion of confidence in the CFA franc, triggering large capital outflows from the zone. By the early 1990s, IMF staff and management concluded that a substantial devaluation of the CFA franc vis-à-vis the French franc was needed. After a long process of consultation among the countries involved, a 50 percent devaluation was announced in January 1994. Immediately following the devaluation, concurrent IMF-supported programs were put in place for all the monetary union members (Tables 3.3 and 3.4).[37] Staff have characterized the devaluation as a prior action for the ensuing programs, although it was not noted as such in any of the program documents.
- The 2009 action plan to address safeguard concerns in the BEAC could also be considered a form of union-level "conditionality" in two CEMAC programs. In 2009, a serious case of fraud was uncovered in the Paris office operations of the BEAC, raising questions about the central bank's

[36] During program discussions in Dominica in 1983, 1984, and 1986, IMF staff, noting that the appreciation of the East Caribbean dollar had compounded the difficulties of the export sector, urged the government to "press its regional partners for an early reexamination of the exchange rate policy in the East Caribbean area" (IMF, 1983). Staff recognized that Dominica had no freedom to adjust its exchange rate on its own and that any program would have to take that fact into account. In 1987, the Dominican authorities "pointed out that exchange rate action was not realistic . . . since the unanimous agreement of ECCB members required for such action would be difficult to reach, in part because of the differences in the movement of real effective exchange rates among the ECCB members" (IMF, 1987).

[37] In Benin, Burkina Faso, Côte d'Ivoire, Mali, and Togo in the WAEMU (then the West African Monetary Union), where reform design and program discussions were already at an advanced stage, programs were supported by medium-term concessional ESAF arrangements; in Niger and Senegal, Fund support was extended initially through SBAs and subsequently replaced by ESAF arrangements. In the CEMAC (then the Central African Monetary Area), except for Equatorial Guinea, which already had three-year ESAF-supported program in place, Fund support was extended initially through SBAs which were later replaced by arrangements under the ESAF or the EFF. The World Bank, France, and other multilateral and bilateral creditors (such as the African Development Bank and the EU) also provided substantial exceptional financial assistance to the CFA franc zone countries, but not jointly with the Fund unlike in the troika programs in the euro area.

ability to safeguard Fund resources.[38] IMF staff informed the Board that the BEAC would need to take specific actions to address those safeguard concerns in order for reviews of two ongoing programs and approval of new programs to proceed; however, these actions were not included as program conditionality. In the event, Board consideration of program reviews for the Central African Republic and the Republic of Congo scheduled for May 2010 was delayed because the BEAC did not make sufficient progress on some actions.

But there have been formal conditions on country-specific measures/variables under the control of the ECCB, BCEAO, and BEAC.

- Until the mid-1990s, IMF-supported programs in WAEMU and CEMAC members routinely specified as a quantitative performance criterion a ceiling on the net domestic assets of the banking system.[39] The programs also included a ceiling on net credit to the government which, given the ceiling on net domestic assets of the banking system, would leave adequate room for some increase in credit to the private sector. The national authorities could control only net bank credit to the government and public enterprises; it was up to the BCEAO/BEAC to ensure that the monetary targets were observed, using the monetary policy instruments at its disposal to intervene when necessary. After the elimination of direct credit controls, the quantitative ceilings on net domestic assets of the banking system were replaced by quantitative ceilings on net domestic assets of the central bank (at the national level) and the central bank used indirect instruments such as its union-wide discount and repurchase rates and reserve requirements to keep domestic credit growth within the programmed limits—see, for example, the 1994 ESAF-supported programs for Côte d'Ivoire, Senegal, and Togo, and the 1996 ESAF-supported programs for Benin, Burkina Faso, Mali, and Niger in the WAEMU; and the 1995 SBA for Cameroon, the 1995 ESAF-supported program for Chad, the 1995 EFF-supported program for Gabon, and the 1996 ESAF-supported program for the Republic of Congo in the CEMAC. Subsequently, with the development of regional money and interbank markets and greater reliance on indirect monetary

[38] The IMF's safeguards policy was introduced in 2000 to obtain reasonable assurance that central banks of member countries using Fund resources have appropriate control systems in place to manage the resources adequately and provide reliable information. Countries requesting a loan from the Fund under most lending facilities undergo such a safeguards assessment. In some instances, safeguard measures have been included as program conditionality or commitments by country authorities.

[39] Monetary policy is designed and implemented by the central bank at the regional level. The national directorate would project an increase in broad money for the country concerned, consistent with the union-wide monetary assumptions and balance of payments objectives of the central bank. The ceiling on net domestic assets of the banking system would ensure a minimum level of net foreign assets (reserves) in the country.

policy instruments in the WAEMU, the scope for national monetary policies became more limited and Fund-supported programs from then on eschewed targets for either base money or for the BCEAO's net domestic assets. Consistent with Fund practice in the WAEMU, such targets also disappeared in the CEMAC.[40]

- The SBAs for Antigua and Barbuda and for St. Kitts and Nevis included program conditions requiring direct action on the part of the ECCB in the financial sector (Box 3.3).[41] During the 2011 Board discussion on "ECCU—Common Policies of Member Countries," at least one Board member questioned why the ECCB appeared to be a subject of policy conditionality in program countries in the ECCU, whereas the ECB was part of the so-called troika that set conditionality for program countries in the euro area. Staff's response was that conditionality in a Fund-supported program for a currency union member could involve commitments that were within the mandate of regional bodies such as the ECCB, as long as the appropriate assurances were provided. In a statement for the 2015 Board discussion of the "Crisis Programs Review," one Director wondered whether the euro's reserve currency status as well as the need to involve financing partners in the euro area contributed to a different approach to program conditionality in the euro area vis-à-vis the ECCU, but the question was not addressed in the discussion.

IMF staff explored possible regional lending modalities with the ECCU but their idea of simultaneous programs did not receive Board support. During the 2010 discussion on common policies of ECCU members the authorities inquired about the possibility of IMF lending into a regional pool. Staff responded that while that was not possible under the Articles of Agreement, it might be possible to coordinate country-specific measures

[40] Although the BEAC for the past two decades has been moving towards a system of monetary management based on indirect instruments of monetary policy operating in the context of regional interbank and money markets, in practice monetary policy has been largely passive and liquidity management remains largely country-based due to the absence of an integrated money market.

[41] There has been no instance of the WAEMU Banking Commission or the COBAC being asked to carry out direct actions in the financial sector in the context of a Fund program. In the WAEMU, actions such as restructuring or closing a bank (e.g., in Benin's 2010 ECF program, Cote d'Ivoire's 2011 ECF program, Mali's 2004 and 2008 PRGF programs, and Togo's 2008 PRGF program) and preparing and implementing a strategy for financial sector development or reform (e.g., in Burkina Faso's 2007 PRGF program and Niger's 2012 ECF program) were undertaken by the national authorities, albeit in collaboration/consultation with the Banking Commission. Similarly, in the CEMAC, actions such as licensing microfinance institutions, supervision of nonbank financial institutions (both in Cameroon's 2005 PRGF program), and bank restructuring (in the Republic of Congo's 2004 PRGF program) were undertaken by the national authorities, in consultation with the COBAC.

Box 3.3. Role of the ECCB in Antigua and Barbuda's 2010 SBA Program and St. Kitts and Nevis' 2011 SBA Program

Antigua and Barbuda

In 2009, Antigua and Barbuda experienced the largest financial crisis in its history. The global economic slowdown had triggered a severe contraction of the economy, aggravating an already unsustainable fiscal position. The recession and associated fiscal crisis coincided with mounting problems in the financial sector, including the failure of the Bank of Antigua in February 2009.

In June 2010, the IMF Executive Board approved a three-year SBA for SDR 81 million, representing 600 percent of Antigua and Barbuda's IMF quota.

Two of the structural benchmarks required direct actions on the part of the ECCB: (i) to recapitalize the Bank of Antigua; and (ii) for on-site inspection of domestic commercial banks (IMF, 2010). The Fund team consulted with the ECCB Governor by video-conference and agreed on these measures before including them in the program. The ECCB Governor wrote a letter to the Minister of Finance—which was published along with the authorities' letter of intent and memorandum of economic and financial policies (MEFP)—confirming that the central bank would take the necessary steps for the benchmarks to be observed within the time frame specified in the MEFP. Both benchmarks were considered to be met in the first program review.

In July 2011, Antigua and Barbuda Investment Bank (ABIB)—the largest indigenous bank in Antigua and Barbuda and a systemically important bank to which various other indigenous banks within Antigua and elsewhere in the region were exposed—failed and had to be intervened by the ECCB. The failure of ABIB brought to light significant weaknesses in financial sector regulation and supervision, and additional financial sector measures (structural benchmarks) were inserted in the program. Three of these additional benchmarks entailed direct actions on the part of the ECCB, which provided the IMF with a written assurance that it would comply: (i) presentation of a strategic plan for ABIB 2012; (ii) full-scope on-site examinations of the remaining indigenous banks; and (iii) developing a strategy for restructuring the indigenous banking system in Antigua and Barbuda (IMF, 2012b). IMF review missions held discussions with the ECCB in addition to the Antigua and Barbuda authorities starting with the combined fourth, fifth, and sixth SBA program review in April 2012.

St. Kitts and Nevis

Following the global economic and financial crisis and the impact of Hurricane Omar in October 2008, St. Kitts and Nevis entered a two-year recession during 2009–10. The overall fiscal deficit deteriorated, the already-high level of public debt increased further, and there was an accumulation of arrears to private creditors. A sizable share of the public debt was held by the banking sector, raising concerns that a fiscal crisis in St. Kitts and Nevis could result in a general loss of confidence in the ECCU banking system and disruption in the interbank market.

In July 2011, the IMF Executive Board approved a three-year SBA for SDR 52.5 million (590 percent of St. Kitts and Nevis' IMF quota) to support the authorities' program, the key elements of which were: (i) front-loaded fiscal consolidation; (ii) a comprehensive restructuring of public debt; and (iii) steps to strengthen the financial sector including the establishment of a Banking Sector Reserve Fund (BSRF), financed by the SBA and administered by the ECCB, to provide a liquidity backstop during the program. The ECCB signed a memorandum of understanding with the government of St. Kitts and Nevis for the operating modalities of the BSRF, a prior action for the program (IMF, 2011c).

The ECCB participated in the discussions for the program request and most reviews. During the first program review in January 2012, a structural benchmark was added for the ECCB to conduct quarterly stress tests for domestic commercial banks and share them with IMF staff. The ECCB provided a written assurance that it would do so (IMF, 2012a). It also requested Fund technical assistance to enhance its stress testing capabilities and allow it to assess the effects of the debt restructuring.

that were part of Fund programs (e.g., country-specific budget support) and the resolution of matters with a regional dimension (e.g., strengthening the lender-of-last resort capacity of the ECCB) (IMF, 2011b). In addition, staff suggested that Fund lending to all ECCU countries concurrently would help foster policy coordination and strengthen the currency union (Box 3.4). However, some Executive Directors (particularly from European constituencies) objected to the idea, arguing that such an approach could not be a substitute for the political will to strengthen economic integration and regional coordination within the ECCU. One (non-European) Director noted that it was premature to consider the possibility of regional engagement before reflecting on the challenges the Fund had recently encountered in tackling systemic vulnerabilities in the currency union context, including its inability to secure binding commitments from key common institutions as well as implications for managing contagion.

The role of the ECB was one of the most controversial elements of the IMF's program engagements in the euro area. As a member of the so-called troika, the ECB participated in program discussions in Greece, Ireland, and Portugal on the same side of the table as the IMF, that is, on the conditionality-setting creditor side, even if it did not itself impose conditionality under the EC or IMF program. (The letters of intent from the euro area country authorities carried the signatures of the finance minister and the governor of the national central bank).[42] According to IEO (2014), authorities from

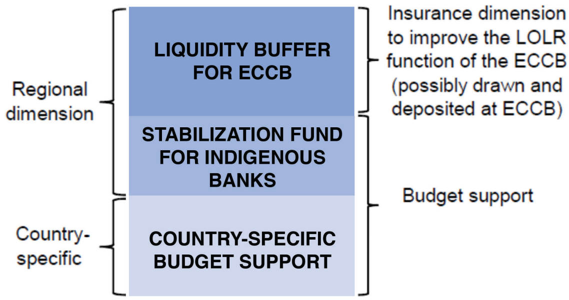
[42] The functions and responsibilities of the ECB and other EU/euro area institutions and their roles in the troika are discussed in detail in Kincaid (2017).

Box 3.4. IMF Staff's Proposed Regional Financing Approach in the ECCU

In 2010, staff proposed a regional financing approach that could substitute for lending to a regional pool. Under the staff proposal, financing arrangements with the Fund would continue to take place on a country basis. Fund financing could either help boost the country's level of reserves or help finance the country's balance of payments deficit. To the extent that Fund financing increased the country's reserves, it would increase the union's reserves because reserves are pooled at the ECCB—this in turn would provide a greater liquidity buffer at the ECCB to support its lender-of-last-resort (LOLR) function. At the same time, Fund resources could also be used to finance the country's domestic budget (if balance-of-payments-related conditions were met), and the budget could include spending on regional initiatives such as the creation of a bank stabilization fund.

Staff reasoned that simultaneous programs with all ECCU members would enhance the regional dimension of this plan, thus providing the Fund a method to lend indirectly into a regional pool.

Country-Specific and Regional Dimensions of Proposed Fund Financial Assistance to ECCU Countries (IMF, 2010)



countries outside the G20 (and Europe) found this arrangement inappropriate because "this implicitly took certain policy actions 'off the table' and constituted bad governance." ECCB, BCEAO, and BEAC officials also indicated in interviews for this evaluation that they would consider this a conflict of interest.

In the other currency unions, the regional central bank never sat on the IMF's side of the table during program discussions, even when it contributed financial support.[43] The letters of intent by country authorities were signed by the country's finance minister (and/or prime minister in some cases). The BCEAO and BEAC national directorates would always participate with the

[43] For example, in 2002, ECCU member governments agreed to provide financial support to Dominica through a drawdown of US$1.8 million from the ECCB's reserves, which helped to close the residual financing gap in the one-year US$4.3 million IMF-supported SBA. The CEMAC/BEAC has also extended exceptional financial support to member countries, but not in conjunction with a Fund-supported program.

country authorities in program discussions with the IMF.[44] In the ECCU, a representative from the ECCB would often (but not always) participate; according to Fund staff, the ECCB representative, if present, would sit with or closer to the authorities and never with the Fund team.

Summary of Findings

The IMF approached the euro area differently than the other currency unions. The Fund created and formalized special modalities for regional surveillance of the euro area when no modalities for surveillance of currency unions existed before. The ECB was granted observer status in the Fund—the only regional central bank to have this privilege. And the ECB participated in program discussions with euro area countries as part of the troika, sitting on the same side of the table as the Fund in an unprecedented arrangement.

To a large extent, the differences reflect the fact that the euro area is different from the other three currency unions. The ECCU, WAEMU, and CEMAC are small—in terms of membership size as well as share of the world economy—relative to the euro area which is systemically important in the international monetary system. The common currencies of the three currency unions operate under a fixed exchange rate regime, unlike the euro which is freely floating and a major international reserve currency. And the three currency unions moved relatively late towards economic union compared to the euro area which was part of the EU from the start. Thus, the Fund tended to consider the euro area in a class of its own and to use it as the archetype for regional integration—lessons were drawn from the euro area's experience for the other currency unions and not vice versa.

Notwithstanding the above justification, the Fund did eventually establish a general framework for regional surveillance of currency unions. To be sure, the Fund established modalities for regional surveillance over the euro area primarily because of the systemic importance of the region. And the Fund had been engaged with the other currency unions before 1999 through other means, such as regular staff visits to the regional central banks, concurrent (and often long-term) program engagements in member countries, and technical assistance missions. But the Fund also began to regularize its policy discussions with the other currency unions in 1998–99, and during the biennial surveillance review in 2004, staff argued, and the Board agreed, that formalization of regional surveillance with modalities similar to those followed for

[44] French Treasury officials did not participate in IMF program discussions with WAEMU and CEMAC countries (France is represented on Monetary Policy Councils of the BCEAO and the BEAC). However, IMF staff teams did routinely exchange information with the French Treasury before and/or after their program missions. According to Stone (2011), "[t]his superior information and preferential access to negotiators in real time clearly represent an opportunity for France to inject its preferences into the Fund policy-making process" and he finds that "French political interests play a much more potent role in the development of IMF conditionality in sub-Saharan Africa and in its other former colonies than in the rest of the world."

the euro area, was appropriate. This led to the 2006 Board decisions establishing modalities for surveillance over ECCU, WAEMU, and CEMAC policies in the context of Article IV consultations with their member countries.

However, the Fund did not establish a general framework for designing IMF-supported programs and conditionality in currency union members. Since the use of Fund resources by euro area members was not seriously considered a possibility in 1998, the Fund did not elucidate program design issues for members of currency unions. No in-depth discussion took place on issues such as what the Fund could/should do when there were identified macro-critical policies that were under the control of the regional institution and not the country authorities; under what conditions the Fund could/should seek to impose conditionality on supranational institutions like the regional central bank; and what type or scope of actions the Fund could legally and practically ask of a regional institution in a program context. In practice, Fund staff approached conditionality on measures within the control of the regional central bank differently in different currency unions. In the CFA franc zone in the mid-1990s, the Fund implicitly assigned the central bank responsibility for meeting the monetary targets (performance criteria) in their member countries' programs; in the ECCU more recently, the Fund obtained written assurances from the central bank that it would carry out certain program actions (structural benchmarks) within its area of competence; and in the euro area programs, Fund staff did not identify any ECB policies as part of program conditionality.

Neither did the Fund clearly establish, from a governance standpoint, the role of regional institutions, particularly the regional central bank, in Fund-supported programs and in the Fund more generally. Prior to the euro area programs, there was no precedent for the regional central bank sitting on the Fund's side of the table in program discussions with a currency union member. There has been no discussion since the ECB observership debate in 1998 on the representation of currency unions in the IMF. In the meantime, the European Commission has made proposals for a unified representation of the euro area in the IMF in the long term—including direct representation of the euro area by the Executive Director of a euro area constituency, following the establishment of one or several constituencies composed only of euro area members—and for securing observership for the ECB and the Commission at the Executive Board during the transition (European Commission, 2015).

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PART II

Technical and Operational Aspects of IMF Performance

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CHAPTER 4

IMF Surveillance of the Euro Area: From Conception Through Crisis

SANJAY DHAR AND SHINJI TAKAGI

Introduction

This chapter assesses the IMF's views on the architecture of the euro area as it was being designed and its surveillance of the euro area at vital points before and during the euro area crisis. The chapter discusses IMF views on the design of the European Economic and Monetary Union (EMU) prior to its establishment, on the subsequent buildup of vulnerabilities before the crisis, and on the nature of IMF advice to respond to the crisis. Adopting such a long-term perspective enables the chapter to identify common themes in IMF surveillance viewed at from critical junctures, and to provide a broader basis for drawing lessons going forward.

The signing of the Treaty on European Union (Maastricht Treaty) in 1992 prompted a large and mostly critical academic literature on EMU. The intensity of reservations about the euro area architecture, however, dissipated following the successful launch and operation of the euro, and robust growth in the periphery. Such growth was largely driven by a surge in borrowing in the euro area periphery, sourced from euro area banks in its core, encouraged by the perceived elimination of currency and country risks. The first decade of EMU was thus characterized by credit and asset price booms in some countries, divergences in productivity growth and inflation, and widening fiscal or current account imbalances across the currency union.

Euro area economic performance in the wake of the global financial crisis, however, was weakest among the major advanced economy blocs. Output had not recovered to its pre-crisis level through 2014, while unemployment was more than double the rate in the United States, United Kingdom, or Japan, and stood at depression era levels in some countries. A number of economies experienced deflation rendering debt resolution more difficult, while low inflation for the euro area as a whole made adjustment through internal devaluation more difficult in periphery economies. This chapter discusses the advice the IMF provided to the European authorities to boost growth and to address area-wide adjustment issues when some periphery economies were in crisis.

The chapter assesses the effectiveness of IMF surveillance against this background. It is based on a review of the IMF's published and internal documents; public statements by IMF management; and interviews with current and former euro area and member country officials, members of the IMF Executive Board, management, and staff. Where relevant, it also reflects upon the views of independent analysts, including those expressed in the academic literature. The chapter complements other chapters of this volume, which discuss the IMF's surveillance and program engagement in individual crisis countries as well as IMF surveillance of financial and fiscal policies.

The rest of the chapter is organized as follows. The second section assesses the IMF's views of the prospective EMU before the introduction of the euro in 1999 against the prevailing academic debate, which is elaborated upon in Annex 4.1. The third section reviews the IMF's pre-crisis surveillance of the euro area, focusing on its discussion of the buildup of vulnerabilities before the crisis. The section also examines how effectively surveillance at the euro area level complemented country level surveillance. The fourth section assesses the IMF's advice on policies to respond to the euro area crisis and to overcome the constraints that undermined recovery in the crisis aftermath. The final section summarizes the chapter's key findings.

IMF Views on the Prospective EMU

> *Europe has neither flexible wages nor functioning labor markets, but already has mass unemployment. EMU will add to it, both on the way there and once the system is trapped in fixed rates across vastly divergent countries. (Rudiger Dornbusch, 1996)*

> *Europe's common market exemplifies a situation that is unfavorable to a common currency. (Milton Friedman, 1997)*

> *Optimists about EMU think they can get along without stabilization policies other than the ECB's commitment to price stability. They would just rely on free markets to make the necessary adjustments to economic disturbances to the union as a whole or to member states. Prices and wages will, they trust, correct fluctuations in production and employment. . . . Europe is much less well equipped than the United States to adjust to interregional disturbances to economic activity both in the strength of forces of market adjustment and in the availability of governmental fiscal responses, automatic and discretionary. (James Tobin, 1998)*

The central proposal of the Maastricht Treaty signed in 1992 was that the member states of the European Community would move towards a monetary union, anchored by a single currency managed by a central bank pursuing price stability.[1] There was no parallel proposal for fiscal integration or the establishment of institutions to provide a fiscal transfer mechanism

[1] The terms "monetary union" and "currency union" are used interchangeably in this chapter. McCarthy (2015) argues that the euro area should not be characterized as a monetary union but rather a common currency area.

within EMU. Instead, the focus of the Maastricht Treaty and the subsequent Stability and Growth Pact (SGP) of 1997 was on curtailing fiscal profligacy through rules limiting fiscal deficits and public debt, the prohibition of monetary financing of public deficits, and a no bailout clause precluding the assumption of liabilities of a member economy by the Union or its other members.[2] Bank regulation and supervision remained national competencies as did deposit insurance, rather than union-level functions, and national financial systems continued to be backed by national fiscal authorities.

EMU was first and foremost a political project. Whereas the choice of exchange rate regime was a matter for each member country, the IMF's surveillance role was to provide candid advice to members on the consistency of that choice with the member's national policies and circumstances (IMF Articles of Agreement, Article IV). The Fund recognized the strong political backing for the prospective EMU and appropriately discussed how to improve its design. But the tone and substance of its public messages contrasted sharply with the dominant view among academic experts (Box 4.1 and Annex 4.1), as it tended to emphasize the advantages of the common currency and downplayed several of the concerns.

For example, IMF Managing Director Michel Camdessus remarked in a 1997 address:

> Europe will reap a number of economic benefits from the introduction of a sound common currency. A common currency will lower transaction costs, reduce exchange risk, stimulate competition, and facilitate the broadening and deepening of European financial markets. It will also cement a larger economic space, which will then be better able to face external challenges and more impervious to adverse external shocks. All of these factors should contribute to sustained, non-inflationary growth and more rapid job creation, once structural impediments are removed.

The Maastricht monetary and fiscal framework was essentially endorsed:

> The Statute of the European Central Bank guarantees the Bank's independence and gives clear priority to low inflation in the conduct of monetary policy. Moreover, the Stability and Growth Pact, with its early warning system and various procedures for enforcing appropriate fiscal adjustment, lays out a strong framework for maintaining budgetary discipline after January 1999. At the same time, the Pact appears to leave sufficient room to tailor policy prescriptions to fit individual country circumstances. All of this augurs well for EMU and the euro.

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[2] Although the central bank was prohibited from purchasing sovereign debt from the issuer, it was not prevented from acquiring sovereign debt in secondary markets. Moreover, its collateral rules facilitated commercial bank financing of public deficits with funds borrowed from national central banks. Both actions were justified by the need to buttress the conduct of open market operations and repos.

Box 4.1. Post-Maastricht Academic Critiques of EMU

The signing of the Maastricht Treaty in 1992 led to a large and mostly critical response from some of the most prominent economists of the era. The essence of the critique was that EMU, as envisaged, did not constitute an optimum currency area (OCA)—i.e., where the benefits of a common currency in terms of lower transaction costs and elimination of exchange rate risk would outweigh the costs. Rigid wages and immobile labor within an economic region characterized by wide disparities would render adjustment to asymmetric shocks very costly in terms of output and employment. This would particularly be the case since the means to provide automatic stabilizers or discretionary fiscal policy at the union level had been ruled out by design. Under these circumstances, fiscal harmonization in terms of the convergence criteria devised for EMU membership would not suffice to ensure stability, nor could it substitute for fiscal integration, or a mechanism for fiscal transfers. By contrast, a subset of EMU nations might indeed constitute an optimum currency area.

A parallel concern related to the implementation of macroeconomic policies. A single monetary policy, likely aligned to the low inflation core, would be pro-cyclical and potentially destabilizing for EMU members with higher inflation. The fiscal rules were criticized on the grounds that they could constrain countercyclical policy, in particular, the scope for fiscal expansion in a deflationary setting. At the same time, pecuniary penalties for SGP violations would be difficult to administer in practice.

In the late 1990s, however, an alternative view emerged suggesting that closer trade links within EMU, which a single currency would promote, would lead to greater synchronization of business cycles, thereby diminishing asymmetric shocks. This view gained influence in policy circles as the final stage of EMU approached.

Distinct from OCA-related concerns, there was also concern that the Maastricht Treaty did not pay enough attention to systemic risks or the capacity to resolve them at the EMU level. In particular, fiscal stress in one country could result in systemic problems for banks and sovereigns in other countries, while a sudden stop in one country could result in sovereign default within the EMU architecture. The prospect of financial integration further pointed to the need for a central authority with a market stability mandate, and a common financial regulatory and supervisory capacity. Some experts highlighted the need for an ECB mandate for financial stability, including an explicit lender of last resort capacity.

Source: Annex 4.1.

Although the Managing Director's remarks recognized that increased labor market flexibility would be needed to allow economies to adjust to asymmetric shocks, they were less concerned than many independent observers about the ease with which structural rigidities could be tackled. Indeed, the thrust of the advice was to avoid delays in EMU completion:

> So what does all of this suggest about EMU? In my view, it suggests that this enterprise has been too long in the making, its foundation too solidly laid, and its achievement too important to European integration

> to court the uncertainties that would stem from its delay. In short, it is time to put to rest, once and for all, any lingering doubts about the future of EMU and to finish the job that is, in any case, so close to completion. (Camdessus, 1997)

The *World Economic Outlook (WEO)* which followed later that year (IMF, 1997a), analyzed these issues in greater depth. It recognized the importance of assessing countries' ability to absorb and adjust to asymmetric shocks in light of the loss of independent monetary and exchange rate policies at the national level. It was critical of the Maastricht framework for not explicitly recognizing the importance of flexible labor markets, and emphasized the need for comprehensively addressing labor market weaknesses. And it noted that if EMU was not accompanied by further progress with structural reforms and fiscal consolidation, there were likely to be serious consequences. But in contrast to most academic observers, the *WEO* was considerably more sanguine about the EMU monetary and fiscal architecture, concluding that:

> In the monetary and fiscal areas, the emerging policy framework appears to strike a good balance between rules and the necessary scope for the exercise of judgment in the implementation of policies. . . . *Thus, the absence of a central fiscal function should not pose the problems that are commonly perceived.* (Emphasis added.)

The *WEO* came to this conclusion by suggesting that national governments in the euro area could adjust to temporary asymmetric shocks in the context of the flexibility allowed within the SGP. Moreover, it gave prominence to the emerging view that convergence within the monetary union would be facilitated by the common currency:

> . . . the incidence of asymmetric demand shocks in the EU may diminish after the euro is introduced, as asymmetric developments induced by national monetary policies or exchange rate movements within the euro area will no longer be a factor; and the discipline imposed by the Stability and Growth Pact should reduce the prevalence of fiscal shocks in the medium term.

The *WEO* stressed the need for both increased fiscal discipline and accelerated structural reforms to enhance labor market flexibility. But compared to outside observers it was overly optimistic that more flexible labor markets could obviate the need for greater fiscal transfers and integration. The continued emphasis on structural reforms in labor markets in the 1990s through the crisis aftermath is testament to the difficulty of achieving and sustaining reforms in this area. Moreover, the IMF's view that the SGP would provide sufficient flexibility to respond to asymmetric shocks without a centralized fiscal capacity did not conform to the dominant academic opinion at the time.[3] Instead, the IMF's optimism on the incidence of asymmetric shocks conformed to that of European officials.

In contrast, the *International Capital Markets* report of November 1997 (IMF, 1997b) was more concerned about gaps in systemic risk management. Drawing on earlier work by IMF staff and others, it found ambiguity in the mechanisms for crisis resolution involving intra-European financial flows; it was critical of Maastricht's silence on lender of last resort functions, the lack of a central authority with the mandate to ensure market stability over the euro-wide financial system, and the lack of explicit and universal cooperation and information-sharing arrangements between the European System of Central Banks (ESCB), ECB, and relevant supervisors.

Finally, in the context of considering possible use of Fund resources by a member of the euro area, an IMF Board paper (IMF, 1998) discussed a number of scenarios, which anticipated problems that would arise more than a decade later:

> In principle, however, circumstances could arise in which the financial system would become segmented, such as if it were perceived that a member might depart from the union. In such circumstances, exchange risk may reappear. But even in the absence of exchange risk, lenders could still be deterred by other sources of country-specific risk, including . . . risk relating to the solvency of the national government. In the unlikely event that such risks assumed significant proportions, residents of an EMU member could find themselves unable to borrow, on suitable terms, as much as is appropriate and necessary to avoid measures destructive of national or international prosperity.

The same paper went on to predict:

> Such circumstances could warrant a request for use of the Fund's general resources by an EMU member. . . . A variety of circumstances could arise where such a need might be discerned, including through exceptional financing or liquidity support by the ECB, supplemented, perhaps, by evidence of interest rate pressures and market segmentation.

The insights from such reports were, however, lost in the euphoria of the pre-crisis period.

The IMF's generally sanguine view was evident in its assessment of Greece's EMU entry.[4] In its last Article IV consultation with Greece (September 1999) prior to its prospective EMU entry in January 2001, the IMF raised a number

[3] The IMF's position on this point appears to have changed in the crisis aftermath in its discussion of the need for a fiscal union in its 2012 Euro Area Policies Article IV report. Some of the same ideas were floated earlier, for example, by the Managing Director in 2010 (Strauss-Kahn, 2010).

[4] Many academic critiques of EMU considered a common currency suitable for a subset of prospective EMU member countries with comparable industrial structures and incomes. In

of concerns. Its focus was appropriately on fiscal policy as well as structural reforms to sustain the recent reduction in inflation that Greece had attained.[5] Nevertheless, the IMF's headline statement below, as signaled in the first paragraph of the Staff Appraisal, was encouraging of a Greek EMU entry:

> The stability-oriented economic policy pursued over the past years has succeeded in placing Greece squarely on the road to joining EMU by the target date of January 1, 2001—albeit with the recourse to indirect tax cuts to restrain inflation within the Maastricht criterion during the relevant reference period. The achievements to date are impressive: growth is strong, wage increases are moderate, fiscal developments are better than budgeted, and some appreciable advances have been recorded in the structural area.

The IMF's Pre-Crisis Surveillance

> *A major effect of EMU is that balance of payments constraints will disappear in the way they are experienced in international relations. Private markets will finance all viable borrowers, and savings and investment balances will no longer be constraints at the national level. (European Commission, 1990)*

At the launch of the euro in January 1999, the IMF adopted a dual-track approach to its surveillance of the euro area: it continued to conduct Article IV consultations, usually annually, with individual member countries of the euro area; in addition, the IMF held twice-yearly staff discussions with the institutions responsible for common policies in the euro area and issued an annual staff report followed by a formal Board meeting on the first round of discussions. The twice-yearly staff discussions would be "considered an integral part of the Article IV process for each member" (Executive Board Decision No. 11846-(98/125)).

This section discusses IMF surveillance during the first decade of the euro, focusing on how it alerted policymakers to vulnerabilities that would impact the euro area and its members. The section first provides an overview of surveillance at the euro area level (i.e., in the context of "Euro Area Policies" Article IV consultations), then discusses the effectiveness with which national and euro area level surveillance were integrated, and closes by assessing how the IMF approached the possibility of balance of payments crises in the currency union—arguably the most egregious shortcoming of its surveillance during this period.

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effect, their reservations amounted to concerns that the EMU architecture was unsuitable if membership was to be broadened to the periphery.

[5] Inflation was being reduced with the help of indirect tax cuts, while public debt was estimated at 106 percent of GDP in 1998.

An Overview of Surveillance at the Euro Area Level

The early years of EMU were marked by improved macroeconomic performance in several areas. The achievement of price stability and confidence in the new currency through a series of external shocks provided a welcome contrast to the turbulence European currencies had witnessed in earlier decades. Relatively strong growth in Greece, Ireland, Spain, and initially Portugal after their EMU entry appeared to vindicate the European single currency project. In this environment, the broader set of concerns among EMU critics dissipated, while attention was directed at slow growth in Germany and violation of the SGP fiscal deficit rule by Germany and France.

The IMF's early surveillance of the euro area thus tended to be congratulatory, and applauded progress on long-sought-after structural reforms:

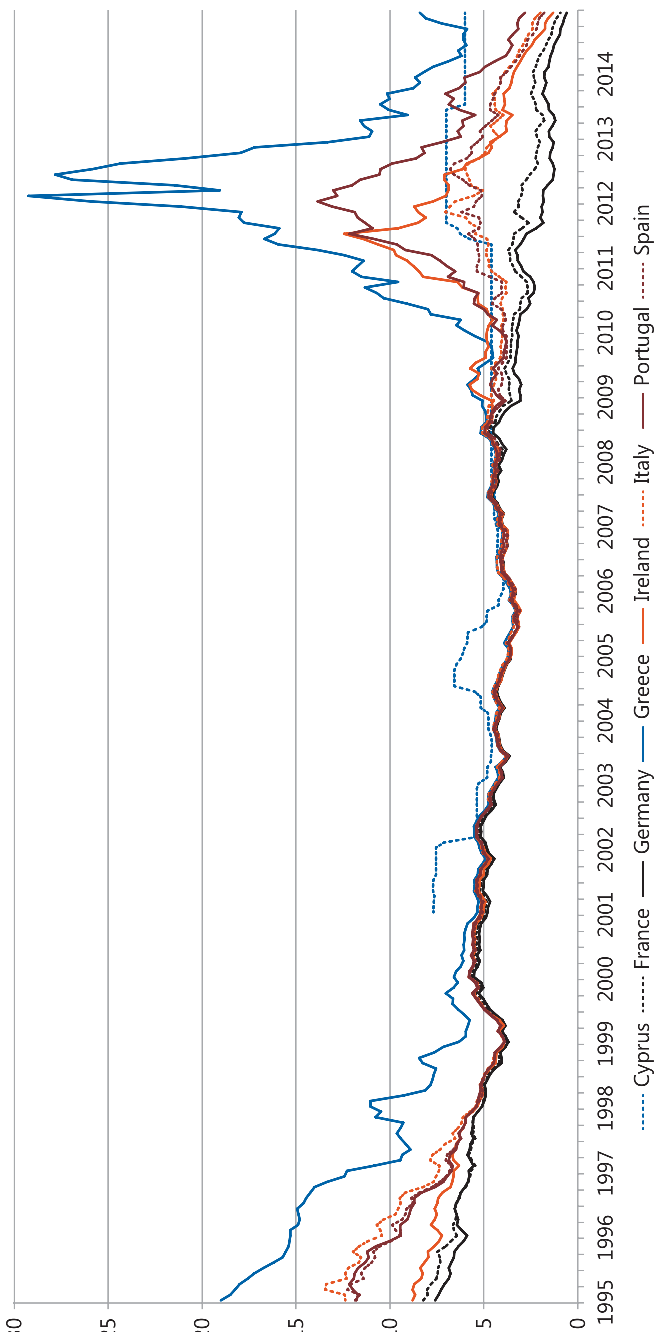
> The launch of the euro is a defining event in the history of modern Europe. An unparalleled example of economic and political cooperation, this project has overcome many challenges in realizing the long-held dream of monetary union, initially for eleven EU countries. EMU offers participating countries and the world economy the promise of greater economic stability and enhanced economic performance. (Euro Area Policies: 1999 Article IV)
>
> As regards structural policies, all euro-area representatives and the mission agreed that progress in product and labor market reforms was bringing about a significant transformation in the microeconomic structure of the euro area, evidenced by greater market integration and competition, falling utility prices, and increased employment content of economic growth in many countries . . . (Euro Area Policies: 2000 Article IV)

The robust performance of the periphery economies, however, was fueled by an extended surge in borrowing from banks in the euro area core, as the creation of the single currency was perceived by markets to have eliminated risk from cross-border lending, as reflected in the convergence of borrowing rates within the euro area (Figure 4.1).[6] The euro area periphery's debt to banks in the euro area core rose about eightfold between 1999 and mid-2008 (Figure 4.2). The counterpart to this borrowing was rapid credit expansion in the periphery, accompanied by higher than euro area average inflation,

[6] Spreads over German sovereign borrowing rates had begun to fall in the mid-1990s in anticipation of the introduction of the euro. Krugman (2012) describes the credit fueled expansion in the periphery as the mother of asymmetric shocks, inherent to but unanticipated by the euro design. Obstfeld (2013) observes that although the growth in capital flows and banking was a global phenomenon, it was accentuated in the euro area by the integration of financial markets, and in part by a lack of credibility embodied in the no bailout clause. Others have noted that the ECB's collateral policy, which initially did not differentiate across EMU members, also alleviated market perceptions of risk (Kopits, 2017). Sovereign yields were also compressed under EU prudential rules that sovereign debt of euro area members would carry zero risk weight for purposes of calculating regulatory capital.

Figure 4.1. Ten-Year Government Bond Yields

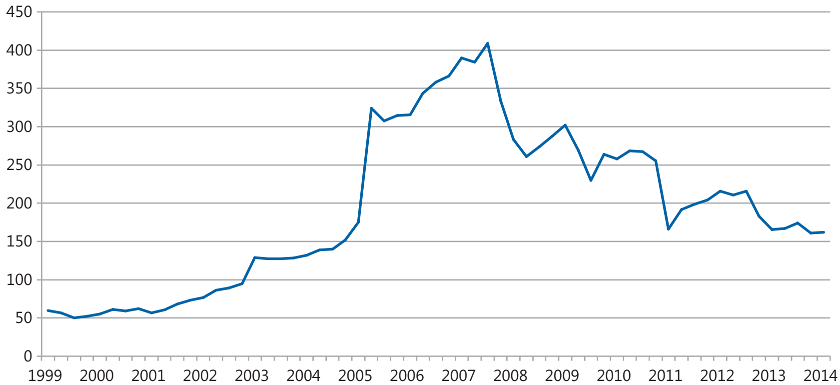
(In percent)



Source: Eurostat.

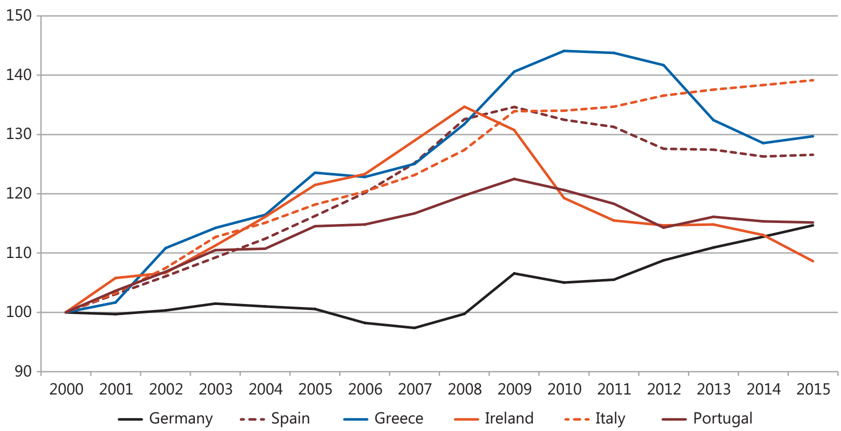
Figure 4.2. Bank Claims of Euro Area Core to Periphery

(In billions of dollars)



Note: Claims of banks from Austria, Belgium, France, Germany, Luxembourg, and Netherlands to Greece, Ireland, Portugal, and Spain.
Source: BIS.

Figure 4.3. Unit Labor Costs Within the Euro Area



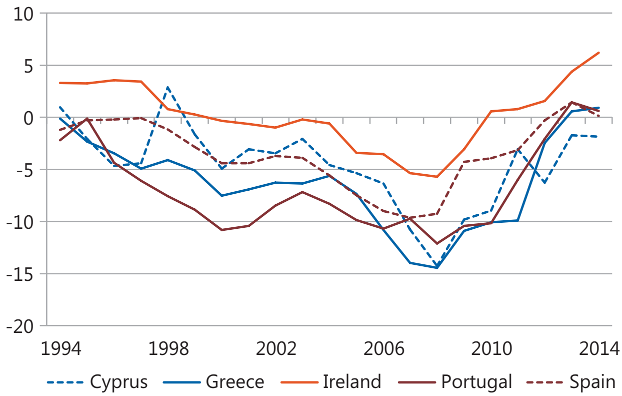
Source: Eurostat.

an appreciating real exchange rate, rising unit labor costs (Figure 4.3), and ultimately double digit current account deficit/GDP ratios (Figure 4.4). The higher inflation reduced real interest rates relative to the euro area core, further stimulating spending in the periphery. Current account deficits in the euro area periphery were almost entirely financed by private capital flows originating from within the euro area.

The main driver of credit growth in periphery economies was growth in private sector borrowing: private debt expanded at a faster pace than public

Figure 4.4. Current Account Balance/GDP, 1994–2014

(In percent)



Source: IMF.

Table 4.1. Increases in Public and Private Debt

Country	General Government Debt 1998–2007 (Percentage change)	Private Sector Debt 1998–2007 (Percentage change)
Greece*	70.2	177
Ireland**	16.3	111
Italy	27.6	98.1
Portugal	108	151
Spain	10.8	265

Source: OECD.
* Greece: growth during 2001 to 2007 (i.e., since joining the euro area).
** Ireland: growth during 2001 to 2007 due to lack of data dating back to 1998.

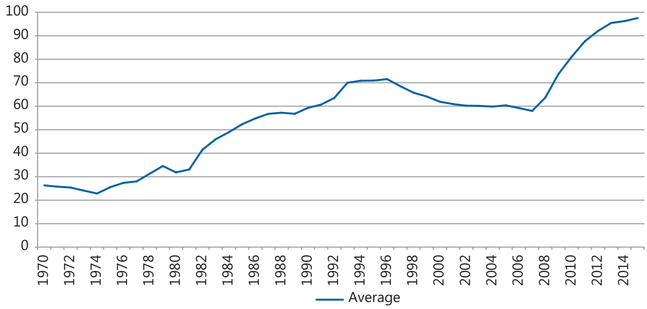
debt (Table 4.1), and was also substantially higher in absolute terms.[7] In some periphery economies, local banks served as the intermediary between banks in the euro area core and their governments; as such, the figures for (gross) private debt expansion may be inflated. In the aggregate, however, public sector borrowing was not the primary factor driving higher borrowing in the euro area: between 1999 and 2007, public debt/GDP for most countries and the euro area as a whole fell (Figure 4.5); and even in Greece, the ratio was up only marginally during this period, albeit from a high initial level.[8]

For the most part, IMF surveillance at the euro area level overlooked the fragility posed by the private credit-fueled rise in current account deficits until

[7] For the euro area as a whole, De Grauwe (2010) reports private debt growing at an annual pace of over 35 percent during 2005–07, while public debt was growing by below 5 percent in the same period.
[8] These trends should not be taken to infer that faster debt reduction in countries with both high and moderate public debt would not have been beneficial in managing the subsequent crisis. In particular, the decline in public debt ratio in several countries was facilitated by lower borrowing costs, which were largely spent rather than used to reduce fiscal deficits. Moreover, windfall revenues from real estate bubbles were not adequately provisioned for, as discussed below.

Figure 4.5. General Government Debt in the Euro Area

(In percent of GDP)



Note: Unweighted euro area average for the first 12 member countries.
Source: IMF, Historical Public Debt Database.

after the Greek crisis erupted in late 2009. It applauded the integration of the euro area bond market as signified by the convergence of yields, with little concern about the growth of private credit this was fueling:

> EMU has fostered a deeper, more liquid, complete, and increasingly integrated government bond market. The convergence of yields shows the degree of integration of euro-area government bond markets. Furthermore, in the wake of EMU the volatility of yields has declined significantly and has been increasingly driven by common factors. (Euro Area Policies—Selected Issues Paper, 2005)

> Monetary and credit dynamics are strong. . . . These developments, together with strong asset (notably housing) price dynamics, were seen to confirm the stimulative impact of the historically low level of interest rates. (Euro Area Policies: 2006 Article IV)

While concerns were expressed about vulnerabilities arising from rising asset prices in individual countries, they were undermined by the tendency to aggregate individual country trends, which obscured intra-euro vulnerabilities:[9]

> At the area-wide level, accelerating credit growth does not raise prudential concerns. (Euro Area Policies: 2006 Article IV)

[9] Article IV reports at the country level tended to discuss the risks of credit expansion more thoroughly. For example, the 2006 Article IV consultation for Spain noted that the main risks identified by the earlier Financial System Stability Assessment (FSSA) under the Financial Sector Assessment Program (FSAP) related to rapid credit growth and a potential downturn in the housing market. (It also reported that the FSSA/FSAP for Spain found a highly dynamic and competitive financial system under strong prudential supervision and regulation.)

The tendency to downplay vulnerabilities via aggregation was also evident in the discussion of the current account, which was roughly in balance for the euro area as a whole. It was against this background that the Euro Area Policies Article IVs of 2006–07 discussed how Europe might contribute to addressing global imbalances (through structural reforms, inter alia, via greater integration of bond, equity, bank and mortgage markets), without pointing out the financing risks of the growing current account deficits in some member countries of the euro area.

Through mid-2008, when the subprime crisis in the United States had already caused significant turmoil in financial markets on both sides of the Atlantic, including the euro area, there was little warning from the IMF about reversal risks from a decade of capital flows into the euro area periphery that had fueled excessive borrowing and asset bubbles. Thus the 2008 Article IV adopted a favorable view of the stability offered by EMU and drew comfort from the improving fiscal position:

> Ten years after its launch, monetary union is a distinct and promising success. EMU's macroeconomic policy framework has brought stability. . . .
>
> The fiscal position of the euro area improved in 2007 and now compares favorably to that in other parts of the world, marking a success for the reformed Stability and Growth Pact. In structural terms, the fiscal accounts of the euro area as a whole reached a close-to-balanced position. All excessive deficit procedures vis-à-vis euro area countries have been closed . . . Concurrently, the general government debt ratio continued to fall. (Euro Area Policies: 2008 Article IV)

In mid-2009, nine months after the Lehman collapse, the Euro Area Policies Article IV noted that the "correction of home-grown imbalances" could exacerbate the global financial turmoil. But it was only in mid-2010—*after* the Greek crisis had erupted—that IMF surveillance finally acknowledged the nature of systemic fragilities posed by the excessive borrowing by periphery economies since the advent of EMU:

> Domestic imbalances linked to unsustainable credit and construction booms, a lack of fiscal restraint, and unsustainable wage developments all contributed significantly. As a result, unsustainable asset and demand booms emerged in some places, and a common monetary policy became increasingly ill-suited for individual parts of the region, creating destabilizing real interest and exchange rate dynamics. The exchange rate being well above fundamentals for an extended period before the crisis aggravated these dynamics: it hurt deficit countries more than surplus countries, reflecting diverging wage developments and specialization patterns. (Euro Area Policies: 2010 Article IV)

Linking National with Euro Area Level Surveillance: Fiscal and Structural Policies in Crisis Countries

Article IV consultations with member countries in the euro area highlighted to a greater extent vulnerabilities that would become relevant in the crisis, while missing others:

- *Greece.* Article IV consultations with Greece following its EMU entry in 2001 consistently stressed the need for fiscal consolidation. The call for consolidation became more determined in 2004 when a data revision revealed that Greece's fiscal deficit had never fallen below 3 percent of GDP during 1997–2003. In 2005, staff pushed for deep reforms to tax administration and expenditure management, as recommended by earlier IMF technical assistance, and the IMF continued to make the case for fiscal policy adjustment and reform to reduce the deficit throughout the pre-crisis period. The need for structural reforms, especially in labor and product markets, was also noted nearly every year as competitiveness was being eroded by rapid wage growth. In the early years, this was cast in terms of the country's need to accelerate convergence through maintaining sustained growth; in subsequent years, the rationale was the need to contain upward price and wage pressure by improving the functioning of the labor market and promoting competition in the product market.
- Not enough attention was paid, however, to the fundamental obstacles to enacting and sustaining the structural reforms that were assessed to be perennially needed.[10] IMF staff tended to praise the authorities for any reform announced or implemented without assessing its impact; and practically any reform was cast in a positive light, albeit with a caveat that more was needed. For example, the 2007 Article IV consultation discussed in favorable terms the reforms in tax administration and expenditure control being implemented under the National Reform Program (2005–08) as well as the passage in November 2007 of the Law on Tax Evasion. In reality, very little substantive reforms were being implemented. To the contrary, the Greek government was legislating numerous structural impediments in the product market during 2004–09 (Katsoulakos, Genakos, and Houpis, 2015; Mitsopoulos and Pelagidis, 2011; Pelagidis and Mitsopoulos, 2014).
- *Ireland.* Article IV consultations for Ireland took place against the background of the country's impressive growth, accompanied by strong FDI inflows and a low stock of government debt (25 percent of GDP in

[10] For a succinct statement of these obstacles, see Phelps (2015).

2007). While the current account remained in near balance until 2004, staff saw signs of overheating in the form of price and wage pressure, rapid private credit growth, and asset (especially house) price inflation. As a result, staff pressed for tighter fiscal policy, initially so as to make it neutral over the cycle; from 2004, the IMF began to call for modest longer-term fiscal tightening. The 2006 Article IV consultation noted that growth was too dependent on construction activity and that banks' reliance on wholesale borrowing made the financial system vulnerable to a "change in international sentiment toward Ireland." The 2007 Article IV noted that rapid credit growth had led to vulnerabilities, including the high share of lending to the real estate sector and the growing reliance of banks on wholesale funding, which was potentially more volatile than retail funding.

- Even so, IMF surveillance did not discuss the risks posed by the size of the banking system relative to GDP, and the consequent high cost of resolving a banking crisis. Instead, it took comfort from the favorable indicators of banking resiliency, favorable recent stress test results, and strengthened regulation and supervision that were in line with the recommendations of the 2006 FSAP Update. Moreover, the IMF's analysis lacked specificity. It did not pay sufficient attention to the composition of government revenue and therefore overestimated the structural fiscal position (at the peak of the housing boom, nearly one-third of government revenues were directly related to the property market). As a consequence, there was a massive discrepancy between pre- and post-crisis estimates of the cyclically adjusted balance (CAB): for example, the 2007 staff report estimated the CAB to be in small surplus in 2007, whereas the 2009 report re-estimated the 2007 CAB as a deficit of 8.7 percent (Donovan, 2017).[11]
- *Portugal.* Article IV consultations with Portugal consistently called for tighter fiscal policy, initially in the context of emerging macroeconomic imbalances amid rapid growth. In 2000, Portugal became the first country to be subjected to the EU's Excessive Deficit Procedure under the SGP. Staff argued that significant fiscal tightening through ambitious spending cuts was necessary to contain the wage and price pressure. As growth decelerated in 2001 and recession set in from 2002, the need for fiscal consolidation began to be framed in terms of ensuring debt sustainability against the background of population aging. Staff also highlighted the need for structural reforms in labor and

[11] A similar problem is evident from the difference between the IMF's pre- and post-crisis estimates of Spain's structural fiscal balance.

product markets in order to maintain medium-term growth necessary for convergence.

- As in other countries, however, IMF staff was too sanguine that EMU membership protected against a reversal of the capital inflows that characterized Portugal's first decade in the euro area, when the current account deficit averaged nearly 10 percent of GDP. By mid-decade, moreover, staff appear to have misdiagnosed the root causes of Portugal's persistent current account deficit: there was too little emphasis on rising imports and residential investment accompanied by declining private savings, and too much emphasis on declining competitiveness even though the export share of GDP and unit labor costs in manufacturing were both stable (Eichenbaum, Rebelo, and de Resende, 2017). As a result, IMF staff was insufficiently focused on the need to boost private savings and facilitate private sector deleveraging.

IMF surveillance at the euro area level ideally would have been used to warn about vulnerabilities with potentially systemic implications, or of problems afflicting more than one country. But hardly any of the issues identified as important in national surveillance were highlighted at the euro area level as a catalyst for policy adjustment or to bring to bear peer pressure. According to some European and IMF officials interviewed for this evaluation, part of the explanation may be that discussions tended to focus, perhaps justifiably, on larger, more systemically important countries, such as Germany and France.

On the fiscal policy framework, IMF staff was in favor of stronger fiscal consolidation than required under the SGP, and supported greater use of automatic fiscal stabilizers. It pointed out deficiencies such as the SGP's focus on nominal targets that promoted pro-cyclicality, its lack of enforcement capacity, and, following the suspension of the excessive deficit procedure by the ECOFIN against France and Germany in 2003, how to restore credibility. While IMF advice was appropriate in its own right, it was unable to translate into concrete action.

Euro area surveillance called attention to the need for structural reforms, especially in the labor market, in order to raise labor market participation and to increase productivity, but policy advice was framed in such a way as to lack specific references to individual countries where action needed to take place. The advice also lacked sufficient specificity (e.g., "staff urged the authorities to make the labor market more flexible"), without giving some indication of the impact of individual measures. By not offering advice on implementation, how to overcome constraints, and the likely impact of a recommended policy measure, the likelihood of any policy action, small to begin with, was diminished further. In this context, a task force of the European Central Bank, in its review of IMF surveillance in the euro area, recommended that the IMF "provide stronger and more clearly formulated policy recommendations on structural reforms, including their estimated impact" (ECB, 2015).

IMF surveillance also did not analyze the adverse consequence of failing to address the identified fiscal or structural issues promptly, especially given the constraints posed by the monetary union. Nor did it discuss the euro area-wide implications of policy inaction in individual countries. Relevant national policies were rarely discussed in euro area consultations as a means to highlight symptoms of individual or systemic vulnerability; in particular, there was no instance in which the imbalances that were accumulating in peripheral countries were seen as posing risks and vulnerabilities for the area as a whole (Schinasi, 2012). Moreover, policy advice was not prioritized in term of macro-criticality, so that focus was not always consistent from year to year, and was overly dependent on the whim of the mission chief. Some staff interviewed for this evaluation noted that there was a limit to their ability to repeat the same advice from year to year without becoming trite.

In summary, at the risk of replicating what has already been observed elsewhere (e.g., Pisani-Ferry, Sapir and Wolff, 2011), we can characterize the manner in which the IMF's pre-crisis surveillance fell short as a catalyst for needed policy adjustment in individual countries, in the following way. First, the IMF's analysis or advice lacked sufficient specificity to trigger policy reaction (IMF, 2011). Second, IMF staff praised country authorities for any reform without assessing its impact. Finally, even staff's sound advice on fiscal policy or structural reforms was not offered with sufficient urgency, as it was concurrently accompanied by the judgment that currency union membership protected against balance of payments crises (see the section "Pre-Crisis Assessment of Current Account Imbalances" below).

A common thread in these weaknesses is the IMF staff's lack of sufficient familiarity with country-specific details. Part of the reason may be that area department missions to Greece, Ireland, and Portugal experienced more frequent turnover in mission members, as reflected in the shorter duration of country assignment, while the size of missions to these countries was also smaller (Table 4.2). These missions also tended to have less likelihood of participation from fiscal or financial experts from functional departments.

Table 4.2. Staffing of Article IV Missions to Selected Euro Area Countries, 2001–08

(Number of missions unless otherwise noted)

	Number of Missions	Average Size (In persons)	Average Length of Country Assignment[1]	Missions with FAD Participation	Missions with MCM Participation
France	7	6.4	2.5	1	2
Germany	8	6.3	2.4	4	5
Greece	6	4.2	1.7	2	2
Ireland	7	4.1	1.7	1	2
Italy	7	5.9	2.3	5	0
Portugal	7	4.0	1.8	1	5
Spain	7	4.7	1.4	5	3

Source: IEO estimates.

[1] Area department staff only, excluding the mission chief.

Finally, the downsizing of IMF staff, which began in 2008, may have contributed to undermining surveillance in the euro area: for example, there was no Article IV consultation for Ireland in 2008 even though Irish property prices were already falling with severe repercussions for the financial sector. While this cannot be the whole story, at least it indicates the priority the IMF gave—rightly or wrongly—to less systemic countries.

IMF surveillance of financial supervision and resolution in the early years of the monetary union served a more useful function, as discussed in more detail by Schinasi (2012) and Véron (2016). For example, the *International Capital Markets* report, and beginning in 2002, the *Global Financial Stability Report*, discussed systemic risks and vulnerabilities associated with the euro area's financial stability architecture for preventing, managing, and resolving systemic problems. A broad concern expressed in IMF surveillance was that the nationally-oriented financial stability framework would be inadequate in handling euro-wide problems or crises. IMF staff continued to warn policymakers through the mid-2000s of the inadequacy of the prevailing system for banking crisis management and resolution and called for creating a framework with more centralized supervisory and resolution capacities. Several European officials interviewed for this evaluation expressed high marks for this aspect of the IMF's euro area surveillance, though some IMF staff alluded to internal pressure against excessively critical analysis.[12]

Even so, IMF surveillance did not adequately warn about the vulnerabilities stemming from the extraordinary expansion of credit to the euro area periphery. The growing size of bank assets relative to GDP, coupled with sovereign responsibility for the rescue of national banking systems, undermined the sovereign's own creditworthiness.[13] IMF surveillance did not foresee how severely banking stress—already elevated as a result of the fallout from the global financial crisis—could become intertwined with sovereign debt problems in the euro area.[14] Coupled with its failure to contemplate the possibility of a sudden stop in capital flows (discussed below), the IMF was not well positioned to provide adequate warnings on the fragility of the euro area in the face of the shocks triggered by the U.S. financial crisis.

European policymakers considered IMF surveillance "to be of little help," with the analysis and tone "too close to the official line of the Commission

[12] At the same time, the IMF was becoming too enamored by the U.S. approach to financial innovation as a means to embellish profitability without adequate attention to risk, encouraging, for example, Germany in 2006 to boost its bank profitability by enabling more financial innovation (IEO, 2011).

[13] Eichengreen and Wyplosz (1998) spelled out a scenario linking the fate of sovereigns and banks even prior to the decade-long expansion in bank lending (Annex 4.1).

[14] Exposure to U.S. subprime assets and the wholesale funding model utilized by banks were clearly not confined to the euro area. But substantial exposure to sovereigns—whose securities would be perceived as more risky—by euro area banks added an extra layer of vulnerability.

and the ECB" (Pisani-Ferry, Sapir, and Wolff, 2011), a view confirmed by some European officials interviewed for this evaluation. Thus, while IMF surveillance identified many of the pertinent issues, it failed to warn the authorities and the world of the crisis that was about to engulf the currency union.

Pre-Crisis Assessment of Current Account Imbalances

A common characteristic of most Article IV reports in countries with large current account deficits was the assertion that EMU membership protected the country from external financing difficulties. In the early years of the euro this issue was nuanced in the sense that the need for (gradual) adjustment was not ruled out:

> Countries that run current account positions that are *fundamentally* unsustainable . . . will eventually have to revise their consumption profile downwards to repay their debts, even in the context of a currency union. What is different is the nature of the required adjustment. Whereas beforehand the change in real exchange rates required to correct these imbalances could be achieved quickly through movements in the value of the currency, the adjustment will now have to come from domestic wages and prices. However, with monetary union reducing individual countries' vulnerability to shifts in market sentiment, adjustment can probably be spread out over a longer time horizon. (Portugal: 2000 Article IV consultation)

Through 2007, the IMF continued to downplay the risk of external financing disruptions:

> Given Spain's membership in EMU and the strength of its financial sector, availability of external financing is not a constraint. (Spain: 2007 Article IV consultation)

This stance, however, appeared to soften in the 2007 Article IV on Greece, issued in 2008 (when the current account deficit was estimated at 14 percent of GDP), although even in this case, the disclaimer about external financing protection due to EMU membership was included:

> In view of Greece's EMU membership, the availability of external financing is not a concern. . . . While the risk of transmitting vulnerabilities to the euro area is very small reflecting Greece's small relative size, large persistent current account deficits would increase the vulnerabilities to a reversal in market sentiment, leading to a corrective retrenchment of private sector balance-sheets in the face of rising indebtedness, and a possible appreciable rise in the cost of funding over time. (Greece: 2007 Article IV consultation)

IMF staff typically approached the divergent current account balances within the euro area from trade and competitiveness perspectives. For example, the 2001 Article IV consultation for Portugal suggested that, in order to contain the current account deficit, structural reforms should be implemented to shift resources from the nontradable to the tradable goods sector. Likewise in 2003, the IMF explained Greece's large current account deficit in terms of falling competitiveness and export market share and called for wage moderation to restore competitiveness. Such analyses and recommendations were clearly pertinent. But in the process, the financing aspect of the deficit was downplayed, notwithstanding the scenario outlined by the IMF in 1998 (see the section "IMF Views on the Prospective EMU" above), in which "an EMU member could find themselves unable to borrow, on suitable terms, as much as is appropriate and necessary to avoid measures destructive of national or international prosperity."

Staff appear to have understood the adjustment mechanism, not in terms of a sudden stop followed by a balance of payments crisis, but in terms of the price-specie-flow-like mechanism analyzed by Meade (1953) for a hypothetical common currency area in Europe.[15] Such a view contrasted with an insight provided by Garber (1998, 1999), who articulated how large one-way flows of capital could result and a currency crisis ensue in EMU once the ECB's willingness to provide unlimited credit was challenged by the market. In the event, a currency crisis of the type predicted by Garber did not materialize as the crisis countries were allowed to accumulate TARGET liabilities, that is, public capital inflows replaced the outflows of private capital (Merler and Pisani-Ferry, 2012). Even so, the mechanism of a sudden stop, and the balance of payments pressure, experienced by Greece, Ireland, and Portugal were almost exactly as predicted by Garber.

Staff's assessment of current account deficits in the periphery appeared to reflect a standard textbook view. An influential paper by Blanchard and Giavazzi (2002), for example, argued that deficits were an expected and desirable phenomenon as euro area members became more integrated in goods and financial markets, allowing poorer countries to borrow more at lower costs to catch up with the higher income countries. Commenting on this paper, however, Gourinchas (2002) outlined how large current account deficits in Greece and Portugal could lead to illiquidity and default following a sudden stop (Annex 4.1), while Sims (2002) argued that the balance sheets and financial institutions of such countries should be carefully monitored given the prevalence of financial problems in countries experiencing large

[15] Meade (1953) argued that, for the price-specie-flow-like mechanism to work, member countries must give up domestic stabilization policies, a condition that is likely to be met only if there are union-wide stabilization policies. He also argued that, given the slow pace of price and quantity adjustment, there must be a system of providing accommodating financing: "[T]here must be some accommodating finance to cover deficits in the balances of payments during the temporary period when changed price relationships are working out their full effect" (p. 37).

capital inflows. Sims observed that there had been a number of defaults by U.S. states in the early history of U.S. financial integration.

IMF staff's hands-off approach to current account imbalances within the euro area contrasted with its advice elsewhere. For example, in other parts of the world, if a country was relying entirely on private capital flows to increase government consumption or fuel a real estate boom, this surely would have been a source for concern. Indeed, for several years before the global crisis, IMF staff was concerned that the United States, whose current account deficit peaked at 6 percent of GDP, could be susceptible to a dollar crisis precipitated by a drying up of capital inflows. Moreover, a number of East Asian and Latin American countries with far smaller current account deficits than in southern Europe had experienced capital account crises in the previous decade.

In fact, euro area economies were arguably *more* susceptible to the consequence of a change in investor sentiment compared to countries that could issue debt in their own currency.[16] Individual economies experiencing credit-fueled overheating could not adjust their exchange rate, while monetary policy for the euro area as a whole could not reasonably be tailored to their needs. Their room for maneuver was therefore primarily limited to tighter fiscal and prudential policies, which proved insufficient.[17]

Some staff members were aware of pertinent euro area vulnerabilities. In internal comments, they were concerned by the large current account deficits in individual countries, the difficulties of designing an appropriate monetary policy across disparate parts of the euro area, and therefore of providing sufficient safeguards in countries with credit and asset booms, and by the no bail-out clause in the presence of these vulnerabilities. Even so, according to interviews with staff, there emerged an official position within the IMF, that EMU membership safeguarded individual economies from risks confronting those outside the monetary union. In considering the situation in EMU analogous to states within the United States, this position did not take into account some of the fundamental differences between the two monetary unions.[18]

[16] Giavazzi and Spaventa (2010) noted that vulnerable euro area members were more susceptible to deteriorating investor sentiment than other weak countries around the world because they did not have their own central bank as "market maker of last resort."

[17] Ireland and Spain ran nominal fiscal surpluses continuously during 1999–2007, sharply reducing their public debt/GDP ratios to well below Maastricht thresholds. Ex post, their pre-crisis cyclically adjusted fiscal positions were determined to be in large deficit by the IMF—but only after the crisis. Spain's macro-prudential policies were well regarded before the crisis.

[18] Critical differences include: the automatic and discretionary fiscal transfers from the U.S. federal budget to the states, which comprise significant shares of state budget resources for the poorer states (averaging some 250 percent of 2009 state GDP for Mississippi, New Mexico, and West Virginia during 1990–2009 (Tressel and others, 2014); U.S. federal regulatory institutions with the authority and resources to resolve regional bank failures in contrast to the euro area; a history of state defaults to private creditors in the United States coupled with more stringent borrowing limits in the case of U.S. states, which limited their reliance on debt compared to many euro area countries; and the more highly developed and integrated U.S. capital markets.

IMF Advice During the Euro Area Crisis

A comprehensive euro area crisis management strategy was never formulated and adopted. I blame the management and staff of the IMF, the euro area countries, and other major countries for this failing. (Truman, 2013)

IMF surveillance of the euro area became more intensive in the wake of the global financial crisis. Reviews of post-crisis IMF surveillance by Pisani-Ferry, Sapir, and Wolff (2011) and ECB (2015) both indicate improvement relative to the pre-crisis period.[19] ECB (2015), in particular, noted that linkages and spillovers were better accounted for; there was more integration of surveillance at the bilateral and euro area levels and with multilateral exercises; and the analysis of risks had improved. And Véron (2016) found the IMF's discussion of the need for and implementation of a banking union in the euro area was constructive.

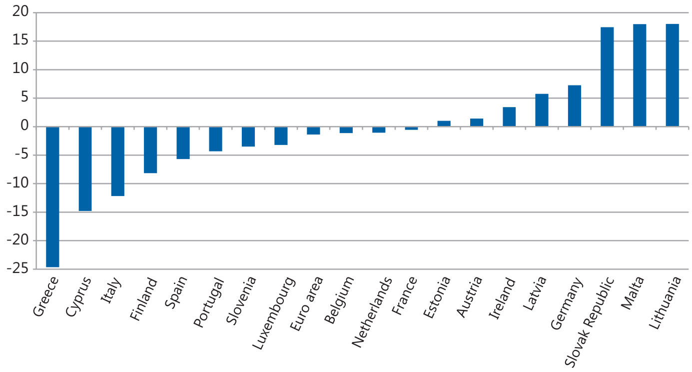
This section addresses a different question: how effectively was IMF advice directed at containing the severity of the crisis and facilitating recovery? It is motivated by the relatively poor post-crisis economic performance of the euro area and the search for lessons for the IMF. After outlining key factors contributing to the weak recovery in the euro area, the section assesses the IMF's advice in these areas. It finds that the IMF did not take adequate account of the euro area dimensions of the crisis, or the difficulties program countries would encounter when faced with an unconducive external environment, coupled with the constraints of adjustment in a currency union.

Economic Context: Factors Impeding Recovery

At the outset of the global financial crisis, the euro area's public debt was comparable to that of the United States, and its overall current account was in approximate balance (versus a large U.S. deficit). Its financial sector was far smaller relative to GDP than that of the United Kingdom. Yet, the euro area economy underwent a harsher adjustment to the crisis compared to the United States, United Kingdom, and other advanced economies. Its recovery has been weaker, with the majority of euro area economies yet to recover their pre-crisis per capita output levels (Figure 4.6). Inflation stood well below target during 2013–15, rendering the intended internal devaluations in periphery economies more difficult, while unemployment in the euro area was more than double the rates of other major advanced economies in 2014, and had reached depression era levels in Greece and Spain.

[19] Pisani-Ferry, Sapir, and Wolff (2011) report improvement since the start of the financial crisis in 2008 through 2010, while the focus of ECB (2015) is on how IMF surveillance changed after the 2011 Triennial Surveillance Review (IMF, 2011).

Figure 4.6. Change in Real GDP Per Capita, 2007–15
(In percent)



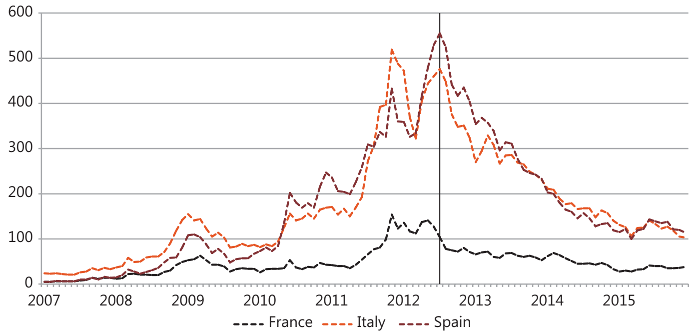
Source: IMF, *WEO*, April 2016.

In the crisis aftermath, the following factors, among others, have been widely discussed as contributing to the slow recovery:

- The euro architecture, aimed at curbing fiscal profligacy, was less suited to address the problems that confronted the euro area after the Greek crisis erupted. Not only was the scope for countercyclical fiscal policy limited, but as De Grauwe (2011) and others have pointed out, the fear of a liquidity crisis for governments lacking control over their own currency drove up bond yields across much of the euro area. Sovereign bond markets became increasingly destabilized by end-2010, with bond yields in 2011–12 reaching levels that raised questions about sovereign solvency extending well beyond Greece. This in turn aggravated distress in national banking systems given their large exposures to sovereign debt, tightening credit conditions, and setting in motion the bank-sovereign vicious cycle. It was only after ECB President Draghi's July 2012 announcement of potentially unlimited sovereign debt purchases by the central bank ("whatever it takes") and the ECB's subsequent clarification of how its Outright Monetary Transactions (OMT) program would operate, did the bond market turmoil conclusively subside (Figure 4.7).[20] In the meantime, however, the extended period of financial market instability was detrimental to growth, and a nascent investment recovery following the Lehman shock was reversed (Figure 4.8).

[20] The introduction in late 2011 of the long-term refinancing operation (LTRO) of six month or longer maturity also provided significant relief to some countries embroiled in fiscal crises or credit crunches. For example, Eichenbaum, Rebelo, and de Resende (2017) indicate that Portuguese bond spreads, which continued to increase following the initial implementation of the troika-supported program for Portugal, only began to diminish following the implementation of this longer-term LTRO.

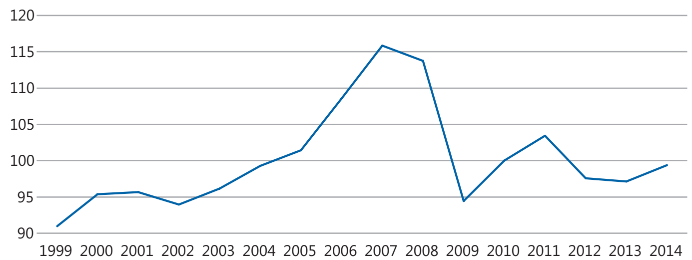
Figure 4.7. Sovereign Spreads Over 10-Year German Bund



Note: The vertical line marks the day of Mr. Draghi's remarks in London, July 26, 2012.
Source: Eurostat, based on monthly averages.

Figure 4.8. Euro Area Gross Capital Formation

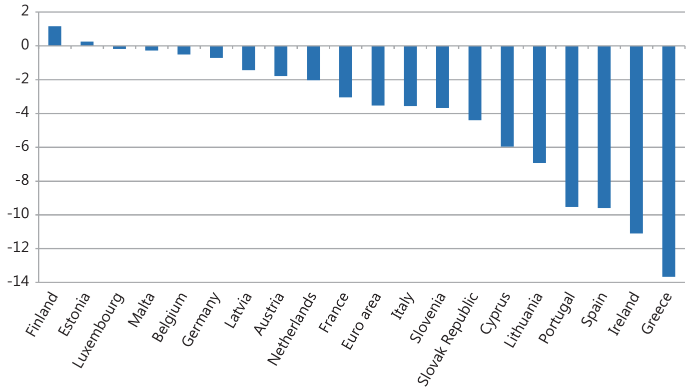
(Constant prices, 2010=100)



Source: World Bank, World Development Indicators.

- *Macroeconomic policies in the euro area were less expansionary than in other advanced economies,* reflecting asymmetric incentives to respond to the crisis, in which debtors were obliged to consolidate in the face of a hard financing constraint, while creditors faced neither incentive nor compulsion to expand. Relative to the United States, the euro area's fiscal stimulus was weaker through 2010, and its cyclically adjusted primary balance reverted to surplus faster. This reflected not only the fiscal consolidation in periphery economies but also tightening fiscal policy in economies with more fiscal space to expand (Figure 4.9).
- *The post-crisis monetary stance in the euro area was also initially less expansionary than in other advanced economies.* Interest rates were raised on two occasions in 2011 (prior to being reversed by late 2011), ECB assets declined during 2012–14 (Figure 4.10) as net asset purchases lagged and bond purchases were sterilized, and a full-fledged program

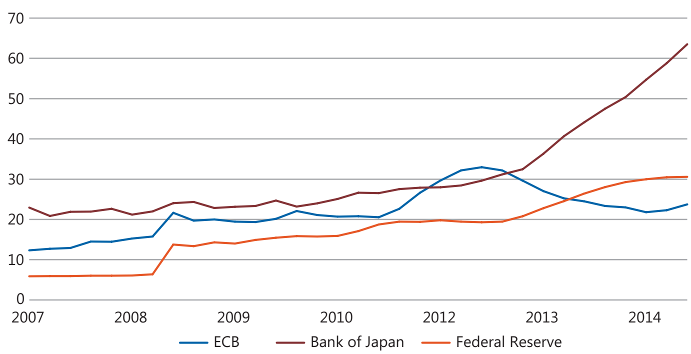
Figure 4.9. Cumulated Structural Primary Fiscal Balances: 2010–2014



Note: Cumulated structural primary fiscal balances are computed as the negative *y/y* change in the structural balance, net of interest, as a percentage of GDP (except for Cyprus). For Cyprus, the cumulated structural primary fiscal balance is computed as the negative *y/y* change in the headline balance, net of interest, as a percentage of GDP.
Source: IMF, *WEO*, April 2016.

Figure 4.10. Central Bank Total Assets

(Percent of 2008 GDP)



Sources: Federal Reserve Bank of St. Louis and IMF.

of quantitative easing via sovereign bond purchases was initiated only in March 2015, six or seven years later than in the United States, United Kingdom, and Japan. Moreover, monetary conditions in program countries were considerably tighter than the euro area average even though their cyclical position called for more accommodative monetary conditions than the euro area average.

- *Weak euro area performance also stemmed from the nature of the adjustment the periphery economies were obliged to undertake*. Absent the option to devalue, nominal wages in periphery economies had to decline relative to the euro area core to regain competitiveness. But the deflation or low inflation which accompanied such adjustment reduced nominal GDP and undermined debt sustainability goals. At the same time, low (and below target) inflation in the euro area undermined the effort to gain competitiveness in the periphery, prolonging their period of adjustment.

IMF Advice on Managing the Crisis

On addressing the liquidity crisis

The IMF was an active participant in the search for institutional solutions to the euro area crisis, and pushed for more comprehensive reforms than the authorities were willing to accept (Pisani-Ferry, Sapir, and Wolff, 2011). It supported the objective of creating a credible firewall to prevent contagion, and was an advocate for expansionary monetary policy, including to support the euro area economy and financial sector. The IMF also provided useful advice on an array of financial sector policies as described in Véron (2016). But it did not offer specific advice, at least openly, on the actions needed and ultimately adopted by the ECB to resolve the crisis of confidence impacting sovereign bonds.

The IMF did not call for a re-calibration of the EMU architecture to emphasize crisis management after the Lehman Brothers bankruptcy in 2008, or as vulnerabilities in Ireland and Greece mounted in 2009. In mid-2011, the IMF emphasized that "a cohesive and cooperative approach by all euro area stakeholders" would be essential to resolve the crisis in the periphery, and supported an expansion in the role of the European Financial Stability Facility (EFSF), including, inter alia, to address the liquidity crisis:

> Rapid implementation of the commitment to scale up the EFSF and a further extension of its potential uses is important to confirm that member countries "will do whatever it takes to safeguard the stability of the euro area." (Euro Area Policies: 2011 Article IV)

Its analysis did not, however, clarify how funds drawn from the resources of euro area governments could resolve a crisis of confidence, which was already impacting the sovereign spreads of major economies such as Italy and Spain (Figure 4.7).

The IMF did not articulate the case for the ECB to play a more supportive role in addressing the liquidity crisis encompassing both sovereigns and banks through mid-2012. In this respect, the contrast between Euro Area Policies Article IV consultations during 2008–12 and 2015 is stark: the 2015 report urges the ECB to use its menu of tools for providing liquidity and purchasing assets more aggressively if needed. Yet, it was in the earlier period, when the euro area was facing a debilitating liquidity crisis, that the IMF could usefully have articulated such advice.

Advice on macroeconomic policies[21]

The adjustment burden facing euro area debtors could also have been eased by curtailing the deflationary bias of the post-crisis response in the euro area. This would have required some combination of more sustained fiscal expansion, more generous wage adjustments, and supplementary measures to stimulate demand in economies with fiscal space and large current account surpluses, and more expansionary monetary policy.

Fiscal policy

In the initial years of the euro area crisis, IMF staff did not analyze macroeconomic policy in individual countries from an area-wide perspective. IMF surveillance included several euro area economies in its generalized call for fiscal stimulus during 2008–09, but in mid-2010 (after the start of the troika-supported Greek program), it called for fiscal consolidation to start in each euro area economy by 2011 at the latest. In 2011, IMF staff noted:

> It was agreed that maintaining easier fiscal policies in the core for the benefit of the periphery would be of little help, as direct demand effects are small. . . (Euro Area Policies: 2011 Article IV)

IMF staff supported Germany's fiscal stimulus in 2009–10, but in 2010 it suggested that fiscal consolidation from 2011 onwards should be pursued in Germany as well to set an example for fiscal consolidation in the rest of Europe "to anchor fiscal policy in the euro area"—rather than to provide a counter to the adjustment necessitated in the euro area periphery. In support of this position, staff argued that German fiscal expansion would have limited consequences for European growth with the impact almost entirely concentrated on its immediate neighbors, fiscal policy changes in Germany would have only a small impact on the trade balance of the euro area's peripheral economies, and would therefore be unlikely to contribute to the reduction of intra-European imbalances.

By 2014–15, however, IMF staff had changed its position on German fiscal policy, calling for it to be more expansionary. In particular, an increase in public investment was found not only to durably raise German GDP, but also to raise growth in the euro area including the periphery economies. If higher wages arose from policies that induced greater labor demand, this too would raise domestic GDP and generate beneficial regional spillovers. By this time, however, the German economy was operating closer to potential with less

[21] A more comprehensive discussion of IMF macroeconomic advice following the global financial crisis is contained in IEO (2014) and Dhar (2014).

slack in the labor market, and hence with less grounds for engaging in fiscal expansion from a purely domestic perspective.

Monetary policy

In line with its advice to advanced economies during 2010–12 to combine fiscal consolidation with monetary expansion, IMF staff was a more consistent advocate of expansionary monetary policy during the post-crisis period. It supported the ECB's measures to inject liquidity to the financial sector, and particularly after 2012, recognized that inadequate rather than excessive inflation would be the more pressing problem for promoting recovery in the euro area. In 2009, the staff argued for consideration of all unconventional monetary policies to support the economy and financial sector. But it did not contest—at least publicly—the ECB's policy rate increases in 2011. From 2012 onwards, however, staff became more proactive on the need for expansionary monetary policy, stressing the risk of deflation, the need for quantitative easing, and negative interest rates.

Incorporating the euro area dimension in program design

In light of the weak economic performance of the euro area and the harsh outcomes in some of the program countries, a number of observers and interviewees have questioned the IMF's approach to addressing the euro area crisis. For example, Truman (2013) argues that given the constraints imposed by the EMU architecture, a crisis management strategy should have been formulated at the euro area level rather than placing the entire burden of adjustment on the periphery economies, but "[the] IMF was too timid, paralyzed, or conflicted to require such steps as a condition for its participation in the Greek or subsequent programs." He acknowledges that such a framework would have been difficult to negotiate, but notes some precedents of non-crisis countries enacting measures to support neighboring countries in crisis.[22]

It is beyond the scope of this chapter to discuss whether the IMF's policy advice to euro area institutions or non-crisis euro area countries should have taken the form of conditionality, as IMF staff recently raised in its recent crisis program review (IMF, 2015).[23] Regardless, it is apparent that IMF staff's advice to the euro area during the crisis would have benefited from a more

[22] For example, China was encouraged not to devalue even when its currency was under pressure during the Asian crisis. Japan exerted moral suasion with its banks to maintain its credit lines to Korean banks and extended official credit in support of private firms in Indonesia. Under the 2009 Vienna Initiative, foreign banks maintained their exposures in emerging Europe, thereby avoiding a large capital flight.

[23] Staff's crisis program review (IMF, 2015) clarifies that "formal conditions on union-wide policies are consistent with the Fund's Articles of Agreement" noting that they "may be necessary for the success of the member's program." It also indicates that "if these approaches prove unworkable, it may be necessary to postpone Fund support until staff can give the Board an assurance that the relevant problems are being adequately addressed."

holistic approach from the standpoint of the whole euro area. Going forward, the IMF needs to ensure that policies that impact a borrowing member's performance but are beyond the control of its authorities do not become binding constraints to recovery for members of a currency union.

Summary and Conclusions

Prior to the introduction of the euro, the IMF's public statements were more optimistic about the benefits of a common currency and less skeptical about the design of the euro area architecture than many prominent scholars of the era. In particular, IMF surveillance noted that the lack of fiscal integration in the euro design would not pose the problems commonly perceived, and remained relatively optimistic that labor markets could be made sufficiently flexible in individual economies to compensate for the lack of an independent monetary policy. By contrast, IMF surveillance of the financial sector was highly pertinent in identifying problems with systemic risk management in the euro area as it related to the payments system and financial supervision—although it was not pursued with sufficient vigor in the pre-crisis period.

In the years prior to the euro area crisis, IMF surveillance provided little insightful discussion of the concerns that would become paramount in the crisis to follow. Vulnerabilities stemming from the extraordinary expansion of bank lending to the euro area periphery were not adequately highlighted; risks to financing double-digit current account deficits in the euro area periphery did not receive sufficient attention; there was little discussion about the risks of a sovereign debt crisis beyond calls for fiscal rectitude, or of the repercussions for banking systems from the reversal of credit and housing booms. Given these shortcomings, the intensifying nexus of banking-sovereign risks was missed. Euro Area Policies Article IV consultations, instead of focusing senior policymakers' attention on systemic vulnerabilities, tended to downplay them, even in comparison to Article IV consultations with individual member countries.

IMF surveillance became more intensive during the crisis, with more frequent interactions at multiple levels. It made useful contributions in terms of proposals for banking and fiscal unions for EMU,[24] and was a positive influence on issues of systemic reform, especially with respect to the financial sector. But it was less effective in its advice on emphasizing the indispensable role of the central bank in containing the crisis of confidence that escalated through mid-2012. Moreover, IMF surveillance did not approach the crisis from a euro area perspective: it did not appear to appreciate the constraints on recovery inherent in the adjustment prospects of the countries in crisis; and it did not call for policies in the rest of the euro area to counter the deflationary pressure and fall in demand that would emanate in the post-crisis period.

[24] As discussed in Véron (2016) and Kopits (2017).

Some of these shortfalls can be traced to deficiencies in earlier episodes of IMF surveillance. Had the IMF been more skeptical about the EMU design before the euro's introduction, it might have been more apt to raise concerns as fiscal, financial, and balance of payments risks mounted before the crisis. And had it been more concerned about such pre-crisis vulnerabilities, IMF staff may have been quicker to recognize the need to address weaknesses in the EMU's crisis management capacity following the Lehman collapse. A common feature of IMF surveillance over almost 20 years was a tendency to side with the positions or views of authorities on most policy issues, undermining its effectiveness.

In explaining why IMF surveillance in the run-up to the financial and economic crisis failed, IEO (2011) noted two types of cognitive bias: groupthink and intellectual capture. Groupthink, the tendency among homogeneous groups to consider issues only within a certain paradigm, explains why IMF staff collectively subscribed to the view that crises were unlikely to happen in advanced economies. Likewise, IMF staff felt uncomfortable challenging the views of authorities in advanced countries, given the large number of qualified professionals working in their central banks and ministries.

These findings resonate in the case of the IMF's role in the euro area crisis. The IMF was too deferential to official views, undermining its effectiveness as an independent technical assessor.[25] This report thus confirms the findings of earlier reports. For example, Pisani-Ferry, Sapir, and Wolff (2011) concluded that the IMF had fallen "victim to a 'Europe is different' mindset," and "eagerness to play a role in the complex European policy process reduced the IMF's effectiveness."

The desire to maintain good working relationships with authorities is both understandable and important in a membership-based institution where national authorities are the shareholders. At the same time, the Fund's effectiveness as a guardian of global stability is diminished if it moderates the candor of its analysis for political considerations.

Recent IEO and IMF reports have provided many suggestions for strengthening surveillance and risk assessment,[26] and many adjustments have already occurred. The findings of this chapter point to the need to pay special attention to the frequently observed tendency of IMF area departments to defer to the views of the authorities, especially in systemically importantly countries. Particularly in such cases, the views of departments within the IMF with expertise but less stake in their interactions with authorities could be given added weight during the review process. More generally, the IMF needs to ensure the independence of its analysis, including by fostering open discussion among staff, encouraging divergent views to be heard, and promoting greater diversity in the background and experience of key decision makers.

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[25] The tendency of staff to defer to the views of authorities has been a well-documented weakness of IMF surveillance since the 1999 external evaluation of IMF surveillance (Crow, Arriazu, and Thygesen, 1999).

[26] For example, see IEO (2011 and 2014) and IMF (2011 and 2014).

Annex 4.1. Post-Maastricht Academic Discussion of EMU

This annex assesses the views of prominent scholars on EMU that appear prescient with the benefit of hindsight, focusing on the period between the signing of the Maastricht Treaty and the introduction of the euro. It finds that many of them expressed serious concerns about the repercussions of EMU for member economies, and several offered useful proposals to strengthen its design.[1] Although much of this discussion was guided by the optimum currency area (OCA) literature—which did not focus on banking or balance of payments risks in a monetary union—some also commented on the latter set of issues. The annex reviews each set of concerns in turn.

Optimum Currency Area Considerations

The signing of the Maastricht Treaty led to the emergence of a large academic literature on EMU. Among the critiques of EMU design were such prominent—yet ideologically diverse—economists as Dornbusch, Feldstein, Friedman, and Tobin. The tone of the early literature was generally skeptical of the long-term viability of EMU, either on optimum currency area grounds or in terms of design features, though a more supportive view later emerged emphasizing the endogeneity of OCA criteria.

As one of the early critiques of the Maastricht Treaty, Feldstein (1992) argued that EMU did not satisfy the requirements of an optimum currency area given the structure of production and trade and limited labor mobility. Without a centralized fiscal system, shocks to aggregate demand that were geographically focused, or shifts in the real equilibrium values of national exchange rates, would have large impacts on regional income and employment. Under these conditions, the loss of an independent monetary policy, in particular giving up the possibility of countercyclical monetary policy and exchange rate flexibility, would be severe, particularly in terms of employment and output, given that wages and prices adjust downwards only slowly.

Dornbusch (1996) was concerned that by abandoning the use of exchange rate adjustments, the task of adjusting for competitiveness and relative prices would fall upon the labor market. Even though Europe had vastly divergent economies, it had neither flexible wages nor flexible labor markets. As a result, the adjustment process would be frustrated, output and employment losses would dominate, and, if a region were to go into decline, deflation would have to take the place of devaluation. Dornbusch was also concerned that the costs of meeting the Maastricht criteria would be large, with minimal benefits once attained.

[1] The annex does not aim to provide an exhaustive literature review. Jonung and Drea's (2010) survey of the work of U.S. academic and Federal Reserve economists during 1989–2002 found a high degree of skepticism of the single currency project as designed.

Likewise, Friedman (1997) argued that Europe exemplified a situation in which flexible exchange rates would be preferable to a common currency. If a monetary union was desired, however, it should follow rather than precede political unity. But a single currency introduced under unfavorable conditions would prove a barrier to the achievement of political union. He was thus concerned that the adoption of the euro "would exacerbate political tensions by converting divergent shocks that could have been readily accommodated by exchange rate changes into divisive political issues." On the sequencing of political and monetary union, Friedman was reiterating the views not only of other economists (including some far pre-dating the Maastricht Treaty),[2] but also a number of policymakers. In particular, the Bundesbank through its President expressed serious reservations about a common currency for Europe prior to the Maastricht conference (Kang and Mody, 2015).

Tobin (1998) cautioned that the combination of a monetary policy focusing solely on an inflation target, the absence of a central fiscal authority, and the prevalence of substantial structural rigidities would undermine Europe's ability to address interregional and asymmetric shocks.[3] Tobin's skepticism of the implicit Maastricht assumption that prices and wages could be sufficiently flexible to adjust to economic shocks, made him critical of the absence of a parallel fiscal entity that would enable automatic stabilizers to operate and could administer discretionary polices at the euro area level.

Other notable critiques (from the United Kingdom) included Walters (1986, 1990) and Godley (1992). Walters argued against Britain's membership in the exchange rate mechanism of the European Monetary System on the grounds that the loss of monetary independence would result in perverse real interest rate trends that would have destabilizing pro-cyclical effects, for example, if inflation in the United Kingdom were to exceed the European average. The so-called Walters critique was influential in subsequent debates in the United Kingdom about the merits of joining EMU.

Godley (1992) found the EMU architecture to be incomplete, and was particularly concerned about the consequences for poorer countries to survive without a mechanism for fiscal transfers: "As the treaty proposes no new institutions other than a European bank, its sponsors must suppose that nothing more is needed. But this could only be correct if modern economies were self-adjusting systems that didn't need any management at all. . . . If a country or region has no power to devalue, and if it is not the beneficiary of a system of fiscal equalisation, then there is nothing to stop it suffering a process of

[2] For example, in discussing the European Common Market, Kaldor (1971) warned it was "a dangerous error to believe that monetary and economic union can *precede* a political union" because "the latter pre-supposes fiscal integration and not just fiscal harmonization."

[3] China's emergence as a major importer of capital goods (to the benefit of countries such as Germany) and exporter of consumer goods (to the detriment of some euro area periphery economies) already provided an example of an asymmetric shock facing the prospective EMU.

cumulative and terminal decline leading, in the end, to emigration as the only alternative to poverty or starvation."

A concern for some scholars was the particular set of problems that could arise from the proposed constellation of monetary and fiscal rules. McKinnon (1996) argued that the probability of default in EMU would rise since the option to inflate away high levels of public debt would be removed. Sims (1999) anticipated a number of problems that the euro area would later face, including: the incompatibility of the Maastricht rules in a deflationary situation where fiscal expansion may be called for; the limited effectiveness of pecuniary penalties for countries violating the Stability and Growth Pact (SGP) since fining a country in fiscal distress would be difficult and counter-productive; and the possibility that a fiscal shift in response to a speculative attack could produce multiple equilibria. De Grauwe discussed several such concerns in various editions of his textbook on European monetary integration first issued in 1992.[4]

Empirical work raised further questions about the susceptibility of the envisaged EMU to asymmetric shocks. For example, Bayoumi and Eichengreen (1993) found that supply shocks would be larger in magnitude and less correlated across regions in Europe than in the United States, contributing to greater difficulty in operating a monetary union in Europe—although Germany, France, the Benelux countries and Denmark would experience shocks of similar magnitude to U.S. regions.[5] Krugman (1993) argued that the lack of a federalized fiscal system would become more problematic in Europe over time as greater integration of markets would lead to increasingly specialized regions, which would then become more vulnerable to region-specific shocks.

It was only as the final stage of EMU approached that an alternative view emerged to argue that greater convergence would follow from the very act of introducing a common currency. In a series of papers that became influential in official circles, Frankel and Rose (e.g., 1996) provided empirical evidence suggesting that exchange rate stability promotes stronger trade links and more synchronized business cycles across countries. This evidence was widely interpreted as suggesting that the very act of introducing a common currency would facilitate satisfying OCA criteria over time.[6]

[4] De Grauwe (2011) later articulated how a monetary union is particularly vulnerable to changing market sentiments and multiple equilibria given the fundamental change in the nature of sovereign debt held by countries that give up the currency in which their debt is issued. In particular, investors recognize that countries with their own central banks cannot face a rollover crisis even if there is no explicit statement by the central bank to provide liquidity in a crisis.

[5] The choice of countries suitable for a common currency varied across studies. For example, De Grauwe (1993) noted: "Whereas there is strong consensus among economists that the Twelve should not form a monetary union, there is an equally strong conviction that there is a subset of EC countries which form an optimum currency area. The minimum set of countries that could form a monetary union is generally believed to include Germany, the Benelux and possibly France."

[6] Referring to the influence of this work on the thinking of European policymakers, Pisani-Ferry (2013) in retrospect characterized it as a "selected reading" of the literature.

Banking and Balance of Payments Risks

The literature also addressed other issues, such as banking risks, the interdependency between bank exposures and sovereign risk, and sudden stops, which were not directly linked to the critiques drawing from the optimum currency area literature, but would become relevant during the crisis.

In discussing various risk scenarios Eichengreen and Wyplosz (1998) foresaw how fiscal stress in one country could impact not only the banks of that country, but lead to more systemic problems for banks and sovereigns in other countries:

> The government of an EMU country gets into fiscal trouble, from which it cannot extricate itself. Investors fear suspension or (more likely) modification of payment on its public debt, and therefore sell its bonds. Its bond prices start to plummet. Banks holding those bonds find their capital impaired, inciting depositor runs. Bond markets (and indirectly banks) in other EMU countries suffer adverse repercussions, as investors in public debt become demoralized. To prevent the collapse of Europe's banking and financial system, the ECB buys up the bonds of the government in distress.

Eichengreen and Wyplosz accordingly suggested higher capital and liquidity requirements for banks than those proposed by the Basel Accords, which were designed for countries with their own central bank, coupled with tighter limits on banks' ability to hold sovereign bonds.

Folkerts-Landau and Garber (1994), concerned about the evolution of financial markets into "liquidity-intensive activities" and their likely convergence within the monetary union, proposed a more activist role for the ECB than envisaged in its statutes, including lender of last resort assistance, together with a parallel strengthening of the ECB's supervisory and regulatory role. Obstfeld (1998) was also concerned about the lack of a statutory mandate for the ECB to act as a lender of last resort to rescue distressed financial institutions. And Buiter (1999) proposed that the ECB should be explicitly charged with responsibility for systemic financial stability, and the Maastricht Treaty should be revised to include the words "lender of last resort."

Shortly after the introduction of the euro, Gourinchas (2002) challenged the prevailing official dictum by arguing that a sudden stop could lead to a situation of illiquidity, and large current account deficits in the euro area would therefore not necessarily be benign[7]:

> Large current account deficits, even when a consequence of credible financial integration, may lead to situations of illiquidity. . . . the fact

[7] This was provided as a comment on the more sanguine view of current account deficits expressed by Blanchard and Giavazzi (2002).

that neither Portugal's nor Greece's debt carries substantial spreads over that of other European countries can be taken as a sign of market confidence in these countries' ability to honor their international obligations. But this does not mean that capital cannot or will not pull out. Even with a relatively evenly distributed maturity structure, markets could refuse to finance additional increases in debt. . . . At current levels, this would mean a sudden stop of the order of 5–7 percent of GDP. Most certainly, this would raise the specter of default. In other words, while a common currency may eliminate concerns that capital flight would force a devaluation, it does not insure against situations of illiquidity.

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CHAPTER 5

The IMF's Role in the Euro Area's Crisis: What Are the Lessons from the IMF's Participation in the Troika?

G. Russell Kincaid

Introduction

This chapter evaluates the ad hoc arrangement between the IMF, the European Commission (EC), and the European Central Bank (ECB)—known collectively as the troika[1]—that negotiated conditional economic policy programs and provided balance of payments financial assistance to four euro area countries during 2010–15: Greece (2010 and 2012), Ireland (2010), Portugal (2011), and Cyprus (2013). The terms of reference for the study exclude the joint programs with Greece (2012) and Cyprus (2013), which were still ongoing when the study was commissioned. Nor is Spain's conditional financial assistance (2012) for bank recapitalization from the European Stability Mechanism (ESM) considered in any depth.[2]

The troika[3] arrangement has raised several questions including, for example: Why was it created? What distinguishes it from other joint lending

[1] The earliest press reference (in English) to the EC, ECB, and IMF as the troika appears to have been in June 2010—when the Greek media so dubbed these institutions. A troika is a vehicle drawn by three horses.

[2] The troika did not negotiate Spain's financial assistance because there was no parallel IMF lending program and thus no IMF conditionality. But because the IMF staff provided concurrent technical assistance to Spain and the EC, which resulted in joint troika-like missions, the case of Spain receives some attention.

[3] Over time, staff from the European Financial Stability Facility (EFSF)/European Stability Mechanism (ESM) became more integrated with the IMF/EC/ECB missions, contributing financial analysis to debt-stability assessments prepared by both the IMF and EC staffs; however, the EFSF/ESM staff did not offer policy advice. Collectively, these four teams have been called in the press "the Quadriga," which is Latin for a four-horse chariot. To simplify the presentation, the term troika is used throughout this chapter even when it refers to these four institutions.

operations by the IMF? Did it operate efficiently? What governance issues does it pose for the IMF? Was the IMF a "junior partner" in the troika, as some have argued? This chapter attempts to provide preliminary answers to these questions.

The analysis focuses on the implications for the IMF of its participation in the troika. In each of the countries studied, this arrangement coordinated two conditional lending programs—one by the IMF and the other by the EC working in liaison with the ECB and on behalf of the Eurogroup. As discussed in the next section, the troika arrangement originated in coordinated conditional lending by the IMF and EU to Hungary, Latvia, and Romania (members of the EU though not the euro area) during 2008–09. Coordination is necessary because two simultaneous conditional lending programs need to be mutually consistent and coherent, given that the country authorities can only implement one set of economic policies. However, the two policy programs need not be, and were not, identical to each other in all aspects.

Coordination of conditional lending programs does not take place in a policy vacuum. Both the IMF and the EU institutions have mandates defined by their respective charters and elaborated by their respective policies and practices. The program country also has separate treaty obligations to the IMF and the EU institutions. A country's treaty obligations to one institution prevail independently of any policy commitments it has made related to conditional borrowing from the other institution. Thus, for example, the Treaty on the Functioning of the European Union (TFEU) obliges EU members at all times to abide by the Stability and Growth Pact and Excessive Deficit Procedure as well as by provisions related to the single internal market (the most notable of which relate to state aid to the financial sector). Program conditionality that an individual EU member negotiates with the IMF must be consistent with its policy obligations to the EU, while conditionality that it negotiates with the EC must also be consistent with the TFEU and the decisions made under that treaty. Similarly, of course, all EU member states have treaty obligations under the Articles of Agreement of the IMF that they also should abide by when negotiating loan conditionality with the EC.

In these circumstances, a major challenge in studying the troika arrangement is to disentangle the implications for program (policy) design of the conditional loan coordination process from the underlying implications of programs countries' membership in the euro area and EU. Because it may be impossible to adequately disentangle these two factors in the troika's operations, it would be hazardous to apply lessons learned from the troika arrangement to other regional financing arrangements that are not currency unions. Further, if a troika-like arrangement were to be developed in other currency unions—the Central African Economic and Monetary Community (CEMAC), Eastern Caribbean Currency Union (ECCU), or West African Economic and Monetary Union (WAEMU)—it would not necessarily function in the same way as the troika has for the euro area.

Troika Origins

Preliminary Considerations in 1998

In September 1998, after the euro project was launched but before the currency union was created, the IMF Executive Board discussed modalities for conducting surveillance, and lending operations in euros, with euro area members based upon a trio of staff papers (see IMF, 1998a, 1998b, and 1998c). As regards IMF surveillance, euro area members were deemed subject to Article IV consultation for the economic and financial policies under their competency (e.g., national fiscal, financial, and structural policies), while discussions with the EC and ECB would need to take place pertaining to the economic and financial polices delegated to them (for example, respectively, area-wide fiscal and trade policies, and monetary and exchange rate polices). These EC and ECB discussions would constitute part of the Article IV consultations with individual euro area countries but, for practical reasons, they were considered best handled separately from the discussions with individual euro area countries. The Executive Board approved these surveillance modalities in December 1998.[4]

The Fund staff considered the use of Fund resources by a member of the euro area "extremely unlikely," because this would signify that the union-wide financial system had become segmented (see IMF, 1998c). Such segmentation might arise if it were perceived that a currency union member might depart from the union, and thus an exchange risk could reappear. Even in the absence of exchange risk, lenders could possibly be deterred by country-specific risk, including macroeconomic risk (e.g., if a national recession endangered the financial viability of otherwise healthy companies); political risk; or risk arising from the insolvency of a national government. The staff thus considered movements in interest rate premiums or official accommodating transactions (such as ECB liquidity support—e.g., TARGET2)[5] to be indicators of a euro area member's need for balance of payments (BOP) support. Specifically, the staff expressed the view that "in the unlikely event that such risks assumed

[4] Decision No. 11846 (98/125). Subsequently, these euro area surveillance modalities were extended to other currency unions (CEMAC, ECCU, and WAEMU). Surveillance modalities for currency unions were generalized as part of the 2007 Bilateral Surveillance Decision and then incorporated in the Integrated Surveillance Decision (2012).

[5] The staff postulated that "if country-specific risks triggered a liquidity squeeze and thus pressures on interest rates in an individual union member, the union central bank or the national authorities (within the confines of their limited authority) might be prompted to take official action, if they perceive a risk to the prosperity of the individual member and/or of the union as a whole." The union central bank could "intervene in the money or credit markets of the member, supplying liquidity or credit to residents (in the form of open market operations or other lending). In the case of EMU, prospective participants have been explicit in ruling out any such intentional intervention." In the staff's view, the central bank's efforts to alleviate a liquidity squeeze in an individual country could be seen as an accommodating BOP flow induced by official action.

significant proportions, residents of a member of the European Economic and Monetary Union (EMU) could find themselves unable to borrow on suitable terms, as much as appropriate and necessary to avoid measures destructive of national or international prosperity." In such circumstances, the Fund staff opined, a euro area member could request to use Fund resources just like any other Fund member.

While a euro member had the legal right to request the use of Fund resources, the IMF staff stated that, "it remains to be seen whether the EU would regard the use of Fund resources by EMU members as consistent with the 'no bailout' clause of the Maastricht Treaty." In discussing the no bailout clause, Fund staff observed that "the EU, however, could provide exceptional financing under the terms of Article 103.a.2 of the Maastricht Treaty, which allows . . . financial assistance to a member state that 'is in difficulties or is seriously threatened with severe difficulties caused by exceptional circumstances beyond its control.'" At that time, EU and euro members had no plans to operationalize this provision. Twelve years later, it would be called into use when a firewall was built in Europe to protect euro members from spillovers from Greece.

One staff paper (IMF, 1998c) dealt primarily with issues related to a balance of payments financing need by an EMU member and to BOP/reserve strength for inclusion of an EMU member into the Fund's operational budget. Issues related to the use of Fund resources were seen to have arisen prior to 1998 with respect to other monetary unions (including the two CFA franc zones (14 countries), the ECCU (6 countries), and the Belgium–Luxembourg Economic Union). In particular, attention was drawn to whether the use of Fund resources by a member of a currency union financed a fiscal gap or a balance of payments gap. The staff concluded, based largely on experience with members of the CFA franc zones (IMF, 1995), that many "balance of payments needs have originated in fiscal needs," especially in cases where the private sector's access to international capital markets was limited or subject to sudden stops.

In the 1998 Board discussion on the implications of the EMU for the IMF, Executive Directors focused on surveillance modalities, ECB representation at the Board, and criteria for inclusion of an EMU member in the Fund's operational budget. Issues related to the use of Fund resources and program design received scant attention, perhaps because Directors agreed with staff that that prospect was remote. But some of the contributions to the discussion are noteworthy. In particular, the U.K. Executive Director opined that "while a balance of payments need for an EMU member may seem an unlikely event . . . I agree that the Fund should be able to provide balance of payments assistance to EMU members in just the same way it provides financing to other members when they get into difficulties." While echoing staff,[6] the U.S.

[6] In particular, "Main Legal Issues Relating to Rights and Obligations of EMU Members in the Fund" (SM/98/131; 6/8/98) observed that an EMU member still had the right to request the

Executive Director noted that "in some circumstances, IMF conditionality associated with the use of Fund resources could involve measures that would conflict with the EMU objectives." Continuing, the U.S. Executive Director wondered "whether it would be desirable to have an understanding with EMU participants whereby the ECB and/or other EMU members agree to provide euros to a member to enable it to fulfill its financial obligations to the Fund." An Executive Director representing a group of developing countries felt that "the issue of conditionality for use of Fund resources in the case of euro members needs to be addressed." In the concluding remarks, no mention was made of program design issues related to currency union membership, although Directors agreed to come back to the issue of identification of balance of payments need for members of a monetary union, notably the EMU. There was no direct or immediate follow up.[7]

An Embryonic Troika, 2008–09

The IMF had no experience in lending to euro or EU members between 1999, when the euro was adopted, and late 2008,[8] when two EU, but not euro, members requested the use of Fund resources: Hungary for a Stand-By Arrangement (SBA) in November and Latvia for an SBA in December. The IMF had not lent to a EU member since the mid-1970s when it lent to Italy and the United Kingdom.[9] As non-euro-area members of the EU, Hungary and Latvia were required under the Maastricht Treaty (Article 119 of the Treaty on the Functioning of the European Union (TFEU)) to consult with the EC and the Economic and Financial Committee (EFC) on their balance of payments needs before seeking conditional financial assistance from sources outside the EU. The Fund's policy on exceptional access to Fund resources and its emergency financing procedures were called into play in both cases.

use of Fund resources notwithstanding various provisions in the Maastricht Treaty. This legal paper also asserted that the Fund had the right to request a euro area member to impose capital controls in accordance with IMF Article VI, Section 1(*a*).

[7] Issues related to balance of payments need, albeit not necessarily specific to currency unions, were examined a decade later (see "Review of Fund Facilities—Analytical Basis for Fund Lending and Reform Options" (2009), "The Fund's Mandate—The Legal Framework" (2010), and "Staff Guidance on the Use of Fund Resources for Budget Support."

[8] The IMF did have considerable experience in conditional lending to 16 IMF members that were also members of the two CFA franc zones (e.g., CEMAC and WAEMU), or the ECCU. Notwithstanding this experience, the IMF's Guidelines on Conditionality did not specifically address the implications for program design of membership in a currency union. Tan (2017) provides a more complete history and comparison of the IMF's engagements with currency unions.

[9] Technically, the EU only came into existence in 1993 (under the Maastricht Treaty). The IMF lent to Portugal in 1983, but at that time Portugal was not a member of the European Community, joining in 1986.

Hungary and Latvia also received medium-term balance of payments assistance from the EC based upon EU-determined policy conditionality. The EC had not lent to an EU member under its medium-term BOP assistance facility in 15 years (Greece in 1991 and Italy in 1993) and consequently it faced a very steep learning curve. Hungary was the first joint IMF-EC lending operation to an EU member; the ECB entered simultaneously into a repo facility in an amount of €5 billion with the Hungarian Central Bank. In Latvia, an ECB representative participated as an observer during the IMF and EC missions to that country, owing to Latvia's membership in ERM2.

Romania's request for financial assistance from EU and IMF in early 2009 prompted missions by staff from the EC and IMF, and the Fund provided assistance under its exceptional access policy. In the second half of 2009, the Polish authorities requested a precautionary flexible credit line (FCL), with exceptional Fund access. There are two apparent reasons why staff from the EC did not join IMF staff in Poland to discuss the use of EU financial assistance. One, the Polish authorities had not requested EU precautionary financial assistance, which did not exist at the time.[10] Two, ambiguity existed about whether a request for a precautionary FCL, with its ex ante conditionality, would trigger the EU consultation clause. While the EU did not provide financial assistance, Fund staff reported that the Polish authorities had requested a swap facility with the ECB.

For the three countries with non-precautionary programs, the financing gaps (after any bank-exposure agreements) totaled almost €48 billion (Table 5.1). The IMF contributed 57 percent of this total, while the EU's BOP assistance contributed 31 percent; the remainder came from the World Bank and the European Bank for Reconstruction and Development (EBRD). These averages mask substantial variation. The IMF covered 63–65 percent of the financing gaps for Hungary and Romania, and only 23 percent for Latvia, as examined below. No financing gap existed for the precautionary FCL with Poland.

Recognizing the unprecedented nature of IMF–EC cooperation, the IMF staff used a box in the 2008 staff report for Hungary's SBA request to record five key cooperation principles: (i) early consultation and ongoing information exchanges during the program negotiations; (ii) contributions of both institutions to financing needs; (iii) joint announcement to underline broad support; (iv) consistency of program design and conditionality; and (v) consultation during the program monitoring process.

[10] Subsequently, the EU created an instrument to grant precautionary BOP assistance; Romania was the first EU case in 2011. The IMF also approved a precautionary Stand-By Arrangement for Romania in 2011. It was also later clarified that prior consultation with the EC is required by EU members for a precautionary SBA with the IMF because an SBA involves ex post conditionality that could run counter to EU policy recommendations.

Table 5.1. Financing Gaps and Official Contributions
(In billions of euros; and in percent of totals)

	IMF	EU	Other	Total
Hungary	12.5	6.5	1.0[1]	20.0
	(62.5)	(32.5)	(5.0)	(100.0)
Latvia	1.7	3.1	2.7[2]	7.5[4]
	(22.7)	(41.3)	(36.0)	(100.0)
Romania	13.0	5.0	2.0[3]	20.0[5]
	(65.0)	(25.0)	(10.0)	(100.0)
Total	27.2	14.6	5.7	47.5
	(57.3)	(30.7)	(12.0)	(100.0)

[1] World Bank.
[2] Czech Republic, Denmark, Estonia, Finland, Norway, Poland, and Sweden.
[3] World Bank and EBRD.
[4] After bank exposure agreement reduced gross financing requirement by €7.5 billion.
[5] After bank exposure agreement reduced gross financing requirement by €24 billion.

These principles borrowed implicitly from the Collaboration Concordat between the World Bank and the IMF (Box 5.1). At the Board meeting discussing Hungary's SBA request, the ECB observer elaborated, saying that "given that the EU has its own policy and instrument framework, conditionality of the IMF has to be reflected or mapped onto our own requirements in terms of, for example, an update of the convergence program, in terms of the excessive deficit procedure and also in terms of the national reform program. This means that one would have two conditionalities running in parallel." IMF–EC cooperation received scant attention in the interventions made by Executive Directors at this Board meeting.

The cooperation principles and the practices established with the experiences in the cases of Hungary, Latvia, and Romania laid the foundation for the troika arrangement with euro area members that followed in 2010.

Cooperation at the technical level between the staffs of the EC and IMF has been judged to be effective in ensuring consistency between the two programs' conditionality, and having contributed to successful outcomes (see the ex post evaluations by IMF staff for these three countries and the detailed review contained in Annex 5.1 below). This cooperation drew extensively on the Fund's cross-country experience and expertise in responding to financial crises, as well as on its ability to mobilize resources quickly in emergency situations. The EU's assistance was embedded in the EU's treaty-based policy framework, which provided a medium-term anchor to policies. But some challenges were identified. From the EU's perspective, Fund staff did not sufficiently integrate the EU dimension, such as the EU's surveillance framework—specifically the Stability and Growth Pact/Excessive Deficit Procedure (SGP/EDP) and competition policy/state-aid rules—into their analysis and operational procedures. As a consequence, frictions arose in all three countries over the operation of automatic fiscal stabilizers, which increased the overall fiscal deficit (above EDP targets) when real GDP turned out to be lower than projected.

Box 5.1. Bank-Fund Collaboration—Principles of the Concordat

When the World Bank provides quick-disbursing financial support in conjunction with IMF resources, their collaboration is guided by principles, agreed by the Bank President and IMF Managing Director, known as the Bank-Fund Concordat (Boughton, 2001). The Concordat was first articulated in 1989 and then was updated and reaffirmed in 1998. The Concordat attempted to identify areas of primary responsibility for each institution but increasing overlaps gave rise to legitimate difficulties/frictions and "made a strict delineation of responsibilities impractical and impossible to define properly" (Boughton, 2012).

Reflecting this delineation challenge, an updated Concordat sought to strengthen operational modalities and improve mechanisms to resolve disagreements. Procedures clarified modalities for exchange of information, including, inter alia, draft and final mission briefs, missions' back-to-office reports, and technical assistance reports. Most major disagreements related to program design or its specific components were expected to be resolved at the staff level. When disagreements could not be so resolved, the issue was to be raised to more senior management, such as area department heads or country directors. At the overall institutional level, the focal point for collaboration was the SPR Director and the appropriate Bank counterpart. Regular, and as-needed, consultations were envisaged between the Managing Director and President as well as the Fund's deputy managing directors and the Bank's managing directors.

To avoid cross-conditionality—where a country's failure to implement the lending conditions of one institution prevents the other institution from lending—each institution can proceed independently with its own financial assistance according to its own standards. In the latter circumstance, Bank/Fund management would present the case to an informal meeting of its Executive Board before proceeding.

The three central principles of Bank-Fund collaboration are:

> "*Clarity for members*. Countries in which both institutions are actively involved need to have a clear understanding of which institution has primary responsibility in any given area of policy advice and reform. When developing their policies and reform programs, countries should be able to draw upon the expertise of staff residing in both institutions under their respective mandates, and on other sources.
>
> *Full consultation between Bank and Fund*. Before finalizing its position on key elements of a country's policies and reform agenda, each institution will solicit the views of the other and share its evolving thinking at as early a stage as feasible. This should lead to better policy advice and program design benefiting from the perspectives of both institutions. When there are differences of view between the two institutions about policy and priorities in countries where both are involved, and the disagreement cannot be resolved at the staff level, the issue will be raised at the level of senior management for resolution. If agreement still cannot be reached, the views of the institution with primary responsibility will prevail in the final advice to, or negotiations with, a member country and such differences will be

reflected in reports on the country to the Executive Boards of the two institutions.

Each institution retains separate accountability for its lending decisions. Programs supported by the Bank and Fund should be complementary and part of an overall reform agenda owned by the member country. The Executive Board of each institution will be made aware of the total package and of how the components covered by one institution complement the parts supported by the other. At the same time, each institution must proceed with its own financial assistance according to the standards laid down in its Articles of Agreement and the policies adopted by its Executive Board. Any difference of view between the two institutions will be reported to the Boards when approval to support a program is sought."

Source: Report of the [IMF] Managing Director and the [World Bank] President on Bank-Fund Collaboration, SM/98/226, Revision 1, September 25, 1998.

In the Latvian case, the Fund's relatively small financing contribution of 23 percent (nevertheless at 1,200 percent of Latvia's IMF quota)—stemmed from the Latvian authorities' strong desire to maintain a currency peg that the IMF staff considered significantly overvalued and did not feel comfortable supporting with the use of Fund resources. This disagreement over exchange rate policy had been simmering for some time. Indeed, owing to the inability to implement the 2007 bilateral surveillance decision in this case, the Fund's Executive Board had not completed two annual Article IV consultations (2008 and 2007) with Latvia.[11] The EU, by contrast, supported the Latvian authorities' preference to maintain the euro peg under ERM2, and provided the requisite external and budget financing.[12] The IMF and EC resumed their more usual financing pattern and policy roles in the case of Romania, which had a floating exchange rate and independent monetary policy.

[11] In retrospect, it was highly unfortunate that the Executive Board did not discuss in September 2008 the Article IV staff report on Latvia. The Executive Board could have provided its views on the interrelated issues of overvaluation of the exchange rate and sustainability of the currency peg. The Board's views would have been particularly timely coming only months before program negotiations. This sequence of events demonstrates that regular discussions by the Executive Board of Article IV staff reports should not be deferred because of tricky or difficult economic situations.

[12] This perspective—IMF staff's unwillingness to support with Fund resources an exchange rate regime considered unsustainable—contrasts with the one presented by Blustein (2015a). He argues that the EU's relative large financing contribution (77 percent)—a "reverse Hungary"—put the EC in the driver's seat, making the EC the senior partner in designing the program, and relegating the IMF to being a junior partner. Thus in Blustein's view, a reversal of financing roles caused a reversal in the policy roles.

The EU and IMF completed their program reviews and disbursements in tandem except in one instance. During a joint mission for the first review (May 2009) for the IMF and EU programs in Latvia, output estimates for 2009 foresaw a real contraction of 18 percent rather than the 5 percent that had been projected. Without new measures, the fiscal deficit was expected to widen to 16–17 percent of GDP, far exceeding the program target of 5 percent of GDP. A supplementary budget was adopted on June 16, 2009 with the full-year-equivalent of 13 percentage points of GDP and containing measures that included cuts in pensions and social benefits. The IMF mission—concerned about the adverse growth implications and the effect of these measures on vulnerable groups—returned to Washington to consult. The European Council, worried that the currency peg might unhinge without financial support, on June 19 "strongly supported the intention of the Commission to propose the swift disbursement of the Community's balance-of-payments assistance…." In mid-July, an IMF team returned to Latvia to hold discussions to complete the first IMF program review. The subsequent staff report made clear that the IMF staff had serious reservations about the rapid fiscal adjustment endorsed by the EU Economic and Financial Affairs Council (ECOFIN). But, as it turned out, bold upfront fiscal adjustment coupled with strong country ownership helped produce an expectations-induced V-shaped recovery in 2010 and thereafter. The EC had seemingly made the right judgment call about the currency peg sustainability, feasible fiscal adjustment, and a small fiscal multiplier.

In September 2009, the Fund staff issued a Board paper (IMF, 2009d) that analyzed 18 crisis programs approved between September 2008 and July 2009, including the 4 IMF-supported programs with EU members. Three main conclusions were drawn. One, compared to previous capital account cases, the 18 programs involved less compression of domestic demand. Two, external adjustment in these programs was less wrenching than in past crises owing to more timely, greater, and more front-loaded financing and supportive macroeconomic policies. Three, banking crises were generally avoided, which was considered remarkable given the externally financed credit booms that had been taking place, especially in Central and Eastern Europe. In this context, the maintenance of private sector exposure through the Bank Coordination Initiative was cited as mitigating the potential effects of deleveraging. Financing support from the EC was found to enable risk sharing, but not to have produced less external adjustment. Indeed, based on the Fund staff's statistical analysis, Latvia's adjustment effort was significantly above the predicted level (based upon initial conditions), while no adjustment in the EU program countries was significantly smaller than predicted. No issues were raised concerning EC-IMF cooperation, suggesting that the staff had identified no problems worthy of Board discussion.[13, 14] The Board paper did however refer to EU constraints pertaining to program design—noting that the SGP/EDP prevented Latvia from immediate adoption of the euro and limited Hungary's scope for discretionary fiscal loosening. The paper did not examine the implications of EU/euro membership for program design and financing, leaving questions unanswered from the 1998 Board discussion.

In discussing this 2009 paper (see Minutes of Executive Board Seminar 09/6-1), IMF Executive Directors from EU countries expressed views on EC-IMF cooperation. In particular, the German Director commented that "staff tend to assess the EU policy framework as a constraint to defining an adequate policy response . . . it should be underlined that the governance framework of the European Monetary Union, which includes the Stability and Growth Pact and the exchange rate system ERMII, is an integral part of the institutional and legal framework in which each EU member state operates. Therefore, it should be fully respected in the design and monitoring of IMF program conditionality." These remarks were endorsed by several other Directors from EU countries. No non-European Director spoke on this issue. The concluding remarks by the Chairman of this Board discussion mildly observed that, "Directors highlighted the importance of close cooperation in the design of financing packages with other bilateral and multilateral creditors, notably the European Union."

The Troika Emerges with the Euro Crisis

In October 2009, the newly elected Greek government revealed that the fiscal deficit for 2008 had been misreported as 5 percent of GDP and was in fact 7¾ percent of GDP, while the projected fiscal deficit for 2009 was 12½ percent of GDP, rather than the 3¾ percent previously projected. Yields on Greek government bonds rose sharply as demand for them fell, limiting the government's access to private market funds. The new Prime Minister telephoned the IMF Managing Director to seek help from the IMF.[15] Euro

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[13] Latvia's preference to maintain its exchange rate peg was described as the IMF respecting the authorities' choice of exchange rate regime, while ensuring the peg's consistency with macroeconomic policies.

[14] About the same time, the EC finalized a note on practical implementation issues related to joint EU-IMF programs. See Appendix I of the EPE for Hungary (IMF, 2011b). The EU's Economic and Financial Committee and ECOFIN discussed this note, which spelled out the work sequence for EC BOP assistance missions including coordination with the IMF, which entailed the systematic mutual sharing of draft briefs/policy notes in order to ensure consistent policy conditionality.

[15] Interestingly, the Fund's General Counsel, in a speech given in Frankfurt in January 2009, entitled "Ten Years of the Euro: An IMF Perspective," had observed that the IMF could provide

members were not eligible for the EU's Medium-Term Balance of Payments Facility that had been accessed by Hungary, Latvia, and Romania, and no mechanism specific to euro members existed for balance of payments assistance. This absence was intentional; it was consistent with the "no bailout" provision of the Maastricht Treaty (Article 125 of TFEU),[16] which in turn was reinforced by the provision that no monetary financing of budgets would be provided by the ECB or national central banks (Article 123 of TFEU).[17] Even if a request for Fund resources was admissible from an IMF standpoint, Greece—as a euro area member—still needed to consult with its European partners before making such an unprecedented request.

During the remainder of 2009, the Greek authorities worked with the EC to devise a stability program for 2010–12, which aimed to reduce the fiscal deficit to below 3 percent of GDP by 2012. The IMF staff provided technical assistance to the Greek government during this period. The Greek-EC stability program relied entirely on financing from private markets. The ECOFIN Council accepted the program in February 2010. Both the EC Commissioner and President voiced confidence that a European-only (no IMF financing) solution would be sufficient, and the ECB President publicly expressed opposition to IMF financial assistance for a euro member. In addition, during this period to February 2010, the German and French finance ministers made public statements excluding a financing role for the IMF in Greece (Bastasin, 2012).

During February–March 2010, it became increasingly clear that private financial markets would not provide the Greek government with the requisite funds on acceptable terms. Official financial resources would therefore be needed to prevent a default by Greece, which had large repayments coming due beginning in May 2010. The Europeans debated whether to have the IMF involved in Greece and, if so, how. According to Bastasin (2012) and senior euro area officials who were interviewed by the IEO, the German and some other euro area governments wanted the IMF to be directly involved in any European lending operation to Greece, desiring to benefit from the Fund's technical expertise and experience in crisis management. Other euro area governments opposed IMF involvement, wishing to keep the resolution solely in European hands. The IMF's possible financial contribution seems not to have played a significant role in these discussions. It was the Eurogroup that induced the ECB, whose independence and credibility was respected by

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financial assistance to an IMF member in the euro area with a BOP need, even if the EU could not, although this case was considered "somewhat theoretical."

[16] Specifically, this provision states that the union, or member states, shall not be liable or assume the commitments of central governments, regional, local, or other public bodies.

[17] This provision prohibits the ECB and national central banks from extending overdrafts or any type of credit facility to any level of government. It also prohibits them from directly purchasing national debt. However, the ECB and national central banks can provide liquidity support to solvent commercial banks.

governments and the European public, to be a troika partner. During this period according to interviews, the U.S. government in its contacts with European governments urged IMF involvement in Greece.

With Greek default looming, the heads of state and government of the euro area announced on March 25, 2010 that "As part of a package involving substantial International Monetary Fund financing and a majority of European financing, Euro area member states are ready to contribute coordinated bilateral loans. This mechanism, complementing IMF financing, has to be considered ultima ratio, meaning in particular that market financing is insufficient. Any disbursement on the bilateral loans would be decided by the euro area member states by unanimity subject to strong conditionality and based on an assessment by the European Commission and the European Central Bank." At a related informal Board meeting on Greece, the nature of IMF engagement was not discussed; perhaps because Executive Directors were told that Greece did not expect to use this new mechanism and that staff had not been asked to discuss a program. The IMF did not issue a press release in response to this announcement either. Nonetheless, the envisaged IMF involvement seems to have been modeled on the IMF-EC lending to EU countries that had taken place in 2008–09.[18] In early April 2010, the Executive Director representing the EU informed his colleagues that the same close collaboration that had been employed in Hungary, Latvia, and Romania was the best approach were it needed. Staff and management did not confirm or elaborate.

The Eurogroup announced on April 11, 2010 that its members had reached agreement on the "practical arrangements, notably financial, of the mechanism for financial support." The meaning of "substantial IMF financing" was not given greater specificity by the Eurogroup nor defined by the IMF during this period. The same day (April 11), the Managing Director issued a press release stating, "an IMF team will hold discussions in Brussels on April 12 with the Greek authorities, the European Commission, and the ECB." April 12, 2010 therefore saw the first meeting of the troika with Greek authorities, albeit it was not termed a negotiation. The Managing Director did tell Executive Directors that IMF staff were not going to share information with the European Commission without giving it to our member [Greece], too. It was only on April 15, 2010 that the Managing Director issued a statement stating that the Greek authorities had requested a Fund-supported program.

Staff prepared an initial concise note under the exceptional access policy, which was circulated to, and discussed by, Executive Directors on April 16,

[18] See the Managing Director's speech, "Strengthening European Integration and Cooperation," delivered on March 29, 2010 to the Warsaw School of Economics: "The IMF has also partnered very effectively with the European Union during the crisis—jointly providing balance of payments support to countries in the region. We see this as both a reflection of our common interests and as a template for better cooperation with regional financing mechanisms in the future."

2010. This note did not quantify the financing requirement, possible IMF access, or prospective European financial support. It did not discuss operational modalities for IMF engagement with the EC and ECB. All four criteria under the exceptional access policy were observed preliminarily. At the informal Board meeting, staff did not provide any additional quantification related to program financing. On April 29, 2010, the IMF mission chief for Greece told Executive Directors that his team was still looking at the external financing need and he couldn't give numbers right now as it was too early. On May 2, Executive Directors were told that a staff-level agreement on a program had been reached and that a Eurogroup meeting was convening at the same time in Brussels. Later that same day, press releases from the EU and IMF formally announced the programs with Greece.

The IEO has found no evidence that Fund management and staff attempted to define the nature of the IMF's possible involvement with Greece and the euro area, or to discuss the related issues with the Executive Board. In particular, such a discussion could have focused on the implications for program design and for financing of a request by Greece—a member of the euro currency union—to have a Fund-supported program.

Other options (than the troika with parallel conditional lending by the euro area) could have been considered for assisting Greece, though each might have had its own drawbacks. For example, the IMF could have been made solely responsible for program design and financing. This would not have altered Greece's economic policy obligations with respect to the EC and ECB that stemmed from its currency union membership; these obligations potentially constrained the scope for Greek policy actions and therefore potentially affected the policy design of any IMF-supported program. Arguably, the EC might have had less influence on program design had it not provided financial assistance, although euro members carry considerable weight at the IMF and could have made their views known via their Executive Directors. To finance the entire Greek program, the IMF would have halved its ability to lend to other members or its forward-commitment capacity (FCC).[19] The subsequent programs with Ireland and Portugal would have more than exhausted the FCC, requiring the IMF to borrow from official sources—such as in the euro area—the necessary resources. The IMF's exposure to Greek credit risk would have been higher under this scenario than it actually was, while the credit exposure of euro area governments to Greece would have been correspondingly lower. Essentially, a risk transfer from the euro area to the entire IMF membership would have taken place.[20]

[19] At end-April 2010 (before Greece), the IMF's one-year FCC was equivalent to about €220 billion; roughly half of this stemmed from borrowing arrangements with EU central banks. The financing need estimated for the Greek program was €110 billion, or half the FCC.

[20] Credit-risk transfer (to the IMF) could have been resolved by maintaining access under the IMF program at its actual level while having loan disbursements from the euro area governments be triggered solely by IMF disbursements (that is, with no separate conditionality

Alternatively, the IMF could have financed a significantly smaller share of Greece's financing gap, even to the point of avoiding the need to trigger the exceptional access policy.[21] The IMF would have still provided its program-design expertise and crisis-management experience (which were the chief reasons given for IMF involvement). It would still have needed to adhere to its policies and practices; as the Director of the Strategy, Policy, and Review (SPR) Department observed in the Latvia context, the IMF "cannot delegate responsibility for use of Fund resources. This applies whether we put in one cent or the entire financing of the program" (Blustein, 2015b). Nevertheless, the question naturally arises whether with "less, or no, skin in the game,"[22] IMF staff would have had less influence over program design with the country authorities or with the EU institutions. In considering this possible money–influence tradeoff, it must be recognized that the IMF would still have put its reputation at risk.

Of course, other possible modalities for IMF involvement exist. The point here is not to be exhaustive or to judge what would have been the best option, but to show that a range of options was available in early 2010 that could have been considered by the Executive Board.

The Troika in Action

Follow the Money

Four countries in the euro area—Greece, Ireland, Portugal, and Cyprus—used Fund resources during 2010–15 (with only Cyprus not triggering the exceptional access policy), while simultaneously receiving financial support via one or more EU/euro financing mechanisms created for this purpose. In the 2010–15 programs the financing gaps typically included costs related to bank recapitalization, but, unlike in the earlier IMF-EU joint programs, foreign banks provided no maintenance-of-exposure agreements to reduce the program financing requirements. Burden-sharing contributions between the IMF and EU/euro area for these four country cases are set out in Table 5.2. In

imposed by euro area governments via EC/ECB). Of course, euro area governments would have still needed to obtain approval by their national parliaments for their respective loan (budget) contributions. Would national parliaments have entrusted their taxpayers' money solely to the IMF without separate euro area conditionality and a role for EU institutions? Any answer is purely speculative.

[21] The exceptional access policy was triggered in 17 of 23 (74 percent) of the General Resources Account arrangements outstanding at end-2009. Clearly, IMF-supported programs providing exceptional access were not unusual at that time. Nonetheless, the IMF would avoid triggering its exceptional access policy in the case of Cyprus (2013).

[22] The IMF could have arranged a no-money program with upper credit tranche conditionality by extending eligibility for its Policy Support Instrument to the entire IMF membership. Policy Support Instrument programs are classified as a form of IMF technical assistance (see Decision No. 3561-(05/85).

Table 5.2. Financing Gaps and Official Funding for Euro Area Programs
(In billions of euros, and in percent of total)

Countries	IMF	Europe	Total
Greece	30.0	80.0	110.0[1]
	(27.3)	(72.7)	(100.0)
Ireland	22.5	45.0[2]	85.0[3]
	(26.5)	(52.9)	(100.0)
Portugal	26.0	52.0	78.0[4]
	(33.0)	(67.0)	(100.0)
Total	78.5	177.0[2]	273.0
	(28.8)	(64.8)	(100.0)
Memorandum items:			
Cyprus	1.0	9.0	10.0
	(10.0)	(90.0)	(100.0)
Greece II	28.0	143.6	171.6[5]
	(16.3)	(83.7)	(100.0)

[1] Includes €10 billion for a Financial Stability Fund.
[2] Excludes Irish authorities' contribution of €17.5 billion (or 20.6 percent of Ireland's financing gap) from their cash reserves and liquid assets.
[3] Includes €17.5 billion for bank recapitalization provided by Irish authorities per footnote 2.
[4] Includes €12.0 billion for a Bank Solvency Support Facility.
[5] This total includes €50 billion for bank recapitalization and about €50 billion to finance credit enhancements for the debt reduction with the private sector and to finance a debt buyback program. This total was reduced owing to a projected €50 billion in privatization receipts.

Greece (May 2010), the IMF covered 27 percent of the identified financing gap, or a somewhat larger share than in Latvia but a considerably smaller one than in Hungary and Romania.

As the IMF Board approved the IMF-supported program with Greece (on Sunday, May 9, 2010), the EU Council was completing the design of a European firewall. The IMF Managing Director attended the EU Council discussions to encourage the creation of a firewall. On Monday morning, May 10, 2010, the EU Council announced new mechanisms[23] totaling the equivalent of €750 billion, of which the IMF's contribution was expected to be €250 billion, or one-third. The EU statement went on to say that "the IMF will participate in financing arrangements and is expected to provide at least half as much as the EU contribution through its usual facilities in line with recent European programmes." (In fact, the average share of IMF financing in the three programs with EU members was considerably larger, or nearly double that of the EU financing (Table 5.1).)

[23] To restore the monetary transmission mechanism in certain market segments, the ECB also announced on May 10, 2010 that it would begin to intervene in dysfunctional euro-area public-debt markets (the Securities Markets Program) and would adopt longer-term refinancing operations for banks.

The Managing Director welcomed immediately these European actions, noting that the IMF contribution would be made "on a country-by-country basis" and quietly walking away from the headline figure of €250 billion, while at the same time endorsing the contribution ratio.[24] The First Deputy Managing Director clarified to the press in Washington on Monday, May 10, 2010 that the IMF had not "earmarked" any money for the euro area and that these announced figures were "illustrative" or "hypothetical." In the first two subsequent programs (Ireland, December 2010 and Portugal, June 2011), the IMF covered one-third of the financing gap as expected, providing half the amount that was contributed by the euro area (Table 5.2).

In both the cases of Ireland and Portugal like that of Greece, the initial concise note under the exceptional access policy circulated to Executive Directors did not contain quantified estimates of the financing gap, IMF access, or European financing support, although the respective policy notes sent to management prior to the circulation of these concise notes contained such quantification (De Las Casas, 2017). At the informal Board meeting on Ireland (November 23, 2010), Fund staff was asked by Executive Directors the size of the financing package and of the total EFF access. Staff did not provide the requested quantification explaining that those numbers haven't been finalized as yet. However, staff had already provided to IMF management preliminary quantification. Quantified estimates were provided to Executive Directors on November 28, 2010 just before the announcement later that day on a staff-level agreement. At the informal Board meeting on Portugal under the exceptional access policy (April 19, 2011), Fund staff told Executive Directors responding to questions on the size of the program, that it was too early to say. However, preliminary estimates had already been provided to IMF management. On May 2, 2011, staff informed Executive Directors that agreement on a program with the Portuguese authorities would probably be reached in the coming days and provided a quantified estimate of the still preliminary financing gap. The Portuguese Prime Minister announced agreement on a EU-IMF program the next day (May 3), although EU-IMF announcements took place only on May 5.

This two-to-one ratio did not last long as an "illustrative" benchmark; by 2012, it was gone. In particular, the IMF's share in the total financing package for the second arrangement with Greece (March 2012) fell to 16 percent, and Spain received financial assistance for its banking sector from the European Financial Stability Fund (June 2012) without parallel use of IMF resources. In 2013 for Cyprus, the IMF's share of the total financing package was only 10 percent. Cyprus's access to Fund resources was 563 percent of quota, or below the 600-percent-of-quota threshold for obtaining exceptional access.

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[24] Not only did such a commitment raise legal issues (for example, no Board decision, and the inability of the IMF to lend to euro area institutions as opposed to euro area countries); it was also made in a context where, as seen above, the IMF's forward-commitment capacity at end-April 2010 was only about €220 billion. After Greece, the FCC was below €200 billion.

The European Stability Mechanism (ESM)—the permanent financing mechanism established by the euro area for its members—was created via an intergovernmental treaty among euro members. The Treaty came under immediate legal challenges within the EU but survived them (Box 5.2 and, for details, Schneider, 2013 and Van Malleghem, 2013). For our purposes, the most notable outcome of the Treaty-ratification process and subsequent legal decisions was the continuing role given to various national parliaments. In particular, the German Federal Constitutional Court ruled that ESM packages must be clearly defined and that the German Parliament must be given the opportunity to review the aid and stop it if needed. This parliamentary check was considered necessary to retain Germany's sovereignty over its national budget—sovereignty that the Court saw as a "fundamental element" of the democratic process. Six other euro area parliaments have similar roles.

The ESM Treaty requires unanimity among its (19) members to enable the provision of ESM financial support and to empower the EC to negotiate the associated economic policy conditionality. Unanimity voting typically grants more influence to members with smaller voting weight/size, although these members may thus come under considerable peer pressure to join the majority. The 19 finance ministers of the euro area countries comprise the ESM Board of Governors. Their voting is constrained by national laws in some cases: in seven countries, notably Germany, the Finance Minister must obtain the consent of the national parliament before voting at the ESM. In considering how to vote, national parliaments may look to other actors, including the

Box 5.2. EU/Euro Balance of Payments Financing Mechanisms for Euro Members

EU/euro countries financed adjustment programs for euro area members via four different modalities. The first three of these were announced in May 2010, consisting of the Greek Loan Facility (GLF), the European Financial Stabilization Mechanism (EFSM), and the European Financial Stability Facility (EFSF). The GLF had resources of €80 billion composed of bilateral loans from 14 euro members. The European Commission administered the GLF, disbursing funds based on decisions taken by the Eurogroup, which evaluated compliance under the EC's MOU as assessed by the EC and ECB, and reviewed findings by the IMF. The GLF was intended as a temporary country-specific response.

The EFSM (€60 billion) and the EFSF (€440 billion) formed the European "firewall" of €500 billon that was expected by the Eurogroup to be supplemented by IMF financing arrangements equivalent to half of the EFSM/EFSF contributions. The EFSM was intended to safeguard EU financial stability "under current exceptional circumstances" (such as the problems of Greece), essentially replicating for all EU members the medium-term BOP financing facility available only to non-euro EU members. The EFSM operated within the Treaty on the Functioning of the European Union (TFEU), and its borrowing in international capital markets was backed by EU budget guarantees. The EFSM had its legal basis in Article 122

(TFEU), which allows the EU to provide a euro member with financial assistance "where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters, or exceptional occurrences beyond its control…." This Article is an escape clause to the no bailout provisions of the Maastricht Treaty. Decisions to approve a loan, or to disburse tranches, are taken by a qualified majority of the European Council. The EFSM lent to Ireland and Portugal, totaling €46.8 billion at end June 2015, or 78 percent of the EFSM's total lending capacity, and all of its lending as of that date.

In July 2015, the EFSM provided "bridge financing" (€7.2 billion) to Greece for a three-month period "in view of the severe economic and financial disturbances caused by exceptional circumstances beyond the control of the [Greek] Government" and "to avoid further default on its repayment obligations." This short-term EFSM loan was repaid by a disbursement from a new loan from the European Stability Mechanism (ESM)—see below for details.

In June 2010 euro area governments agreed to establish the EFSF as a temporary crisis mechanism for euro members and as a private company under Luxembourg law. The EFSF disbursed €185.5 billion to Greece, Ireland, and Portugal as of June 2015. It borrows on international capital markets and euro area governments guarantee its debt. The EFSF has the same credit standing as any other sovereign claimant (that is, pari passu); it is not a preferred creditor. The EC was mandated to negotiate the policy conditionality, in consultation with the IMF and ECB.

Legal complaints were filed against Germany's participation in these rescue efforts. While the German Federal Constitutional Court rejected these complaints in September 2011, the Court ruled that aid packages cannot be automatic and may not infringe on the decision-making rights of Parliament. Thus, the German Parliament must be given the opportunity to review the aid and stop it if needed.

In December 2010, euro area governments decided to establish the ESM as a permanent body to replace the EFSF with an effective lending capacity of €500 billion. To implement, the European Council amended in March 2011 the TFEU, adding: "The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made to strict conditionality." The legality of this new TFEU provision—including its consistency with the no bailout provisions—was challenged. The European Court of Justice rejected this complaint in October 2012 (ECJ, 2012). The ESM Treaty was signed in February 2012. The ESM began operation in October 2012 and new requests for financial assistance by euro members have been directed to the ESM since July 2013. The ESM Treaty accepts that the IMF has preferred-creditor status over the ESM. The German Federal Constitutional Court and the European Court of Justice upheld in 2012 the consistency of the ESM Treaty with respectively, German Basic Law, and EU laws. The ESM has lent to Spain (€41.3 billion) and to Cyprus (€9.0 billion). On August 19, 2015, the ESM Board approved a new MOU with Greece and a new three-year loan (for up to €86.0 billion), following its endorsement by ESM members according to their national procedures. The IMF did not negotiate a corresponding Letter of Intent, or disburse resources.

ECB and IMF, for assessments. National parliaments of ESM members are typically informed of the status of an IMF program. Many of the European officials who were interviewed by the IEO cited this prospective need for parliamentary action by some euro members, especially Germany, as a factor in giving the IMF a perceived "veto power" within the troika.

The ESM's financial assistance to Spain is noteworthy because a concurrent request for an IMF program was absent.[25] The Eurogroup announced on June 9, 2012 that it would respond favorably to an expected formal request by Spain for financial assistance by the ESM to cover estimated capital requirements (plus a safety margin), for the Spanish banking system.[26] The Eurogroup statement added that the EC in liaison with the ECB, European Banking Authority (EBA), and IMF would propose the necessary policy conditionality for the financial sector. The IMF Managing Director issued a statement on June 9, 2012 strongly welcoming the Eurogroup's announcement and noted that "The IMF stands ready, at the invitation of the Eurogroup members, to support the implementation and monitoring of this financial assistance through regular reporting" (IMF Press Release No. 12/215).

As was made known subsequently, the absence of an IMF financial contribution (or IMF program) for Spain was explained to euro area national

[25] Nor did the third European program with Greece (8/19/2015) have a concurrent request for a use of Fund resources (UFR) program with the IMF, but such a request was expected subsequently. The EC MOU that was signed by the Greek authorities stated that the MOU was prepared in liaison with the ECB and with input from the IMF. Separately, the EC indicated that the IMF would take part in the regular review missions and was expected to participate financially later. From the EC's perspective, the IMF was a "partner in the ESM programme as envisaged under the specific arrangements of the ESM Treaty." The ESM stated that both the MOU and the ESM loan agreement were approved by ESM members according to their national procedures, which included parliamentary approval in several countries. The IMF mission chief to Greece confirmed in August 2015 (IMF Press Release 15/377) that the IMF would "make an assessment of its participation once the steps on the authorities' program and debt relief have been taken, expected at the time of the first review of the ESM program."

[26] On June 8, the day before the Eurogroup's announcement, the IMF Board considered a Financial System Stability Assessment (FSSA) report on Spain that identified a need to increase capital buffers by €40 billion. The FSSA report (IMF, 2012e) and the Board minutes (Minutes of Executive Board Meeting 12/55-1), particularly interventions by Executive Directors from euro countries, do not reveal any foreshadowing of the Eurogroup's announcement, although press reports about a potential EU loan were noted by one non-euro-area Executive Director. Five Executive Directors questioned the departure from usual practice in considering a standalone report (without the usual Article IV staff report) of the FSSA and the shortened circulation period for the FSSA report. Indeed, one Director opined that "once again the Board is being led to diverge from recommended procedures to suit the situation and preferences of a euro area country." Some unease was also expressed about the IMF—the Board—taking an official view, especially in a press release, on the strength/resilience of Spain's financial system without the backing of an accompanying Article IV analysis. The 2012 Article IV consultation mission was in Madrid at that time, and completed its work on June 14 when it issued its concluding statement. Thus, a Board discussion of the FSSA and Article IV staff report could have taken place without a lengthy delay with some effort.

parliaments by the fact that the IMF did not have a facility to provide sectoral financial assistance. Thus, the "where possible" clause related to the IMF's involvement in the ESM Treaty came into play. Nonetheless, while it is true that the IMF had no sectoral lending facility, IMF resources were used to help to fill financing gaps arising inter alia from requirements for bank recapitalizations in the cases of Greece, Ireland, Portugal, and Cyprus.

The Spanish government formally requested financial assistance from the EFSF/ESM on June 25, 2012. A joint mission that included staff from the EC, ECB, EBA, EFSF/ESM, and IMF visited Spain from June 27, 2012 to July 4, 2012, negotiating an EC memorandum of understanding for ESM financial assistance and terms of reference for IMF technical assistance (TA) in the context of ESM financial assistance. This joint mission (and subsequent ones) resembled a troika mission plus participants from the two additional European institutions (the EBA and ESM/EFSF). The memorandum of understanding (MOU), which defined financial sector conditionality, was agreed between the EC and the Spanish authorities on July 20, 2012, or the same day as the IMF's terms of reference were finalized. The Spanish authorities also agreed to comply fully with the EU's Excessive Deficit Procedure commitments and recommendations, which provided macroeconomic and nonfinancial structural policy elements to this financial assistance from the ESM (Véron, 2016). As regards the terms of reference, Fund staff preferred that the request for technical assistance be made by Spain plus other individual Eurogroup members. This was partly because TA requests from Fund members can be acted on without Board authorization, while TA requests from non-Fund members—such as the Eurogroup—do require Board authorization, and partly because in the staff's view, the Fund's "honest broker" role would be enhanced if the request were not made by the EC, ECB, or EBA. In any event, the staff felt that the Fund should be free to voice disagreement, including publicly, with policy recommendations (for example on the extent of deleveraging, bailout/state aid, or legacy asset management) made by EU institutions.

The IMF terms of reference (TOR) for staff monitoring of the EU program for Spain were sent to the IMF Executive Board, for information only (FO/DIS/12/135; 07/20/15), on July 20, 2012, the day they were agreed. The TOR were made public later that day. They specified that the Fund staff would not be party to the EC's memorandum of understanding for financial assistance, nor would the Fund staff be responsible for the MOU's conditionality; these were matters solely for the Spanish authorities and the EC. The monitoring to be conducted by the Fund staff was described as a form of technical assistance under Article V, Section 2(*b*). Thus, the staff would play a very different role than in the euro area cases that used Fund financial assistance. IMF staff monitoring was to be conducted "independently of the views of the authorities and EC." This role represented a compromise between the wishes of those euro area governments (not least Germany's), that wanted IMF involvement, and of the Spanish government, which insisted that the IMF play only an advisory role and not impose any conditionality (Véron, 2016). The TOR did not restrict the Fund staff from expressing its views regarding recommendations and policies formulated by the authorities and the EC. The TOR also made clear that the IMF staff reports would be provided to the IMF Executive Board for information only.

This was the first time (since the box on EC-IMF cooperation in the staff report for Hungary's 2008 SBA request), that IMF staff described to the IMF Board the nature of IMF-EC collaboration. However, the Board was merely informed, rather than engaged in a decision making process. Indeed according to De Las Casas (2017), management and staff made a series of choices that effectively excluded the Board from a decision-making role on possible modalities for IMF engagement with Spain. On July 25, 2012 the Board concluded the 2012 Article IV consultation with Spain and "welcomed the European financial assistance for the recapitalization of Spanish financial institutions and the accompanying policies, as well as the envisaged role of the Fund in monitoring progress."

Joint review missions related to Spain's financial sector were conducted by the EC, in liaison with the ECB and EBA. These verified compliance with the MOU's policy conditions, while the IMF staff supported implementation and monitoring with analysis, policy advice, and its own regular reporting (Véron, 2016). Progress in meeting the EDP commitments was regularly monitored by the EC. Thus, the EC's surveillance procedures were reinforced by its conditionality on macroeconomic and structural policies via its lending operation.

Interviews conducted by the IEO with the Spanish authorities and relevant staff at the IMF, EC, ECB, ESM, and EBA portrayed the IMF staff as a co-equal partner with the EC, ECB, and EBA as regards providing insightful analysis of Spain's financial sector and appropriately targeted policy recommendations to address identified financial sector problems. In Spain as in Ireland and Portugal, Fund staff debated with partners over the appropriate pace of bank deleveraging, arguing for a slower pace (Véron, 2016). Cooperation was deemed excellent by all parties and Spain successfully exited from this EC program with a stronger financial system. But some Europeans expressed doubts whether the "Spanish model"—with no parallel IMF program or conditionality—would be easily repeated in the future, and expressed a desire to have IMF "skin in the game." Looking ahead, the ESM may be less involved with future bank recapitalization efforts because the Single Resolution Fund now provides an alternative instrument. Some European interviewees also noted that Spain's macroeconomic policy performance under the ESM program could have been better; they noted in this context that the Excessive Deficit Procedure target for 2013 was not achieved, even though macroeconomic outcomes benefited from the sharply lower interest rates that were largely a response to the ECB President's pledge in mid-2012 to "do whatever it takes" to save the euro.

What Is the Troika Arrangement?

When two or more institutions engage in conditional lending to support a country's adjustment program, consistency is necessary because a country can only adopt one set of policy measures (for example, only one target for the fiscal deficit) that must satisfy both institutions' conditionality.[27] Even if conditionality does not overlap directly, policy measures must not work at cross-purposes. The institutions also need clear rules of the game to handle situations where the conditionality set by one institution is not observed, preventing that institution from disbursing as scheduled. Coordination issues naturally arise. To address them, two broad options exist: (i) one institution "borrows" the conditionality set by the other, tying its disbursements to disbursements by the other institution—such arrangements can be termed "co-financing"; or (ii) the participating institutions provide "parallel" or "joint" financing and agree on modalities to assure consistent conditionality.

Before discussing how the troika parties handled the coordination of conditionality, this section looks more generally at how these coordination issues apply with respect to the IMF's interactions with regional financing arrangements (RFAs) and currency unions.

Treatment of coordination in regional financing arrangements and currency unions

Both in surveillance and in the use of Fund resources, an IMF member's membership of a currency union raises policy and procedural issues that do not apply for non-currency-union members. Policy and procedural constraints may also differ among currency unions,[28] and the specifics of the financing mechanism and any associated conditionality of the RFA add further complications. Financing mechanisms for (or the policy rules of) currency unions may raise different issues from RFAs in regions without currency unions.

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[27] As the ECB's Outright Monetary Transactions (OMT) program has not been used, only the EC and IMF conditional programs are reviewed in this section. The OMT program is discussed in the section "On Which Side of the Negotiating Table Should the ECB Sit?" below on the ECB's troika role.

[28] Notably, the economic governance architecture of the CEMAC, ECCU, and WAEMU differs from that of the euro area; for example, the fiscal rules are generally less restrictive than EMU rules and their enforcement mechanisms are also weaker (Schaechter and others, 2012; Hitaj and Onder, 2013; and Bova, Carcenac, and Guerguil, 2014). There are also major economic differences among these currency unions (Tan, 2017). The euro area has systemic importance and the euro has a role as a reserve currency. Relatedly, the EC and ECB have more staff and broader responsibilities than their equivalents in other currency unions. In addition, and more controversially, nationals from these three currency unions do not hold as prominent senior positions within the IMF, including management positions, as do nationals of the euro area and EU more broadly. This greater prominence could result in a tilt—even if unknowingly—toward "European exceptionalism." Finally, the voting power and voice—number of Executive Directors or Alternates— for the euro area is considerably larger and louder than for other currency unions (Eichengreen and Woods, 2016).

With regard to regional financing arrangements, the G20 finance ministers and central bank governors endorsed on October 15, 2011 six non-binding principles for cooperation between the IMF and RFAs (Box 5.3). Several of these principles are germane to the troika: (i) cooperation should respect the roles, independence, and decision-making processes of each institution, taking into account regional specificities in a flexible manner; (ii) cooperation should include open sharing of information and joint missions where necessary; (iii) consistency of lending conditions should be sought to the extent possible, to prevent arbitrage and facility shopping; and (iv) RFAs must respect the preferred-creditor status of the IMF.

Box 5.3. G20 Principles for Cooperation between the IMF and Regional Financing Arrangements, as endorsed by G20 Finance Ministers and Central Bank Governors, October 15, 2011

In November 2010, G20 leaders tasked G20 finance ministers and central bank governors to explore "ways to improve collaboration between RFAs and the IMF across all possible areas." Based on contributions by the EU and by ASEAN+3 countries that are members of the G20, the following nonbinding principles for cooperation have been agreed. Also, collaboration with the IMF should be tailored to each RFA in a flexible manner in order to take account of region-specific circumstances and the characteristics of the RFAs.

(i) An enhanced cooperation between RFAs and the IMF would be a step forward towards better crisis prevention and more effective crisis resolution and would reduce moral hazard. Cooperation between RFAs and the IMF should foster rigorous and evenhanded surveillance and promote the common goals of regional and global stability.

(ii) Cooperation should respect the roles, independence, and decision-making processes of each institution, taking into account regional specificities in a flexible manner.

(iii) While cooperation between RFAs and the IMF may be triggered by a crisis, ongoing collaboration should be promoted as a way to build regional capacity for crisis prevention.

(iv) Cooperation should commence as early as possible and include open sharing of information and joint missions where necessary. It is clear that each institution has comparative advantages and would benefit from the expertise of the other. Specifically, RFAs have better understanding of regional circumstances and the IMF has a greater global surveillance capacity.

(v) Consistency of lending conditions should be sought to the extent possible, in order to prevent arbitrage and facility shopping, in particular as concerns policy conditions and facility pricing. However, some flexibility would be needed as regards adjustments to conditionality, if necessary, and on the timing of reviews. In addition, definitive decisions about financial assistance within a joint program should be taken by the respective institutions participating in the program.

(vi) RFAs must respect the preferred-creditor status of the IMF.

Though endorsed by the G20, these principles are not binding on the IMF or on any RFA. Importantly, the IMF Executive Board has not endorsed, nor even discussed, these G20 principles even though the International Monetary and Financial Committee (IMFC) in April 2011 "urged the Fund to work with regional financing arrangements to develop broad principles for cooperation with the IMF." The IEO has not found any evidence that the Eurogroup, EC, or ECB have adopted the principles. The principles are too general to be used for meaningful assessment purposes.

The G20 held a seminar on an IMF staff paper entitled "Stocktaking the Fund's Engagement with Regional Financing Arrangements" (IMF, 2013b) at the IMF on April 17, 2013. This staff paper had been circulated for information, but not discussion, to the IMF Executive Board on April 11, 2013, with a note that it provided background for the forthcoming seminar. According to published summary of seminar participants' views (http://en.G20russia.ru/events_summit/20130417/780961032.html), they observed that while agreeing on the desirability of cooperation, the extent and form of such cooperation were "the most difficult question to answer."

On May 10, 2013, IMF staff circulated to Executive Directors a note on issues for discussion (FO/DIS/13/64) related to the "Stocktaking" paper. Questions posed included: (i) whether Directors saw a need to review the nonbinding G20 principles; (ii) whether formal cooperation mechanisms should be put in place with individual RFAs; and (iii) whether financing mechanisms for currency unions raised different issues from RFAs in regions without currency unions. The IMF Executive Board had an informal discussion on May 13, 2013. No summing up or minutes were produced because the session was informal, but available records and interviews indicate that Executive Directors were not inclined to move towards a structured, formal arrangement with RFAs. In December 2015, in concluding their discussion of the IMF staff's Crisis Program Review (IMF, 2015b), "many Executive Directors supported establishing operational guidelines that build upon the G20 principles for cooperation between the Fund and regional financing arrangements (RFAs)…."

The troika arrangement was uniquely developed by the Eurogroup to benefit from the IMF staff's technical expertise and crisis-management experience, allowing coordination of the EU's and IMF's separate, but parallel, conditional lending operations. No other currency union has yet developed a financing mechanism such as the euro area's ESM. In studying the troika arrangement, it is extremely difficult to distinguish its possible effect on loan conditionalities from the possible effect of the policy constraints that were imposed on the program countries by their membership of the euro area and EU. To the extent that lessons from the troika experience derive from the effects of euro/EU membership, any lessons would be less germane for RFAs without a currency union. For RFAs that are also a currency union, the lessons depend on the similarity of their policy and financing frameworks to those in the euro area and EU.

"Borrowed" conditionality

Against this background, the relevant policies established by the IMF Executive Board are examined. According to the Fund's Guidelines on Conditionality (Decision No. 12864 (02/102), as amended), the IMF is prohibited from allowing the use of Fund resources to be directly subjected to the rules and decisions of other organizations. Thus, the Fund cannot "borrow" conditionality from another institution. The Conditionality Guidelines also state that "there will be no cross-conditionality, under which the use of the Fund's resources would be directly subject to the rules and decisions of other organizations." Fund staff reiterated this point in 2014 (IMF, 2014), saying that the Fund cannot delegate its responsibility, including to RFAs, in assessing whether the conditions for the use of its resources have been met. This is necessary in order for the Fund to ensure that "adequate safeguards" are in place to preserve the revolving character of Fund resources as required by its Articles of Agreement. If the Fund assesses that its conditions have not been met, it will not disburse, irrespective of the judgments reached by other lenders. Conversely, in cases where the Fund assesses that its conditions have been met but the conditions imposed by other lenders are not met, so that they do not disburse, the Fund may not be able to release its resources. The absence of financing assurances—a situation wherein the IMF-supported program is not fully financed—can block the IMF from disbursing, given the need to safeguard its resources.

Unlike the IMF, the Eurogroup could have decided to "borrow" IMF conditionality by choosing to trigger its financial assistance solely upon the program country's observance of IMF conditionality, or by deciding effectively to cofinance the IMF program. It must be noted that the euro authorities did not consider delegating program conditionality to the IMF at the time they were debating the IMF's involvement. Borrowed IMF conditionality has been used in debt restructurings by the Paris Club and London Club, and in official bilateral lending during the Asian crisis, Mexico (1995), and Brazil (1998). According to IMF staff, only one out of five regional financing arrangements requires an IMF program for use of RFA resources, and in that case the use of these resources must exceed a threshold amount (though the use of the RFA resources has never been activated).[29,30]

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[29] According to IMF (2013b), three RFAs include no explicit role for the IMF. The Chiang Mai Initiative Multilateralization (CMIM) requires the existence of a Fund-supported program for disbursements above 30 percent of its member's maximum quota. Below that threshold, the CMIM may set its own conditionality. Neither provision has yet been used. The North American Framework Agreement does not require an IMF-supported program; however, a letter from the IMF Managing Director, stating confidence in the borrower's policies, is needed by the U.S. Treasury Secretary to authorize use of the Exchange Stabilization Fund.

[30] Would "borrowed" IMF conditionality have been politically feasible for European governments? Given that their large loans frequently required authorizations by their respective national parliaments, would these national parliaments have accepted less involvement by the

Even without separate European loan conditionality, the design of the IMF-supported program for a euro area member needs to contend with the country's EU Treaty obligations as administered by the EC and ECB. The EC and ECB have an obligation to treat EU/euro members evenhandedly, while also considering the potential spillovers for the EU/euro area as a whole. Thus, the policy disagreements that arose between the IMF staff and EC/ECB staff within the troika (e.g., on the pace of fiscal adjustment, sovereign debt restructuring, bank recapitalization, or treatment of unsecured bank creditors) would likely still have emerged even without the troika arrangement.

Modalities for assuring consistent conditionality

What of the modalities to assure consistent conditionality by the EC (in liaison with the ECB) and the IMF? The IMF's Conditionality Guidelines state that "the Fund's policy advice, program design, and conditionality will, insofar as possible, be consistent and integrated with those of other international institutions within a coherent country-led framework." In addition, Fund staff explained in the 2011 Review of Conditionality (IMF, 2012b) that the "[Conditionality] Guidelines do not provide explicitly for coordination with regional institutions [such as EU institutions]. However, they provide clear guidance regarding coordination with the World Bank that can be transposed to coordination with other institutions." In 2014, the operational guidance to IMF staff on the 2002 Conditionality Guidelines was revised to add a paragraph on collaboration with regional financing arrangements; in particular, it was considered "useful for staff to understand the timing and phasing of RFA disbursements . . . and to reach mutual understandings on policy objectives and program design to remove or minimize any inconsistencies" (IMF, 2014).

Some but not all of the IMF's experience in coordinating with the World Bank on joint conditional lending to developing countries is relevant to the EU program cases. Typically, the Bank-Fund collaboration process has involved exchanges of information and analysis, sharing of briefing papers, and joint or parallel staff visits. As regards policy substance, under Bank-Fund collaboration a division of labor applies that is consistent with their respective institutional mandates. This principle has resolved most (though certainly not all) Bank-Fund coordination issues.

Unlike that of the World Bank, the policy mandates of EU institutions with respect to euro members overlap extensively with that of the IMF. Hence the IMF and the EC developed a modus operandi for assuring "consistent and integrated" conditionality—per the conditionality guidelines—based upon their experience with joint lending programs for Hungary, Latvia, and

EC and ECB? Would the various national courts and the European Court of Justice have viewed differently the legal challenges to the euro area's rescue mechanism? Answers to these counterfactual questions are left to the reader.

Romania. One consequence of the overlapping responsibilities was duplication in staff assignments by troika partners. This increased the overall size of troika teams, which placed a burden on country authorities. Troika teams in Greece reportedly could total 30–40 persons, though teams in Ireland and Portugal were substantially smaller. In addition, country authorities, particularly in the case of Greece with the EU's Task Force for Greece, needed to accommodate a great number of technical assistance missions in revenue administration, expenditure management, banking, and statistics.

The IMF, EC, and ECB all used similar internal procedures/practices for fielding their respective teams (ECA, 2015). Once tentative mission dates had been determined, each team would begin to prepare a policy brief/note that identified the main challenges facing the country, the principal policy recommendations of the respective team, and an assessment of financing requirements. Consultations would take place among troika partners (including via teleconferences and the sharing of preliminary notes), and the EC would consult with the EFSF/ESM on funding issues while, within the EC, the Directorate-General for Economic and Financial Affairs, which provided the EC team leader, would consult with other Directorate-Generals. Efforts would be made to converge on analysis, assessments, and policy prescriptions, while retaining needed flexibility given the uncertainties involved. Internal consultations would also take place within each institution. Senior officials within each—the responsible Deputy Managing Director in the case of the IMF—approved the final draft policy brief/note. The EC played a dual role: one, acting as agent for the euro area members (or EFSF/ESM), it sent the policy brief to the Economic and Financial Committee/Euro Working Group President; two, it represented the general interests of the EU community because formal ECOFIN Council decisions may be required (e.g., EDP), or EFSM disbursements, which are EU-wide matters.

On the IMF side, the policy on exceptional access (EA) mandates early informal consultation with the Executive Board once IMF management decides that new, or augmented, exceptional access to Fund resources may be appropriate. The EA policy requires that Executive Directors be provided a concise note that sets out "as fully as possible:" (i) a tentative diagnosis of the problem; (ii) outlines of the needed policy measures; (iii) the basis for a judgment that exceptional access may be necessary and appropriate, with a preliminary evaluation of four substantive criteria and including a preliminary analysis of the external and sovereign debt sustainability; and (iv) the likely timetable for discussions. Concise notes were circulated to Executive Directors in all three country cases. While the initial notes in each of the three cases signaled that exceptional access to Fund resources was anticipated, none of them provided quantitative estimates of the financing requirements, of expected European financing, or of possible access to Fund resources. This information was, however, contained in the respective policy notes that were sent to IMF management before the three initial notes were sent to the Executive Directors. According to interviews with various IMF Executive

Directors/Alternates, or their staffs, who attended informal Board meetings under the exceptional access policy, quantitative estimates were not communicated orally either.

Such estimates *were* made available to the Eurogroup by EC staff to gain the Eurogroup's authorization to negotiate loans and policy conditionality on its behalf. Consequently, an information asymmetry resulted among IMFC finance ministers, with finance ministers from the Eurogroup having more detailed information. Depending upon what information the Eurogroup shared with their IMF Executive Directors, this information asymmetry might have also extended to IMF Executive Directors. This information asymmetric is distinct from the usual information asymmetry enjoyed by the Executive Directors representing the country seeking an IMF-supported program.

In the field, troika teams met jointly with the country authorities whenever feasible. They also met regularly among themselves to share information, to revise the macroeconomic framework and estimated financing requirement, to discuss adjustments to proposed policy conditionality, and to give mutual feedback on evolving drafts of their MOUs/LOIs. Progress reports were provided to headquarters—in some cases daily—to seek additional guidance. Because the EC acts as agent, the Euro Working Group (EWG) President is kept informed of developments by EC staff. The EWG President may inform other Economic and Financial Committee/EWG members of important developments as appropriate. If substantial disagreements arise among troika partners or with country authorities, troika deputies are involved, working with their counterparts and their teams to devise solutions. As necessary, troika principals may discuss matters with the objective of allowing commonly agreed proposals to be presented to the Eurogroup.

The IMF's policy on exceptional access provides that "additional [to the initial] consultations will normally be expected to occur between informal meetings and the Board's consideration of the staff report. The briefings will aim to keep the Board abreast of program-financing parameters, including assumed rollover rates, economic developments, progress in negotiations, any substantial changes in understandings, and any changes to the initially envisaged timetable for Board consideration. . . . Management will consult with the Board specifically before concluding the discussions on a program and before any public statement on a proposed level of access." Additional informal consultations with the Executive Board prior to the announcement of a staff-level agreement (see De La Casas, 2017): Greece (2); Ireland (1); and Portugal (2). As discussed earlier, Executive Directors were not provided quantified estimates of the financing gaps, possible IMF access, or European financial support in the initial concise notes for Greece, Ireland, and Portugal or during the respective informal Board meeting on exceptional access. Directors were only informed once staff-level agreement had been reached and was about to be announced publicly. Executive Directors were not in all likelihood as well informed as Eurogroup members.

Executive Directors were not consulted in advance under the EA policy on three key policy issues: (i) in Greece, related to the absence of "high probability" for sovereign debt sustainability; (ii) the need to amend the EA policy in the case of Greece, by introducing the systemic exemption clause; and (iii) whether to apply haircuts to senior unsecured bondholders in the case of Ireland. As to consulting "before concluding discussions on a program," in the cases of Greece and Ireland the last informal briefings took place on the same day as the announcement of the staff-level program agreement, while in the case of Portugal the last informal Board briefing took place three days before the announcement of the staff-level agreement (De Las Casas, 2017). The same-day announcement of the staff-level agreements in the cases of Greece and Ireland raises a question whether the Board was consulted or merely informed.

The IMF staff needed to share confidential IMF information with EC/ECB/ESM staff (and vice versa) in order for the troika arrangement to function. The IMF's code of conduct for its staff prohibits the communication of confidential information to outsiders (who include EC/ECB/ESM staff) without authorization. Such authorization could take the form of either direct instruction from management or general policies established by the management and the Executive Board. According to the Legal Department, management has the authority to consent to such sharing without the need for a policy approved by the Executive Board, and without the need to inform the Board of such sharing or to share the same information with the Board. Staff in EUR, LEG, and SPR were not able to provide the IEO with copies of written authorization by management to permit sharing of confidential information with troika partners. Nor were concurrent records (such as minutes or memorandums to files) provided documenting oral authorization by management. SPR and LEG maintain that the sharing of confidential IMF information with third parties is authorized by the Board in the context of obtaining financing assurances for the member's program; creditors/lenders will not support the country's program without knowing the Fund's contribution and level/magnitude of policy adjustment. In any case, written staff guidance on sharing of confidential information under these circumstances was not provided to the IEO. The ECA in its 2015 audit report noted that no formal arrangement existed between the IMF and EC regarding the exchange of confidential information; the ECA also recommended formalizing the mechanism for information sharing and the handling of confidential information. It is also good practice to obtain assurances from a recipient party that it will treat shared confidential information confidentially. The IMF staff has not been able to provide written evidence of such assurances from the EC, ECB, or ESM.

Decisions by the European partners (the Eurogroup, European Council, and the EFSF/ESM/EFSM) related to euro/EU loans preceded the IMF Board meetings on use of Fund resources. This sequencing assured that the IMF-supported program was fully financed—satisfying the IMF's financing assurances policy—by the time the IMF Board met. But this sequence also created the perception that the IMF Board was faced with a fait accompli, and that the IMF Board merely rubber-stamped decisions that had already been taken in Europe. Alternatively, the IMF Board could have held its meetings prior to the decisions by European partners, using a more cumbersome "in-principle" decision procedure. Under this procedure, the Board approves Fund action in principle, but that action only becomes effective once the European partners take the corresponding decision. Whether making this procedural change would alter these perceptions is open to debate.

How Operationally Efficient Was the Troika Arrangement?

Answers to the question about the operational efficiency of the troika arrangement may differ from one program country to another and even for a single country depending upon the period chosen. This section attempts to provide a high-level overview of troika operations in Greece, Ireland, and Portugal. At the outset, it must be noted that an assessment of operational efficiency of the troika arrangement is distinct from an assessment of the quality or suitability of its policy advice or program design.[31]

The operational efficiency of coordination within the troika arrangement was examined by the IMF staff in the 2011 Review of Conditionality and in the context of ex post evaluations (EPEs) for exceptional access arrangements for Greece and Ireland.[32] Two of the three scheduled EPEs for programs with euro area countries have been completed; those for Greece (IMF, 2013e) and Ireland (IMF, 2015a) have been discussed by the Executive Board. The EPE for Portugal has not yet been completed and issued to the Board, though it should have been circulated to the Board in early July 2015 to adhere to the exceptional access policy.[33]

To place the analysis of the troika's operational efficiency in context, the time between the request for financial assistance by the euro member and the announcement of the staff-level agreement of a program was calculated for Greece, Ireland, and Portugal. The shortest was two weeks and the longest was four weeks, indicating that the troika arrangement was able to quickly negotiate the initial programs for these euro countries. In addition,

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[31] Even though troika partners worked well together and with the country authorities, they still could produce agreed policy advice judged to be less than appropriate. For an understanding of the appropriateness of policy design, see Donovan (2017); Eichenbaum, Rebelo, and de Resende (2017); Kopits (2017); Schadler (2017); Véron (2016); and Wyplosz and Sgherri (2017).

[32] See the four background papers for that review (IMF, 2012b).

[33] The EPE guidelines (IMF, 2010d) state that the ex post evaluation should be completed within one year of the end of the arrangement, where "completion" means approval by management for circulation to the Board. The EFF with Portugal expired on June 30, 2014. Thus, this EPE should have been approved by management for circulation to the Executive Board by June 30, 2015.

the quarterly program reviews were completed in a timely manner; any delays were due to substantive policy disagreements with the country authorities rather than to policy disagreements among the troika members.

According to the staff report for the 2011 Review of Conditionality (IMF, 2012b), troika coordination "functioned well operationally and improved over time, but nevertheless added an additional layer of complexity to conditionality design and decision-taking." At times this added complexity produced extended periods of discussion on crucial issues such as the pace of fiscal consolidation, debt restructuring, or regaining competitiveness. Coordination developed "in the spirit"—as formal agreement was absent—of the Bank-Fund Concordat. The Fund was seen as focusing on short-term macro-critical policies, while the EC covered comprehensive medium-term structural reforms. Overlaps existed within this division of labor, notably on fiscal, competitiveness, and financial policies. (From the IMF's perspective, fiscal and competitiveness policies are of particular importance in programs with currency union members, which cannot use exchange rate policy to achieve adjustments, yet in the euro area countries the EC also had responsibility for fiscal and competition policies.)

EC structural conditions have been observed to be more numerous and detailed than structural conditions in the Fund-supported programs.[34] The large number of structural conditions identified in the EU program contrasted with the IMF's principle of parsimony. Staff noted that, over time, the IMF and EC each ventured increasingly into areas of structural reform that were initially the province of the other institution. These overlaps increased the need for coordination, requiring "constant cross-checking and a gradual adaptation between the MOU and MEFP" (IMF, 2012b). Such coordination, plus the reliance on review-based conditionality, avoided situations where cross-conditionality might prevent IMF disbursements owing to an absence of financing assurances.

In light of these findings, the 2011 Review of Conditionality concluded that the conditionality guidelines remained broadly appropriate, while implementation needed to be strengthened by, inter alia, "improving partnerships with other institutions including in currency unions, where program success can be linked to union-level policies." More specifically, the staff recommended "maintaining a standing dialogue with regional financial agencies on policies and procedures regarding program conditionality and design, including a discussion of approaches for dealing with recurrent problems." But, arguing that to do so was premature, especially in the euro area context, the staff provided few details on how to improve these partnerships through

[34] IMF staff noted that the exact numbers of EC measures were difficult to establish because they were typically broken down into sub-measures. Extensive EC structural conditionality has been noted, for example by Pisani-Ferry, Sapir, and Wolfe (2011a, 2011b) and by the ECA (2015). The latter estimated EC structural conditions at nearly 400 in the cases of Ireland and Portugal. The ECA did not review the European program with Greece.

policies and procedures pertaining to program conditionality and design for a member of a currency union.

At the Board meeting for this conditionality review (September 2012), Executive Directors acknowledged that experience with the troika arrangement was limited but many of them nonetheless wanted a more in-depth study of the troika. For example, the Director from Japan encouraged staff to conduct, if necessary, an ad hoc review of the conditionality guidelines in order to reflect lessons learned. The Director from Australia noted that "we would be interested in a more in-depth discussion of the role played by European institutions in program design. Lessons drawn from the more developed relationship with the World Bank may provide guidance on enhancing the operational aspects of cooperation." Similarly, the Director from Canada believed "that the costs and benefits of the troika model merit additional consideration" and "ask[ed] the staff to look deeper into the troika partnership and report back to the Board with recommendations for this partnership." The Director from the Netherlands suggested that "going forward, we would encourage some written framework of cooperation between the Fund and partner organizations." On the other hand, many Directors representing euro area countries were of the view that troika cooperation "proved quite successful in the end;" was "very effective" and "well-functioning;" some said they would "insist more than staff on the positive aspects of this cooperation." While the summing up endorsed the recommendation to have a standing dialogue with relevant regional organizations, it added that "many Directors encouraged staff to draw preliminary lessons from these [euro area] cases in a timely manner, including on coordination with troika partners and the modalities of designing programs and conditionality." To date, the staff have not prepared a Board paper to present such lessons, although a short box on cooperation experience with the IMF and EU institutions appeared in a report (IMF, 2016) that was prepared for an informal discussion on strengthening the international monetary system.

The EPE for Greece painted a similar picture to that in the 2011 Conditionality Review, while the EPE for Ireland did not specifically refer to troika-coordination problems. In the EPE for Greece (IMF, 2013e), Fund staff concluded that the troika coordination was good despite differences in its members' internal procedures, documentation requirements, and confidentiality rules. The EPE pointed out that the IMF and European institutions had different perspectives: the IMF was more accustomed to analyzing issues from the vantage point of the specific country, while European institutions emphasized possible spillovers within the euro area. The Fund staff observed that a clear division of responsibilities within the troika was difficult to achieve, given the overlapping responsibilities of the three institutions. Synergies were seen to arise from cooperation in areas with shared expertise, while European institutions had a comparative advantage in structural areas that were outside the Fund's core areas of expertise. Thus, work in areas that were not macro-critical could have been assigned more efficiently, while scope existed to streamline procedures and documents to reduce the burden on country authorities.

According to the same EPE, the Greek authorities felt the troika arrangement suffered from coordination problems. They noted that the troika took time "to gel" as a unit to formulate, for example, a common macroeconomic view, but that dealing with the troika was fairly smooth. Detailed conditionality posed coordination challenges, while a lack of continuity in the troika teams added to the burden on the country authorities. Moreover, while the IMF made decisions in a structured fashion, decision making by the euro area was more fragmented, spanning multiple institutions and varying levels, including heads of states. All in all, the Greek authorities found the process to have exacerbated uncertainties and reduced the possibility of early agreements. They also endorsed the Fund staff's recommendations to streamline troika procedures and documents.

In a joint statement to the Board, responding to the 2013 EPE for Greece, Executive Directors representing euro area countries "beg[ged] to differ on the assessment of the relative areas of expertise within the troika" and believed that "the functioning of the troika in Greece was overall much better than described in the paper." Moreover, although internal troika discussions were acknowledged as protracted at times, those discussions "improved the quality of the policy advice." The Board summing up concluded that "mindful of the need to ensure equal treatment across the Fund's membership, Directors generally saw scope for tailoring the Fund's lending policies to the particular circumstances of monetary unions, including appropriate modalities for collaboration with the union-level institutions."

The EPE for Ireland (IMF, 2015a) did not discuss troika coordination itself, but noted that close and effective interaction between the IMF and relevant union-level authorities was required for program success. Interviews with troika teams for Ireland revealed that troika coordination was smooth, notwithstanding internal policy disagreements that were significant at times. To some extent, according to those interviewed, this smooth process may have reflected early lessons from the Greek experience. That said, the EPE for Ireland identified similar issues with the troika process as in Greece: initial teething issues as the teams learned to establish what would become a "very effective" working relationship based in part upon complementary expertise; and the difference in perspective between the IMF, with its country focus, and the European institutions, with their euro area focus.

The Irish authorities did not comment on the troika process for the EPE report. However, at the relevant Board meeting, the Alternate Executive Director for Ireland stated that "from a practical point of view, where the IMF is involved in a multi-institution program, it is much better for the program country if there is some form of coordination body, such as was in place with the troika. The troika worked reasonably well in Ireland and it certainly would have been more difficult to run a multi-institution program without such a coordinating entity." Executive Directors representing euro area countries in their joint statement expressed the view that "the success of the Irish program also illustrates the effectiveness of cooperation with the troika." The Board summing up did not mention issues related to troika collaboration.

The IEO conducted not-for-attribution interviews in June 2015 with staff of the EC, ECB, and ESM/EFSF who had worked as team members in the cases of Greece, Ireland, and Portugal.[35] Overall, they saw troika teamwork as a continuation and deepening of a rather successful EU-IMF coordination experience in Hungary, Latvia, and Romania. They pointed out that while the troika arrangement was broadly similar in each case, differences emerged that reflected the individual countries' economic circumstances and political situations, as well as the personalities and working styles of troika team leaders and other members. Some differences in working style stemmed from differences in institutional procedures; in particular, IMF mission chiefs had more delegated authority than EC/ECB heads, although as they gained experience the EC/ECB teams felt they were given more room for maneuver. Effective cooperation was seen to require trust and direct, open communication among all troika partners. Typically, troika teams took time to build the requisite trust in each other and personnel changes could necessitate a partial reset. Trustful and constructive personal relationships were viewed as vital for successful cooperation. Experience also showed that some policy disagreements among troika teams could only be resolved at a political level. That said, some European interlocutors expressed the view that direct contacts by IMF staff (on topics such as debt restructuring) with major euro members (such as Germany) outside the troika arrangement could create possible misunderstandings, to the detriment of troika cooperation.

European interviewees expressed some annoyance and surprise at the fact that IMF teams seemed not to understand or appreciate the constraints placed on national policy options by countries' membership in the European Union and the euro area currency union. In their view, IMF teams appeared to have an individual country focus and to pay only limited attention to the implications for—or spillovers to—other EU/euro countries. They contrasted this focus with the EC/ECB emphasis on preserving the single market and currency union; on minimizing spillovers (such as could have affected other euro area members from the proposed "haircut" for Irish senior bondholders); on avoiding tilting the competitive playing field via state aid (particularly in the financial sector); and on adopting common practices for all EU countries. Nonetheless in their view, collaboration with the IMF resulted in valuable creative tensions, forcing EC/ECB teams to question their implicit operating assumptions and to encourage changes to various EU/euro rules/policies.

[35] The ECB in written testimony to the EU Parliament described troika cooperation as conducted in "a very good and fruitful manner. The different perspectives and experiences that the three institutions bring to the table provide for a more complete assessment and minimise possible errors or omissions."

The smooth coordination of troika conditionality could have suffered, but in fact did not, from two stumbling blocks. One, fiscal conditionality by both the IMF and EC was set consistently ex ante, but could have been inconsistent ex post. In the IMF arrangements the fiscal performance criteria were based upon cash nominal euro amounts for the primary deficit in the cases of Greece and Ireland and the cash nominal overall deficit in the case of Portugal. The EC's fiscal target—in line with the Stability and Growth Pact and the Excessive Deficit Procedure—was set on the overall deficit relative to GDP, using European System of Accounts (ESA) accrual accounting. The European Court of Auditors criticized in its 2015 audit the EC's monitoring of fiscal targets based upon ESA accrual, owing to problems with timely measurement, and recommended instead the use of quarterly cash balances with arrears limits. Automatic fiscal adjustors were features of the fiscal performance criteria for Greece and Ireland but not of the EC's corresponding fiscal targets. These definitional differences could have meant that the fiscal targets set by the IMF or EC could have been missed while the other institution's fiscal targets were met. As recommended in the EPE for Ireland, "a unified approach would have helped communicate the program objectives more effectively and avoid possible uncertainties and mixed signals."

The second possible stumbling block stemmed from the extensive and detailed structural measures that the EC included in its MOU—estimated by the ECA at nearly 400 in the cases of Ireland and Portugal—compared with the Fund's more parsimonious approach to structural benchmarks.[36] With respect to structural conditionality, both the EC and IMF followed a review-based approach to determining whether to disburse their respective tranches. A review-based approach allows considerable flexibility to determine whether specified structural measures have been adequately implemented and whether to disburse. Thus as a result, the more numerous and detailed structural measures imposed by the EC did not produce inconsistent outcomes from the IMF's more parsimonious approach to structural conditionality. However, such consistency is not assured and greater procedural clarity would be desirable. As the numerous and detailed structural measures contained in the EC's MOU have been criticized (for example by Pisani-Ferry, Sapir, and Wolff, 2011b), some movement toward the IMF practice might contribute to lessening this potential problem. In addition, the IMF staff concluded (IMF, 2015b) that extensive structural conditionality may have resulted in reform fatigue in some cases; as the number of structural measures increased, the percentage that were promptly implemented declined. The staff also observed that the combination of IMF and EC structural conditionality may have strained the authorities' implementation capacity. The European Court of Auditors (ECA, 2015) recommended that "[structural] conditions should

[36] Albeit less parsimonious in these three euro program cases than in Fund-supported programs with countries outside the euro area (IMF, 2015b).

be used sparingly, and should clearly relate to reforms that are essential to crisis resolution or the repayment of assistance. Programme teams should be obliged to justify the need for each and every condition."

On Which Side of the Negotiating Table Should the ECB Sit?

The IEO's evaluation of "The IMF Response to the Financial and Economic Crisis" (IEO, 2014) reported that in the context of the euro crisis some G20 authorities thought it was "inappropriate, from a governance perspective, for the IMF to be seated at the negotiating table alongside the monetary authority of a member country. In their view, this implicitly took certain policy actions 'off the table' and constituted bad governance."

In their statement on April 11, 2010, the euro area heads of state defined the European Central Bank's role in the troika arrangement as to work "in liaison" with the EC, which was tasked with negotiating conditionality—the MOUs—for the European financial assistance program for Greece. The ECB was also to provide assessments of economic developments under the program to the Eurogroup as an input for its disbursement decisions.[37] Subsequently, these liaison and assessment functions of the ECB were enshrined in the ESM Treaty, which was signed on February 2, 2012.

Some IMF Executive Directors, country authorities, and commenters have expressed the view that it was inappropriate for the monetary authority—the ECB—to be seated on the same side of the negotiating table as the IMF (Bernes, 2014). Pisani-Ferry, Sapir, and Wolff (2011b) have cited several potential conflicts of interest between the ECB's euro-wide policy responsibilities and its role in the troika. One, that the ECB's focus on price stability might bias its recommendations toward fiscal consolidation in program countries. Two, that the ECB's responsibility to provide liquidity assistance to banks could conflict with its responsibility to protect its balance sheet by bailing in the private and official sectors. Three, that Securities Markets Program/Outright Monetary Transactions operations in a program country can cause the ECB to become a significant sovereign creditor, possibly causing it to take a tougher line on fiscal adjustment and debt restructuring.

These same governance issues and conflicts of interest, albeit over different policies, could be seen to arise with the EC's role in the troika, too. For example, bank restructuring and competition policies at the EU level had significant implications for program design and implementation for Greece, Ireland, and Portugal. Moreover, conflicts have been perceived between the

[37] Pisani-Ferry, Sapir, and Wolff (2011b) offer three reasons for ECB involvement in the troika: (i) the ECB had significant exposure in these countries, particularly Greece and Ireland; (ii) euro area leaders trusted the ECB's judgment; and (iii) the ECB could directly counter any IMF recommendation that might challenge ECB policies.

EC's role as "guardian of the Treaty" and its tasks as Eurogroup agent in the troika (European Parliament, 2014a). These various concerns plus others led the European Parliament in February 2014 to adopt a resolution that, inter alia, called for the creation over the medium term of a European Monetary Fund by combining the financing role of the European Stability Mechanism with the EC's conditionality functions. The European Parliament also requested that the "ECB be given the status of a silent observer with a transparent and clearly defined advisory role, while not allowing it to be a full negotiation partner."

In written testimony to the EU Parliament, the ECB described its troika role as follows: "ECB staff provides advice and expertise on a broad range of issues which are relevant for ensuring a proper functioning of the transmission mechanism of monetary policy (including debt sustainability), contributing to financial stability, and ultimately supporting the general economic policies of the Union. The decision to grant financial assistance, including the conditionality attached, lies with ECOFIN and the ESM Board of Governors" (ECB, 2014). As described, ECB staff sat next to the EC staff at the negotiating table and across from the national authorities of the euro member, listening and advising, while conditionality associated with euro area financial assistance was set by the ECOFIN/ESM and not the ECB. While this arrangement was formally and legally valid, the ECB nonetheless played a significant role in program design, owing to its views on several threshold issues (such as debt restructuring; fiscal adjustment; bank "deleveraging") and actions (such as providing bank liquidity; lowering sovereign interest rates via the Securities Markets Program). Meanwhile, the authorities of the national central bank (which like the ECB and other national EU central banks is part of the European System of Central Banks), sat alongside their national authorities, voicing their bank's views on topics related to bank supervision, bank restructuring, and national emergency-liquidity assistance.

As noted earlier, when the IMF conducts surveillance of a currency union, it does so at two levels—the national and the supranational, or union, level—based on where the policy competency is located. Thus, when dealing with the euro area, the IMF conducts its surveillance over the EC and ECB as well as individual euro members. The supervision of banks within the euro area was a national policy competency until November 2014, when the ECB became the single supervisor. Provision of bank liquidity, or effectively in some circumstances the lender-of-last-resort function for banks within the euro area, is split between the ECB and the emergency liquidity assistance (ELA) provided by the national central bank. This same two-level arrangement applies to IMF surveillance of the CEMAC, WAEMU, and ECCU, but in these three currency unions bank supervision and the provision of emergency liquidity to banks is a union-level responsibility, according to the IMF staff (IMF, 2012b). The supranational and national authorities of these four currency unions can be viewed as sitting on the same side of the table and across from the IMF during Article IV consultations.

Currency unions, or other regional financing arrangements, are not IMF members and therefore they cannot request to use Fund resources.[38] However, for a country within a currency union the split in policy competencies that affects the conduct of IMF surveillance also affects the design of programs and the implementation of policy. In particular, the IMF's conditionality guidelines state that "conditions will be established only on the basis of those variables or measures that are reasonably within the member's direct or indirect control. . . ." Policy competencies that have been transferred to a supranational institution can reasonably be assumed to be outside the control of the national authorities. While the Fund's surveillance policy and associated operational guidelines explain how surveillance for a currency union member should be conducted, the Fund's conditionality guidelines do not offer similar explicit instructions to IMF staff, national authorities of currency union members, or supranational institutions of the currency union.

IMF-supported programs are customarily negotiated with the country's fiscal and monetary authorities. Thus typically the finance minister and governor of the central bank sign the IMF's letter of intent. When the IMF member is also a member of a currency union, the program negotiations take place with the national authorities, usually led by the finance minister. In the case of the CEMAC, WAEMU, and ECCB, the respective regional central bank often sends a representative (from the local/national office) to follow developments and to clarify issues pertaining to monetary policy. Unlike the European Central Bank, these regional central banks have not participated in joint missions with the IMF staff to design program conditionality. In these three currency unions, letters of intent are customarily signed only by the finance minister of the country using IMF resources. In the cases of Greece, Portugal, Ireland, and Cyprus, the letters of intent were signed by both the finance minister and the governor of the (national) central bank. The latter signed because the national central bank has a separate legal identity from the ECB and possesses germane policy competencies (bank supervision, emergency liquidity assistance).

According to the IMF Legal Department, under Article V, Section 3(*a*) of the IMF's Articles of Agreement the IMF can impose program conditionality on union-level institutions such as the central bank (or can more generally require union-level measures) under certain circumstances (IMF, 2015b).[39] Measures at the union level must be macro-critical and needed for the success of the Fund-supported program with a member of the currency union. In

[38] Only individual members of a currency union can request Fund financial support. Fund conditionality is applied in order to safeguard the Fund resources used by the requesting member.

[39] Union-level measures may be difficult to implement in practice, because policy changes that may be desirable from the point of view of a particular member may not be so for others in the union, particularly if spillovers from the member to others are not considered to be systemic. More generally, union-wide policies can be hard to change quickly as they can involve complex decision-making procedures and multiple countries.

several instances, program conditionality has been effectively directed at the regional central banks of the CEMAC and WAEMU as well as the ECCU. In one instance, the CFA franc was devalued against the French franc to establish the necessary conditions for IMF-supported programs with members of the CEMAC and WAEMU. Following the devaluation, eleven Fund-supported programs were in place by end-March 1994 (IMF, 1995). In another instance, prior to the monetary reforms of 1993–94 in the CEMAC and WAEMU, the national fragmentation of financial markets within these currency unions led the IMF to impose national limits—quantitative performance criteria—on the net domestic credit of the national agency of the regional central bank. In the CEMAC, ECCU, and WAEMU, limits that were set on net credit to the government from the banking system typically took the form of performance criteria for the program countries. Limits on net credit to the government from the banking system were also used in IMF-supported programs for euro area countries. In a third instance, a special audit of the regional central bank (BEAC) for CEMAC revealed a significant risk that unauthorized outflows from BEAC's reserves could occur due to poor oversight and inadequate internal controls. Under the IMF's safeguard assessment program, remedial measures were identified and implemented in accordance with a time-bound action plan: IMF program reviews and new IMF programs for CEMAC countries would only proceed as long as BEAC made satisfactory progress. Board consideration of program reviews scheduled for the Central African Republic and Republic of Congo was postponed because of BEAC's delays in implementing some of the actions (IMF, 2010c).

On two different occasions, structural conditionality was linked to actions under the authority of the Eastern Caribbean Central Bank (ECCB). In the first case, the letter of intent from the Finance Minister of Antigua and Barbuda, dated May 2010—the same month/year that the IMF program with Greece was approved—attached a letter from the Governor of the ECCB that "took note" that structural benchmarks—on the recapitalization of the Bank of Antigua and onsite inspection of domestic commercial banks—required direct actions by the ECCB. The Governor welcomed the inclusion of these benchmarks and gave assurances that the ECCB would take the necessary steps to observe both within the specified time frame. In the second case, in December 2011, the ECCB Governor sent a similar letter in the case of St. Kitts and Nevis promising that bank stress tests would be conducted and that the results would be shared with IMF staff as specified in the relevant structural benchmark.

In the euro area, the European Central Bank announced in August 2012 the creation of a new instrument—Outright Monetary Transactions (OMT) in the secondary sovereign debt market—that is intended to safeguard an appropriate monetary policy transmission and the unitary nature of euro area monetary policy. According to the ECB, no ex ante limit would be set on the size of OMT. To qualify for OMT, a member country must conform to strict and effective conditionality attached to an appropriate ESM program;

the ECB will terminate OMT operations wherever there is non-compliance with the macroeconomic adjustment program. The European Court of Justice (2015b) ruled that the ECB's OMT program as constructed was consistent with EU treaties. Thus, the ECB could use OMT to reduce or eliminate excessive risk premiums in sovereign yields, but it should not go further than necessary. The Court also ruled that the ECB has the authority to purchase government bonds in the secondary market—but only so long as such purchases would not have an effect equivalent to direct purchase of government bonds, and thereby undermine the effectiveness of the prohibition in Article 123 of the Treaty on the Functioning of the European Union. Interestingly, the Court did not mention the recommendation made by the Advocate General in January 2015 that the "ECB refrain from any direct involvement in the financial assistance programmes to which the OMT programme is linked." Consequently, the ECB can still legally participate in the troika.

Using various central bank instruments (especially where currency-union financial markets are fragmented), a regional central bank could help individually small national economies to adjust their monetary conditions to their cyclical situations without adversely affecting monetary conditions in the currency union as a whole (see Kincaid and Watson, 2015). To tailor the design of fiscal policy to the prospective monetary situation in a euro-program country, troika teams need insight into that situation. Such insight could come from the ECB being more forthcoming with the IMF/EC teams about its policy intentions with respect to program countries within the currency union. Another example where the ECB could be more forthcoming concerns its ex ante commitments to as-needed bank liquidity support; Ajai Chopra, former IMF mission chief to Ireland, in testimony (September 2015) before the Irish Parliament, criticized this lack of ex ante commitment, noting that it hurt confidence in the banking system and likely increased the required amount of Euro-system funding. Moreover, in the summing up for the EPE on Ireland, Executive Directors "noted that securing strong commitments upfront from monetary union authorities would be important when those are critical for program success." Ex ante commitments need to be followed through. In the case of Greece, the Fund staff noted (IMF, 2011c) that "contrary to program expectations," the ECB Governing Council had not made a decision on accepting eligible collateral from the proposed tranche of government-guaranteed bank bonds. In the judgment of Fund staff, this was "itself a negative factor for system stability and is almost certainly contributing to tight credit conditions."

Beginning in November 2014, the Single Supervisory Mechanism for the euro area banking system came into force with the ECB as the central prudential supervisor. The ECB directly supervises the largest banks while the national supervisors continue to monitor the remaining banks following instructions given by ECB. Thus, the national competencies for bank supervision have been transferred to the ECB. The Single Bank Resolution

Mechanism for the euro area, with its own board (Single Resolution Board), became fully operational at the start of 2016. This means that the structure of euro area bank supervision is now more similar to that in the CEMAC, WAEMU, and ECCU. Thus, rather than the relevant national central bank or supervisory agency, the ECB and the Single Resolution Board would now seem to be the proper interlocutors for the IMF/EC on bank supervision and bank restructuring for an individual national system within the euro area. In addition, the ECB has policy instruments that can be directed toward monetary conditions in individual national economies without compromising its area-wide responsibilities. For example, macro-and micro-prudential tools could be used to affect bank lending and deposit rates only in program countries. Given that ELA provision and some macro-prudential tools remain in the hands of national euro area authorities, the relevant national authorities would seemingly also merit a seat at the table.

Was the IMF a Junior Partner in the Troika Arrangement?

The nature of the IMF's role in the troika arrangement was questioned from the very beginning with the IMF being termed a "junior partner" in the troika arrangement. Two aspects have received attention: financial contributions and policy substance. As regards financial contributions, the IMF clearly was a junior partner, committing at most one-third of the program financing for Greece, Ireland, and Portugal, and substantially less in later joint programs for euro-crisis countries (Table 5.2 above). Only Ireland received the full amounts that the IMF and EC committed. Portugal decided not to request its last disbursement from either the IMF or the EC, following an adverse Constitutional Court ruling on expenditures, requiring more time to formulate a comprehensive response. In Greece, two-thirds of the amounts that were committed by the IMF and under the Greek Loan Facility were disbursed before these programs were replaced. Interestingly, this pari passu approach to disbursements did not continue with the Greece II or III programs, to which the IMF has not committed financial resources. With the Greek program off track, the last IMF purchase occurred in June 2014, lifting IMF credit outstanding to Greece to SDR 24.7 billion; subsequently, however, IMF credit outstanding to Greece declined to SDR 12.5 billion at end-January 2016, shortly after the Greek authorities cancelled the EFF. During this same period (June 2014 to end January 2016), the European Stability Mechanism (ESM) made net disbursements of €12.5 billion to Greece.

European interviewees observed that IMF loans are legally senior to loans from the European Financial Stability Fund and the European Stability Mechanism. The ESM treaty formally recognizes that IMF loans are senior to ESM loans. The original pari passu clause in the EFSF/ESM loans was waived for Ireland and Portugal to allow early repayment to the IMF. Moreover, when Greece failed to make scheduled repayments to the IMF in mid-2015, creating overdue obligations to the IMF, European partners accorded Greece enough European financial assistance, with appropriate conditionality, to allow it to extinguish its overdue IMF obligations and to help prevent a recurrence of arrears to the IMF.

With respect to policy substance, the perception expressed by outside commenters has been that program design decisions were taken by the EC and ECB, backed by the Eurogroup. For example, "if a regional grouping can set IMF conditionality, what is the point of the Fund anyway? This could create a very dangerous precedent" (Goldstein, as reported in the *Financial Times*, April 2010). The Fund's "credibility is being squandered by the IMF serving as the junior partner…" (Chowla, 2011). The Fund "is the junior partner in a 'troika' of institutions…" whom "the pro-austerity ECB and EC has outmuscled" and "the Fund's views count for less than its partners" (Coggan, 2012). The IMF has been "used as a cover for the continent's policy makers and its independence lost" (Mandeng, 2013); in a similar vein, "the IMF has toed the European/German line on the crisis, possibly to the disservice of Europe and the world" (Subramanian, 2012). The occasional contrary view appeared in the press: "the Fund could be a junior partner in terms of financing but a senior partner in terms of negotiations" (Prasad, quoted in Beattie, 2011b). Reflecting this debate, the IEO (2014) observed that the troika arrangement "raises questions as to whether it afforded greater traction of IMF's policy advice, or whether it increased the pressure on the IMF to compromise its positions."

To obtain a view from inside the troika, not-for-attribution interviews were conducted by the IEO with staff from the EC, ECB, ESM, and IMF who had participated in troika activities for Greece, Ireland, and Portugal. Their clear and common opinion was that the IMF was not a junior partner with respect to the policy substance of these programs. But neither was it a senior partner. This contrasted with the IMF's customary sole, or lead, role in its lending to emerging market and developing countries. From a European perspective, the IMF needed to get accustomed to not being alone in the driver's seat and to learn to act in tandem with EU institutions. The three troika partners were frequently described as each having a veto power on actions, which forced them to find collectively an approach that each of them could accept. The European agencies' veto power derived from their financial contribution but also from the need for the program country to have its policy actions endorsed by the EC, ECB, or European Council, given its EU treaty obligations. The IMF's veto power stemmed from the recognition of its considerable expertise and crisis-management experience, and its credibility with key euro members and their parliaments whose consent was required in the context of EFSF/ESM lending decisions. Thus, the troika arrangement was effectively viewed as comprised of co-equal partners.

These interviewees also disputed the notion that the IMF's relatively small financial contributions muted either its voice in policy debates or its impact. To support this contention, they observed that it was the IMF's expertise and experience, and not its financial resources, that prompted its invitation from the Eurogroup to participate. In addition, they pointed out that in the second Greek program (the EFF) and the Cyprus program, the Fund's influence over program design remained unchanged even though its financing share had fallen (to 16 percent and 10 percent, respectively, from roughly one-third). They noted the IMF staff's key roles in assessing (in 2011/12) the suitability of the Greek sovereign debt restructuring and the bank restructuring in Cyprus.

Clearly various outside commentators viewed the situation differently from the troika participants. To draw one's own conclusions, it is necessary to identify specific situations in which the IMF and EU institutions apparently had, at least initially, a difference of view on the preferred policy approach, and then to discern whether the troika arrangement as a coordinating device was the responsible driving force or whether membership in the euro area currency union was the dominant force. Specific situations examined below are: (i) the disagreement about sovereign debt sustainability in Greece, along with the introduction of the systemic exemption clause to the Fund's exceptional access policy; and (ii) the disagreement about how to treat senior bank bondholders in Ireland. This section draws heavily on other chapters of this volume.[40]

The IMF has been criticized (and has criticized itself in the EPE for Greece (IMF, 2013e) for not restructuring Greece's sovereign debt in early 2010 and for introducing the systemic exemption clause to the exceptional access policy in May 2010. In 2010, both the EC and ECB were opposed to sovereign debt restructuring, as were the Greek authorities. The IMF staff was divided on this issue. At that time, Fund management decided not to press for debt restructuring, owing to worries about possible contagion within the euro area (which lacked an adequate firewall) and about spillovers to a fragile world economy struggling to recover from the global financial crisis. These concerns were shared by at least some major IMF shareholders, notably the United States. If the troika—a coordinating arrangement—had not existed, would anything have changed? Since Fund management (and major non-euro IMF shareholders) considered debt restructuring by Greece to be too risky for the euro area and the global economy in early 2010, the Fund would probably not have proposed debt restructuring even had it been alone in the driver's seat.

What about the decision to introduce the systemic exemption clause to the second criterion into the Fund's exceptional access policy? This decision, taken at the IMF Board meeting to approve the SBA request by Greece, was purely an internal IMF matter, and IEO interviews suggest the euro area partners were as surprised by this change as other IMF shareholders. Indeed, euro area partners tended to regard Greece's sovereign debt as sustainable if

[40] Country case studies by Donovan (2017); Eichenbaum, Rebelo, and de Resende (2017); and Wyplosz and Sgherri (2017); and studies on fiscal policy by Kopits (2017). For financial sector policies see Véron (2016).

supported by the requisite fiscal consolidation, resulting in the programmed primary surplus of 6 percent of GDP. But some senior IMF staff, in particular those in the Legal; Research; and Strategy, Policy, and Review departments, had serious reservations about debt sustainability; they did not think that "a rigorous and systematic analysis indicate[d] that there is a high probability that debt will remain sustainable" as required under the exceptional access policy. At the same time, senior staff in the European; Monetary and Capital Markets; and Fiscal Affairs (FAD) departments argued that restructuring Greece's debt would be too risky for the rest of the euro area if not the world.[41] Moreover, some Fund senior staff argued that there was insufficient time to organize an orderly debt restructuring before large debt repayments fell due in mid-May.

Faced with serious doubts about debt sustainability, IMF management searched in April 2010 with senior staff for ways forward. IMF management was concerned that changing the debt sustainability criterion under the exceptional access policy might send an adverse signal to financial markets about the strength of the program, undermining its chances for success. Some IMF senior staff advocated that the IMF should approach European partners to obtain assurances that European lending over the medium term would be sufficiently concessional to help achieve debt sustainability. Other senior staff (SPR/LEG) noted that any change to the exceptional access policy could be "done quietly" in the SBA staff report; the Board discussion would enable further oral clarifications. In the end as observed by Schadler (2017), the decision to introduce the systemic exemption clause was made at the last minute and staff did not call attention to this policy change which was ["quietly"] embedded in the assessment of the second exceptional access criterion. Staff only offered oral clarifications after one Director questioned during the Board meaning of this passage in the staff report. Interviews with government officials from major non-euro IMF shareholders indicated that they supported introduction of the systemic exemption clause on the grounds that it was deemed necessary to allow the IMF to lend, albeit considering this change to merely be a "housekeeping" matter at the time.

The above analysis should not be construed as validating the decisions made, or as endorsing the IMF's decision-making process, particularly regarding the introduction of the systemic exemption clause. Indeed, the IMF eliminated the systemic exemption clause in early 2016. Findings and conclusions related to IMF decision-making are outside the scope of this study, but are examined by De Las Casas (2017).

As economic developments in Greece turned out to be worse than projected and the euro area made policy changes such as the creation of the European Financial Stability Facility and the ECB's Securities Markets Program,

[41] For an FAD perspective on default in an advanced economy like Greece see Cottarelli and others (2010).

IMF management and staff became convinced that sovereign debt restructuring was necessary and feasible. They made their arguments for debt restructuring within the troika, starting in late 2010 and extending into 2011. With the passage of time, more European partners recognized the changed fundamentals. In July 2011 euro governments announced that the EFSF loan terms would be softened by extending their maturity and lowering their interest rate—effectively constituting official sector involvement—and that private sector involvement on a voluntary basis would take place as "an exceptional and unique solution" (DG-ECFIN, 2011c). Euro leaders accepted an initial proposal by the Institute of International Finance (Henning, 2011) for sovereign debt restructuring. However, IMF staff analysis concluded that this proposal was overly generous to private creditors and would not achieve debt sustainability (IMF, 2011d). As a consequence, the Institute's proposal was revised to give private creditors a bigger haircut and a new agreement with euro leaders was reached in mid-October 2011. The deal closed in March 2012.[42] These developments demonstrate that the IMF played an influential role but at the same time the key decisions were taken in Brussels and not in Washington. Greece's membership in the euro currency union was the underlying reason for the decision-making locus to be in Brussels with the Eurogroup.

In the case of Ireland, IMF staff and management supported a "bail-in" of senior unsecured bank bondholders, or private sector involvement (IMF, 2015a; Donovan, 2017). While this bail-in would have benefitted Ireland albeit its size was modest, concerns about adverse spillover effects to the rest of the euro area caused the ECB and EC to oppose it. The Irish authorities were caught in the middle. IMF management took its case to the G7 finance ministers, and in a teleconference in November 2010 the U.S. Treasury Secretary vetoed any haircut for senior unsecured bank bondholders because it might spread via contagion to the European banking system and then back to the U.S. banking system. This episode shows that the IMF management had a "court of appeals" for policy disagreements with its euro partners. In this instance, the "court" supported the euro area's policy view and not the IMF's. This scenario could have played out in the same way without the troika arrangement—witness the involvement of the G7 during the Asian and Latin American crises. Also of interest in this case is that the G7, and not the G20 or the IMF Executive Board, was the forum selected to resolve this dispute.

The pace of fiscal consolidation and its implications for real growth were recurrent tension points among the troika partners in all three programs with euro area countries, as they had been in the three earlier programs with non-euro EU members (Annex 5.1). As noted by Kopits (2017), these three

[42] Even this revised debt restructuring has been deemed too expensive for Greece (Zettelmeyer, Trebesch, and Gulati, 2013), and as continuing a pattern of "too little, too late" (IMF, 2013c).

programs were constrained by currency union membership; in particular, the pace of fiscal consolidation was influenced by the EU institutions' desire for program countries to reach the Maastricht reference level for the fiscal deficit (3 percent of GDP) by the end of the program period. The program fiscal targets proposed to the country authorities thus represented compromises reached within the troika. In addition, as the program countries' real GDP turned out to be lower than projected, debates ensued among the troika teams pertaining to the operation of automatic fiscal stabilizers. They burst into the open with the publication of the October 2012 *World Economic Outlook*. That *WEO* reported empirical results showing that the short-term fiscal multipliers used for the three euro area programs had been systemically underestimated, implying a larger than projected fiscal drag on real activity. Both the EC and ECB published rebuttals (Box 1.5 in the EC's *European Economy* No. 7/202, and Box 6 in the ECB's *Monthly Bulletin*, 12/2012), adding other relevant macroeconomic variables to the equations and producing fiscal multipliers close to the value (0.5) employed in these programs.

As regards the three program countries, interviews conducted by the IEO indicated that their authorities tended to side with the EU institutions because they wanted to be considered "good euro area citizens." Moreover, since the three countries had lost access to private creditors, following a more gradual fiscal adjustment path would have required greater official financing, which was not forthcoming from the EFSF/ESM or from the IMF. A more gradual fiscal adjustment would have also exacerbated already-existing concerns about the sustainability of these countries' public debt, and adding relatively more senior debt from the IMF could be seen as adding to the possible haircut for private creditors as well as augmenting the risks for the IMF. These conundrums were not a product of the troika arrangement but were a product of the underlying economic situations and currency-union constraints.

Turning to financial sector policies, IMF staff were considered to be better prepared than the other troika partners, particularly in the initial years. According to Véron (2016), IMF staff had the needed experience with the politically difficult sequence of bank triage, recapitalization, and bank restructuring, which was most evident in Ireland and Spain and least in Portugal. On several occasions, the IMF's heft, leadership, and problem-solving built consensus with the troika, and the Fund also showed itself more adept at interacting and learning from financial market participants. IMF staff members working on financial sector issues also earned the respect of key national policymakers for their competence, impartiality, and discipline. Tensions nonetheless arose among the EC, ECB, and IMF, in large part owing to institutional differences of perspective and interests. Véron (2016) reports that the need to reach a troika consensus often resulted in better policy assessments and choices than if the IMF had been acting alone. He also observes that the IMF staff on several occasions appeared unwilling to acknowledge the EU's institutional realities, especially as regards state aid to the financial sector, to the detriment of the IMF's own effectiveness.

In summary, the IMF was clearly a junior financing partner compared with the euro area institutions. According to troika participants, the junior financing status did not lessen the IMF staff's impact in policy debates within the troika. This judgment (based upon interviews) is most strongly supported by the basically unchanged policy influence of the IMF staff in the design of the later programs for Greece (EFF) and Cyprus, notwithstanding the sharp drop in the IMF's relative financial contribution.

Of course, the IMF's influence might still diminish as the IMF's financing share approaches zero. Here the experience in Spain is instructive. Spain's program financed by conditional lending from the European Stability Mechanism was not accompanied by access to Fund resources, and the role, scope, and impact on policy conditionality of IMF staff lessened—by design—dramatically from those in the euro area country cases that used Fund resources.

In conclusion, the IMF was not a junior—policy—partner in the troika arrangement but neither did it play its customary role as the senior, or lead, policy partner. Co-equal partnership seems the appropriate characterization.

Key Findings and Conclusions

The Eurogroup devised the troika arrangement in 2010 to meet their requirements and capabilities at that time. IMF management and the IMF Executive Board implicitly accepted this arrangement, as the modus operandi for joint efforts to lend to euro countries in crisis. Because IMF management and the Executive Board did not approve explicitly the IMF's participation, define its role in the troika arrangement, or produce written operational modalities, it is not possible to assess outcomes relative to expectations. Nor has the Executive Board yet endorsed the 2011 nonbinding G20 Principles for Cooperation between the IMF and regional financing arrangements. In any event, those principles are crafted with too high a degree of generality for evaluation purposes.

The IMF has a long history of parallel, conditional lending operations with the World Bank (and regional development banks). Indeed, IMF staff have asserted (IMF, 2012b) in the context of the troika that the Bank-Fund Concordat "can be transposed to coordination with other [regional] institutions." These principles thus can provide a frame of reference to evaluate the troika arrangement from the IMF's perspective. The Concordat was agreed mutually at the highest level—by the World Bank President and IMF Managing Director—and then circulated to the respective Executive Boards.

No mutually agreed principles exist for the troika arrangement. *Agreed written principles on joint lending operations between the heads of the EC, ECB, and ESM and the IMF Managing Director would provide clarity for all parties* *plus member countries.*[43] Establishing clear principles that are mutually agreed for parallel conditional lending operations would promote more efficient interactions among troika partners and between the troika and the borrowing country. These mutually agreed principles endorsed by the appropriate governing bodies would also enhance the legitimacy of the troika arrangement and the accountability of the troika institutions.

Similar agreed cooperation principles adapted to the circumstances of each regional financing arrangement might also prove useful for the Fund's possible program involvement with regional financing arrangements (RFAs). The International Monetary and Financial Committee called in 2011 for the IMF to work with RFAs to develop broad cooperation principles. Meanwhile the G20 established in late 2011 nonbinding principles, but the Executive Board has had no formal—decision-making—discussion of those principles; it has only discussed them informally—non-decision-making. The Executive Board in both 2014 and 2015 generally supported the development of cooperation guidelines with RFAs. *It is time for the Board to discuss formally the G20 principles for cooperation between the IMF and RFAs and for the IMF staff to develop individualized principles for cooperation with each RFA.*

The troika arrangement was uniquely developed by the Eurogroup to benefit from the IMF staff's technical expertise and crisis-management experience, allowing coordination of their separate but parallel conditional lending operations. In these circumstances, a major challenge in studying the troika arrangement is to disentangle the implications for program (policy) design of the conditional loan coordination process from the underlying implications of membership in the euro area and EU. Because it may be impossible to adequately disentangle these two factors in the troika's operations, it would be hazardous to apply lessons learned from the troika arrangement to other regional financing arrangements that are not currency unions. As for RFAs with currency unions, the lessons would depend on their similarity with the policy and financing frameworks developed by the euro area and the EU. Consequently, cooperation frameworks between the IMF and any RFA would need to be individually tailored, although based upon broad principles in order to ensure consistent treatment across RFAs.

The troika arrangement proved to be operationally efficient, although areas for improvement were also identified. Conditional lending programs were negotiated quickly by the troika with the country authorities and program reviews were by and large completed expeditiously; program delays could not be attributed to the troika process itself. This assessment is based on IMF staff reviews, EPEs for Greece and Portugal, and IEO interviews with troika participants and relevant country authorities. Areas for improvement in

[43] Any agreed collaboration principles would usefully be supplemented by operational guidelines for IMF staff. Such guidelines would help ensure that the IMF staff understands how to implement the agreed collaboration principles; prompt their consistent application; assist in the training of new staff members; and provide a means to disseminate experience within the IMF.

the troika arrangement include: (i) agreed procedures among the troika institutions that are transparently shared with their memberships and the public; (ii) enhancing the information flow to, and role of, the IMF Executive Board; and (iii) efforts to reduce burdens placed on country authorities by large missions, staff turnover, duplicate documentation, and extensive conditionality.

While the principle of lead institution based upon areas of primary responsibility that is used in the Bank-Fund Concordat cannot be easily applied to the troika arrangement, the Concordat does recognize that "there is a broad range of matters which are of interest to both institutions" and that therefore enhanced collaboration is needed between the institutions. In particular, close contacts between the two staffs including "sharing of information and views at the earliest possible stages" is expected to produce "improved and consistent policy advice." Thus, sharing of confidential information by IMF staff with Bank staff and vice versa is formally authorized; this is consistent with a G20 cooperation principle. No written principles for sharing of confidential information amongst troika institutions has been made available to the IEO. Written guidance to IMF staff on the sharing of IMF confidential with troika partners, which is consistent with the staff code of conduct, is also absent.

The IMF and EU institutions should regularize their mutual sharing of confidential information. Such an agreement has been proposed by the European Court of Auditors. An internal guidance note on the sharing of confidential IMF information would avoid possible inadvertent violations of the staff code of conduct. A cooperation document could also clarify issues related to the various IMF expectations described in the ESM Treaty. Procedures could be established to resolve differences of view at the mission level by involving their respective superiors. If such matters remain unresolved, interactions could take place between the appropriate IMF Deputy Managing Director and EU counterparts, and if necessary the IMF Managing Director and the corresponding head of institution can resolve matters. Such procedures would also provide that (in the words of the Bank-Fund Concordat) "in those cases, which are expected to be rare, the managements will wish to consult their respective Executive Boards before proceeding." This latter provision may need to be modified to fit differences in the memberships, voting powers, and governance structures of various currency unions and RFAs.

Articulating three other topics from the Bank-Fund Concordat could improve the IMF's relations with the EC, ECB, and ESM (and perhaps RFAs more generally):

- The IMF needs to avoid inconsistent conditionality with these institutions, especially in overlapping policy areas such as fiscal policy, financial sector restructuring, and structural reforms, while also avoiding cross-conditionality. Each institution should be allowed to proceed with its own financial assistance according to the standards required by its legal charter and governing bodies; this also is a G20 cooperation principle.

However, in the event one institution were to consider proceeding without the others, the conditions for such action should be understood in advance—including the scope for prior communication.

- Cooperation principles could spell out efforts to reduce the burdens placed on country authorities by large mission teams, frequent changes in team staffing, and needless duplication of documents.
- The implications of overdue obligations, or arrears, to one institution by a borrowing country for the actions of the other institutions could be usefully clarified in cooperation principles, recognizing of course the different nature of the various institutions (for example that debt obligations to the IMF are senior to those to the ESM); a G20 cooperation principle specifies that the IMF's preferred-creditor status must be respected.

Such an institutional agreement could also clarify the conditions for requests to the IMF to provide technical assistance when EU institutions are lending to a euro member, such as took place in the case of Spain, and the modalities to be used by the IMF in such a case. Thus, the rules of the game for such TA provision would be jointly and transparently established. In this connection, it would be useful if the IMF staff prepared an ex post evaluation for Board consideration of its technical assistance activities with Spain and the EU institutions during 2012–13. *This staff evaluation could identify lessons learned that could inform possible future such TA operations.*

Cooperation principles—such as embodied in the Concordat—are more about process than about the substance of program design and conditionality. The IMF has long recognized (see IMF, 1995) that program design and conditionality for countries that are members of currency unions need to differ from that for countries that have a flexible exchange rate and an independent monetary policy (in particular, fiscal policy and structural reforms must play a larger role in programs with countries that are members of currency unions). Moreover, policy competencies in a currency union are split between national- and union-level authorities. The implications of this split for the conduct of Article IV consultations are explicitly considered in the various IMF surveillance decisions and in the corresponding guidance notes to staff. But neither the 2002 Conditionality Guidelines nor the Revised Operational Guidance (IMF, 2014) inform the IMF staff or country authorities as to its implications for program design or conditionality. Where should the EC and ECB sit at the negotiating table and under what circumstances could program conditionality be appropriately assigned to them? A country's ownership of its policy program is crucial for successful implementation and is a central tenet of IMF conditionality guidelines. But the authorities in the euro area program countries also own their euro membership, wanting to be considered "good euro area citizens" in the eyes of the Eurogroup, EC, and ECB. This dual ownership can give rise to policy tensions, given the more constrained policy options associated with a currency union. Moreover, the economic governance structures built to support the euro area are stronger and more extensive than those in other currency unions, reinforcing member countries' tendency to follow the policy advice given by EU institutions. *Amending the Fund's Conditionality Guidelines by introducing an explicit treatment of issues germane to countries in a currency union would bring these guidelines into conformity with surveillance policy and practices, and promote evenhanded treatment of IMF members in different currency unions.*

The IMF was clearly a junior financing partner compared with the euro area institutions. However, this junior status did not appear to lessen the IMF staff's influence in policy debates within the troika. Nor did the Fund see its influence decline when its relative financing contribution declined in the EFF for Greece or the EFF for Cyprus, whose access to Fund resources was below the threshold to trigger the IMF's exceptional access policy. Of course, the IMF might see its influence diminish as its financing share approaches zero. At some point, the IMF might find its program (conditionality) involvement switched to an advisory (technical assistance) role with less influence, as was the case in Spain.

This junior financing role had advantages for the IMF, diminishing its exposure to credit risk and its need to borrow resources. Moreover, European partners were able to assist in the clearing of arrears by Greece to the IMF in mid-July 2015. Finally, the IMF's smaller financial contribution made it possible for the IMF to reduce its exposure to these three program countries even as the ESM maintained or increased its exposure.

Though the IMF was a junior financing partner in the troika, the evidence and analysis marshaled in this paper indicates that it was not a junior policy partner. But neither did it play its customary role as senior, or lead, policy partner. A co-equal partnership seems to be the appropriate characterization of the troika arrangement in the three cases examined. On occasions, tensions emerged within the troika regarding proper policy recommendations, but their resolutions were typically constructive and represented differences in judgment and institutional realities. The consistency of conditionality that was achieved by the troika partners enhanced effectiveness and reduced the burden on country authorities. But the policy product of troika cooperation should also be consistent with the IMF's mandate, policies, and practices, and recognize its independent decision making. (The same applies to the EU institutions.) In addition, the IMF should feel free to air publicly major policy differences with the EU institutions/Eurogroup and national authorities in order to preserve its credibility and independence—balancing of course the need to maintain its trusted advisor role. The disagreement between the IMF and EC over debt sustainability and fiscal sustainability in Greece, which became public in mid-2015, is a case in point.

The policy framework for exceptional access to Fund resources sets out stronger procedures for Board decision making on management's proposals for exceptional access than exist for regular-access proposals. These stronger procedures were intended to provide additional safeguards for the use of Fund resources and to enhance accountability and include, inter alia, an early, informal Board session on needed policy measures and program-financing parameters whenever management decides that exceptional access is appropriate. Additional informal meetings are to take place as needed to keep Executive Directors “abreast” of progress in policy negotiations and program financing. Such Board meetings are intended to “provide the basis for consultations with capitals, and the issues that emerge would be addressed in a further informal session.” Two interrelated questions can be posed in this connection. One, were these strengthened Board decision-making procedures followed in the spirit envisaged under the exceptional access decisions? Two, did these procedures keep the IMF Executive Board and their capitals as well informed as the euro area finance ministers who attended the Eurogroup meetings?

Based on written documents circulated to Executive Directors, transcripts of informal Board meetings, and interviews with Executive Directors, Alternates, and their staff, serious shortcomings existed in the information provided, and issues presented, to Executive Directors, notably about estimated financing gaps; preliminary figures on European and IMF financing; doubts about debt sustainability in Greece; need to introduce a systemic exemption clause into the exceptional access policy; and the IMF recommendation, plus EC/ECB opposition, to apply a haircut to senior unsecured bondholders in Ireland. In most cases, the Eurogroup had the relevant information or was aware of the issues. (The Eurogroup was not aware of the extent of the doubts by IMF staff about Greek debt sustainability in 2010 or the need to modify the exceptional access policy by introducing the systemic exemption clause.) The information asymmetry was not caused by the troika arrangement itself, but stemmed from internal IMF practices/decisions. Both SPR and LEG contend that Executive Directors were provided all necessary information to make decisions under Fund policies; in particular all the requirements of exceptional access policy were observed. In light of these findings, *the Executive Board might consider commissioning an independent review of experience with the implementation of the exceptional access policy, especially the extent of information provided and the policy issues that were presented during informal sessions.*

Finally, the troika arrangement has been cited as one facet of a broader IMF “Europe is different” mindset, producing more favorable treatment of the EU and euro area than of other IMF members. The above recommendations—to define program design and conditionality for currency unions; to develop mutually agreed cooperation principles with the euro area (and other regional financing arrangements), especially procedures to settle policy disputes; and to enhance internal IMF decision-making procedures—would collectively go some way toward remedying such actual or perceived uneven treatment. Evenhanded treatment is reinforced by clearly defined rules of the game, mutually agreed implementation procedures, and transparent, informed, and broadly based decision making.

Annex 5.1. EC-IMF Cooperation in Lending Programs with EU Countries, 2008–09

Prior to the four IMF-supported programs with euro area countries (Greece, Ireland, Portugal, and Cyprus), the IMF and EC cooperated in joint lending operations to three non-euro EU members (Hungary, Latvia, and Romania) during 2008–09. The cooperation principles developed during these IMF-EU programs became the model upon which the troika arrangement was later built. In all three cases, IMF staff and EC staff butted heads over the pace of fiscal adjustment and the application of the SGP/EDP rules. Latvia stands out because it had a currency peg to the euro that IMF staff considered unsustainable, but that the country authorities with the financial support of the EU sought to maintain through the use of substantial fiscal consolidation and structural reforms. By 2010, when the joint programs with Greece, Ireland, and Portugal were designed, the lesson learned from Latvia's case seemed to be that the EC got right the economic forecast and policy judgments (about the currency peg sustainability, feasible fiscal adjustment, and small fiscal multipliers) and the IMF apparently got it wrong. Subsequently, however, the applicably of this lesson to other economies has been called into question (Blanchard, Griffiths, and Gruss, 2013).

Hungary

The Hungarian authorities contacted the Fund staff on October 9, 2008 to request possible use of Fund resources, owing to stresses in Hungarian financial markets, particularly the government debt market. However, as a non-euro-area member of the EU, Hungary was required under EU treaties to consult with the EC and the Economic and Financial Committee (EFC) on its balance of payments needs before seeking assistance from sources outside the EU that are subject to conditionality. Fund staff consulted immediately with EC staff and, in view of the severity and urgency of the situation, the EC agreed that parallel consultations could take place.

A Fund mission arrived in Hungary on October 13, 2008 and was subsequently joined by an EC team. During the negotiations, both teams operated and coordinated efforts to proceed at the same pace. As required under the Fund's exceptional access policy, an informal Executive Board meeting was held on October 28. Once staff-level understandings had been reached, coordinated IMF-EC announcements were made before financial markets opened on October 29. Both the EC and IMF teams attended a press conference in Budapest, organized by the authorities. On November 4, 2008, the staff report for the SBA request under the exceptional access policy was issued to the Fund's Executive Board; this request was approved on November 6, 2008 under the Emergency Financing Mechanism. Thus, the elapsed time from the authorities' call to IMF disbursement was less than one month—which is very fast.

The BOP financing gap identified for the program period (17 months) was €20 billion. This gap was filled by commitments from the EU (€6.5 billion or 32.5 percent of the gap), World Bank (€1.0 billion, or 5 percent of the gap), and the IMF (€12.5 billion, or 62.5 percent of the gap). The IMF program was heavily front-loaded; the initial purchase was €4.2 billion or almost one-third of the IMF total. This financing pattern reflected in large part EU constraints. For example, when the IMF and EC teams were in the field, the size of the EU's BOP financial assistance facility was only €12 billion. It was recognized that the facility was too small. Therefore, on November 4, the European Council authorized an increase in its size to €25 billion, while also granting a loan to Hungary of €6.5 billion. This Council decision stated that the first EU disbursement (€2 billon) to Hungary would be released once a memorandum of understanding (MOU), which would lay out the EU's policy conditions, was signed by the EU and Hungary. The MOU was finalized on November 19, 2008 and the first EU disbursement took place on December 9, 2008, or only about a month after the first purchase from the IMF. Under the circumstances, this pace was fast.[1]

While the IMF and EC teams were in Hungary, the ECB was engaged in separate discussions with the Hungarian Central Bank (MNB) on a repo line. The IMF team discussed with their Central Bank counterparts the workings of this repo line, including its collateral requirements. As recorded in the LOI (and MOU), the MNB established on October 16, 2008 a foreign exchange swap facility, which would be supported by a repo facility with the ECB amounting to €5 billion, to improve liquidity in domestic financial markets. This euro provision promised by the ECB was not counted toward filling the financing gap, because it was viewed as largely a domestic monetary operation and because of uncertainties considering its drawdown. Later, a foreign exchange swap line replaced the repo line.

The 2008 staff report for Hungary's SBA request (IMF, 2008) recognized (in its Box 1) the precedents that were being established for cooperation between the IMF and EC in a joint lending context. Specifically, the box observed that, "prior to the recent events in Hungary, no operating procedures had been developed for such interaction between the EU and the IMF. The process as developed in the case of Hungary could, however, become a reference on how to proceed should further cases of a similar nature arise. . . ." The box recorded five key principles: (i) early consultation and ongoing information exchanges during the program negotiations; (ii) contributions of both institutions to financing needs; (iii) joint announcement to underline broad support; (iv) consistency of program design and conditionality; and (v) consultation during the program monitoring process.

For our purposes, this box made two important elaborations. One, it was expected that EC conditionality (to be included in the MOU (yet to be

[1] The conditionality for the World Bank loan was also not agreed by the time of the IMF Board meeting in November 2008. The World Bank loan was approved only in September 2009, but was never signed or disbursed.

written)) would be consistent with IMF conditionality and that, in particular, EC surveillance mechanisms such as the Excessive Deficit Procedure would incorporate the policy commitments made by the Hungarian authorities. This sequencing implied that the Fund-supported program effectively determined fiscal targets, but this did not take place later in the program period (see below). Two, if program deviations occurred, the authorities were to inform in parallel the EU and IMF and both institutions would coordinate closely during the related discussions. This second principle would be first tested in Latvia. The two principles were supported by the ECB observer at the Fund Board meeting, saying that "given that the EU has its own policy and instrument framework, conditionality of the IMF has to be reflected or mapped onto our own requirements in terms of, for example, an update of the convergence program, in terms of the excessive deficit procedure and also in terms of the national reform program."

At the Board meeting on Hungary's SBA request, Executive Directors generally did not comment on IMF-EC cooperation. Two Executive Directors, however, welcomed this cooperation and no Director expressed any reservations. Two Directors did question the lack of specificity on the conditionality to be imposed by the EC (and World Bank).

EC-IMF cooperation in the case of Hungary has been deemed successful by all parties (see, for example, IMF, 2011b). All program reviews were completed together. Both programs moved to a precautionary mode at the same time. The final two reviews of the IMF and EU programs were not completed owing to policy disagreements with the authorities. Cooperation was facilitated by several modalities. Frequent communications took place via telephone and email by the country teams for the EC and IMF. In addition, the IMF staff shared their draft policy note, formerly the briefing paper, with EC (and World Bank) staff at the same time as it was circulated to Fund departments. EC staff provided written comments electronically, while Bank staff could attend the policy consultation meeting. Meetings could take place in Brussels prior to reaching Budapest to clarify any outstanding points. The IMF, EC, and ECB staff attended meetings together with the country authorities. IMF staff shared their spreadsheets, programming expertise, and cross-country crisis experience, while EC staff shared their greater knowledge of EU policies and practices, particularly as it applied to Hungary. The two teams worked together in Budapest on their respective policy-intentions documents—the LOI and MOU. Starting with the first program review (March 2009), these two documents were signed by the authorities on the same date. This practice helped ensure consistent conditionality (even though EC conditionality was more detailed than IMF conditionality especially in the fiscal and structural areas) and more rapid EU disbursement.

Areas of difference or light friction emerged on occasion, particularly related to fiscal monitoring and the fiscal stance. As regards fiscal monitoring, the IMF's performance criteria were set on the primary cash balance of the central government, while the EU fiscal benchmark was set on the overall accrual balance of the general government—using the EDP, or ESA-95, definitions. Thus three definitional differences existed—primary vs. overall balance, cash vs. accrual, and central vs. general government. The IMF definition ensured timelier reporting, while the EC definition was more comprehensive and consistent with EU obligations. The IMF and EC teams took steps to lessen associated communication and signaling risks; IMF fiscal targets as reported in the staff reports were consistent with the EC's concept of the overall deficit of the general government, while EC monitoring took into account progress in achieving the IMF's cash-flow deficit target for the central government.

Friction developed over the fiscal stance during 2009 because Hungary's real GDP contracted by more than projected (by 6.7 percent compared with the projected 1.0 percent), placing pressure on the fiscal deficit to exceed the SGP limit of 3 percent of GDP. IMF staff advocated allowing automatic stabilizers to operate in order to cushion aggregate demand. The second program review was completed on the basis of additional (pro-cyclical) fiscal measures that offset about half of the automatic stabilizers and a two-year extension in the time to reach the EDP target. The IMF staff report recommended that if economic activity contracted by more than was currently envisaged, automatic stabilizers should accommodate fully. The EC MOU did not contain similar language and, as reported in the EPE (IMF, 2011b), the authorities had a strong commitment to adhere to their EU convergence program and the EDP.

Latvia

To fully appreciate the program design issues that arose in Latvia, it is necessary to understand the policy debate that raged starting in 2007 over the exchange rate peg. As documented by the IEO (Wagner, 2010), Article IV consultation staff reports for Latvia were increasingly "alarmist," starting in 2004 and continuing in 2006, sending clear messages about overheating, massive imbalances, and financial sector vulnerabilities. But the 2007 Surveillance Decision with its emphasis on external instability (and the associated "labeling"—fundamental exchange rate misalignment) created a rift on its application and led Fund management not to issue to the Executive Board the draft 2007 Article IV staff report on Latvia. Nevertheless, the Board did receive a Financial Sector Assessment Program update on Latvia that warned of serious threats to systemic financial stability and called for a strengthening of Latvia's contingency framework, and a selected issues paper that concluded that Latvia's real effective exchange rate appeared to be significantly overvalued—by some 20 percent.

In early September 2008, the Executive Board was issued an Article IV consultation report on Latvia that observed a much-needed slowing in domestic demand but noted that significant concerns still existed regarding external stability. In addition, an FSAP update supplement judged that the downside risks had risen, owing to the domestic economic slowdown and fragile global liquidity conditions. The revised staff estimates for exchange rate overvaluation ranged from 16 percent to 37 percent, averaging 27 percent. The staff was of the view that adjustment under the prevailing exchange rate peg remained the preferred option but entailed risks. Because the staff could not yet make a determination regarding fundamental misalignment, it recommended an ad hoc consultation with another Board discussion in about six months. The Board meeting on this staff report, which was scheduled for September 22, 2008, never took place. Relatedly, a Board meeting for the 2008 Article IV consultation with China was scheduled for September 26, 2008; in its staff report, China's real exchange rate was considered to be substantially undervalued, but staff was "not yet making a determination regarding specific findings under the 2007 Surveillance Decision" and likewise recommended an ad hoc consultation in about six months. The Executive Board never discussed this staff report on China. These two Article IV consultations were delayed owing to "ongoing internal discussions on the implementation of the 2007 Surveillance Decision" (IEO, 2011; Blustein, 2013).

From a European perspective, IMF surveillance posed a complication because Latvia was an ERM2 member. According to the ERM2 operating procedures (March 2006), the ECB "shall closely monitor, on a permanent basis, the sustainability of bilateral exchange rate relations between each participating non-euro area currency and the euro" and it "shall have the right to initiate a confidential procedure aimed at reconsidering central rates." At the same time, the EC was responsible for monitoring and assessing Latvia's progress toward euro adoption, employing the Maastricht convergence criteria. Moreover, the Latvian authorities disputed the IMF staff's analysis and assessments and were supported by their IMF Executive Director. There therefore was a risk that IMF surveillance might call into question aspects of the peer review conducted by EU institutions.

On November 15, 2008, a deposit run on Parex Bank turned into a speculative attack on the currency peg. The Latvian authorities requested financial assistance from the EC and the IMF in mid-November. An informal Board session to activate the emergency procedures was held on November 17, 2008, while preliminary talks (with the IMF/EC/ECB) took place in Latvia during November 17–23. The ECB joined this mission as an observer, owing to Latvia's ERM2 membership. The IMF staff reaffirmed its estimates of real exchange rate misalignment (about 30 percent), while the EC's and ECB's estimates were at, or below, 10 percent. Any change in the peg was strongly opposed by the Latvian authorities, the EC, the ECB, and Sweden. The latter three parties worried about possible contagion to other EU members and to Swedish banks. Immediate euro adoption after a parity change was ruled out by the EC and ECB. The Latvian authorities also strongly desired to maintain their euro peg unchanged. According to Fund staff, because of the EU's key role in overall policy design, including on the exchange rate strategy, the EC's financing contribution was expected to substantially exceed that of the IMF. Thus, the EU's key role in program design—supported by the Latvian authorities—led to the EU's predominant share in the financing package rather than to the EU's financing contribution giving it sway in the program's design.[2]

The staff report requesting a three-year SBA for Latvia was issued to the Board on December 19, 2008 and the Board meeting was held three days later on December 23.[3] With unusual candor, the staff made clear that a change in parity and immediate adoption of the euro had been discussed, but that this "technically more attractive" option had been "firmly ruled out" by the EU authorities and strongly opposed by the Latvian authorities. The envisaged fiscal adjustment was substantial and front-loaded (7 percentage points of GDP), and was expected to produce a moderate contraction of real GDP, owing to positive but limited fiscal multipliers; the inability of households to borrow to smooth consumption spending; and the lack of a monetary policy to offset fiscal tightening. The SGP limit (3 percent of GDP) was targeted for 2011, or the last year of the three-year program.

Latvia's gross financing requirement was estimated at €15 billion. However, the program contained commitments from Swedish (and another Nordic country) parent banks to maintain their exposure, while the program assumed rollover rates of 40 percent for other foreign creditors. Consequently, the net financing gap was lowered to €7.5 billion, or about 50 percent of GDP. This financing gap was to be filled by the EC (€3.1 billion, or 41 percent of the total gap), four Nordic countries (€1.8 billion, or 24 percent), the IMF (€1.7 billion, or 23 percent), three European emerging market countries (€0.5 billion, or 7 percent), and the IBRD/EBRD (€0.4 billion, or 5 percent). Thus, the ratio of other financing to IMF resources was 3 to 1; the IMF share was only 24 percent for Latvia compared with 65 percent for Hungary. Nonetheless access relative to Fund quota was somewhat higher in Latvia (1,200 percent) than in Hungary (1,015 percent).

As in Hungary, the initial IMF purchase was heavily front-loaded—constituting nearly one-third of the entire arrangement—to allow Latvia to take out a bridge loan granted by Nordic central banks. The EC loan was similarly front-loaded (e.g., about one-third of the total in the first disbursement). The EC MOU was signed on January 28, 2010 and the first disbursement occurred on February 25, 2010. The EC MOU was signed about one month after the IMF LOI was signed (a time difference similar to that for the first EC MOU with Hungary).

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[2] Blustein (2015a and 2015b) argues, citing various published and unpublished sources, that the IMF's smaller funding role—a "reverse Hungary"—in Latvia made the IMF a junior partner to Brussels, reversing the roles in Hungary. On the other hand, Aslund and Dombrovskis (2011) see program design as determined by strong country ownership, swaying an IMF staff that was of two minds on the currency peg.

[3] Informal Board meetings under the exceptional access policy were held on December 5, 2009 and December 10, 2009 to outline the major features of program design and the likely financing requirements.

As documented in the EPE for Latvia, the IMF worked closely with the various financing partners who also contributed technical expertise. The EC was heavily involved in the fiscal and financial sectors, as reflected in the MOU conditionality. The World Bank provided inputs on social safety nets and the legal framework for the financial sector, while the EBRD tackled the resolution of Parex Bank; both provided sectoral financing in these areas. In addition, interviews demonstrated that frequent communications took place via telephone and email between the country teams for the EC and IMF. The IMF, EC, and ECB staff (as did other partners) attended meetings together with the country authorities.

At the time of the first program review mission (February 2009), there were clear signs that output was contracting much deeper than envisaged and that the program was off track. Mass demonstrations against the program took place. As the governing coalition was blamed for Latvia's economic problems, the Prime Minister resigned in late February. The review mission left an aide-mémoire to help the incoming government to identify measures to bring the program back on track. During this pause, changes were made in the team leaders for both the IMF and EC. These new team leaders visited the newly elected government in April. It was agreed that a supplementary budget would be sent to Parliament after municipal/EU elections in early June. Deposit outflows and loss of international reserves placed pressures on the currency peg, triggering under the IMF program the need for a discussion on contingency plans with the Latvian authorities. Technical assistance on revenue administration and public expenditure management from the IMF continued in April and May to assist the Latvian authorities in preparing a supplementary budget.

Efforts to complete the first program review resumed in late May 2009 between the Latvian authorities and the IMF, EC, and ECB along with representatives from the World Bank, EBRD, and Nordic countries. Output was now expected to fall by 18 percent in 2009 compared to the program projection of a 5 percent decline. This far deeper recession increased the projected budget deficit to 16–17 percent of GDP—far exceeding the program target of 5 percent. In addition, Latvia was seen to be at risk of running out of money, as its international reserves had declined by 25 percent since end-2008. On June 16, Parliament approved a supplementary budget of the full-year equivalent of 13 percentage points of GDP and containing measures that included cuts in pensions and social benefits. The IMF staff was concerned about the adverse growth implications and the effect of the measures on vulnerable groups. The EC (and the Nordics) were worried that the currency peg would not be able to withstand further delays in disbursements, seeing the IMF as too willing to risk a currency crisis to obtain improvements in fiscal policy.

In the event, the European Council met on June 19, 2009 and concluded that it supported "the adoption of the new budgetary measures in Latvia aiming at sizeable fiscal consolidation this and next year. It stresses that rigorous implementation of the measures adopted together with credible medium-term strategy will deliver a successful outcome of the current adjustment programme. The European Council strongly supports the intention of the Commission to propose the swift disbursement of the next installment of the Community balance-of-payments assistance in the framework of the adjustment programme." On June 24, the EC sent a note to the ECOFIN Council proposing disbursement of the second EU installment, and stating that "the Commission services carried out a review mission from 27 May to 17 June in close cooperation with the IMF staff (which undertook its first full review under their SBA in parallel). . . . Based on the findings of the above-mentioned review mission and additional available information, the economic policy criteria for the second installment as laid down in the MoU can be considered to be fulfilled." In its review, the EC acknowledged that the supplementary budget contained poor-quality measures that would have negative distributional consequences and doubtful sustainability, but the EC felt that these deficiencies could be corrected in the 2010 budget. The formal decision was taken on July 2 and the second installment was disbursed later in July. The Fund mission was surprised that the EC would disburse without the IMF.

After high-level discussions between the IMF and EC, a joint IMF/EC/ECB mission along with the Nordic representative returned to Latvia on July 12, 2009 to complete the first IMF program review. The mission completed its work by end-July and the IMF staff report was circulated to the Board on August 7, 2009. In this report, the staff made clear that it preferred "a slightly higher budget deficit in 2009 to protect basic services and to rebalance the burden of adjustment, while preparing for structurally sound adjustment in 2010." The staff also took issue with the rapid fiscal adjustment pace for 2010–12 that was proposed by the Latvian authorities and endorsed by ECOFIN. Unusually, an IMF "program scenario" was also presented with less rapid fiscal adjustment—reaching the Stability and Growth Pact target of 3 percent of GDP in 2014 rather than 2012—that was considered to be more credible and was projected to yield somewhat faster output growth. The IMF Executive Board completed the program review on August 27, 2009. Eight Executive Directors from EU countries supported the rapid fiscal adjustment strategy, while most other Directors supported the less rapid one.

The Latvian authorities' bold upfront fiscal adjustment sparked a revival in market confidence (Giudice, 2012), easing liquidity pressures, and real growth resumed unexpectedly in the fourth quarter of 2009. Their strong program ownership continued to be exhibited in their 2010 budget formulation and implementation. A V-shaped recovery was increasingly in evidence during 2010, while the current account was in surplus. By early 2011, the stronger Latvian economy allowed the authorities to stop drawing on the amounts under both the IMF and EC programs.

These events arguably showed the IMF staff's judgment to be in error regarding the sustainability of the currency peg, the feasible fiscal adjustment, and the implications of fiscal consolidation for real growth. On each issue, the

EC staff supported the country authorities, which had a strong political commitment to joining the euro at the earliest possible date. Essentially, the EC seemingly got it right and the IMF got it wrong. The EC by deciding to go it alone without the IMF displayed its independence and confidence. While in retrospect the IMF seems to have made the right, albeit risky, decision of completing the first program review, this decision may have contributed to a perception of the IMF as a junior partner in this international rescue package. In addition, EC staff believed Latvia provided lessons—particularly as regards the confidence-enhancing role of fiscal consolidation and structural reforms—that could be applied to euro-crisis countries (Giudice, 2012; Deroose and others, 2010), while the IMF's Economic Counsellor (Blanchard) blogged in 2012, "The sad truth is that many of these conditions [that led to Latvia's V-shaped recovery] are not satisfied elsewhere. So the lessons are not easily exported."

Romania

Severe pressures on Romania's balance of payments became evident in late 2008, as the domestic economy overheated and access to foreign liquidity dried up with the global financial crisis. Recognizing these pressures, an IMF staff visit took place in Bucharest in late January/early February 2009 to assess the situation and provide policy advice. As the situation continued to worsen, preliminary discussions on a possible IMF-supported program were held in Washington in early March with the Romanian authorities. These discussions were quickly followed by a visit to Bucharest from an IMF/EC negotiating team. The IMF mission chief stopped in Brussels to coordinate with the EC before proceeding to Bucharest. Teams from the EBRD, World Bank, International Finance Corporation (IFC), and European Investment Bank (EIB) also flew to Bucharest. An informal IMF Board meeting under the exceptional access policy was held on March 13, 2009.

A staff-level agreement on a program for Romania was concluded on March 25, 2009. Cooperation among all parties (IMF, EC, WB, EBRD, and EIB) was close throughout the negotiations although complicated by their numbers. In addition, from an IMF perspective the EC's occasional internally conflicting objectives and cumbersome decision-making procedures were viewed as hurdles. On a more positive note, the EBRD, EC, IMF, WB, and EIB organized the first country meeting under the newly created European Bank Coordination Initiative on March 26, 2009. This meeting was attended by the nine largest foreign-owned banks incorporated in Romania; their parent banks; the National Bank of Romania; representatives of the home country authorities (Austria, France, Greece, and Italy); and an observer from the ECB. These banks committed to maintain their exposure to Romania and to recapitalize their subsidiaries as needed following stress tests.

The staff report to request a 24-month SBA (IMF, 2009c) was circulated to the IMF Board on April 24, 2009 and the Board meeting was held on May 4. Owing largely to the bank exposure agreement, the gross financing requirement (€44 billion) was reduced to a financing gap of €20 billion. This gap was filled by the IMF (€13 billion, or 65 percent of the total gap), the EC (€5 billion, or 25 percent), the World Bank (€1 billion, or 5 percent) and the EBRD, EIB, and IFC (collectively €1 billion, or 5 percent). These contribution shares were closer to those observed for Hungary than for Latvia. The IMF contribution was equivalent to 1,111 percent of quota—similar in quota size to Hungary and Latvia—and required use of the exceptional access policy. As in Hungary and Latvia, the SBA for Romania was heavily front-loaded with the initial purchase (€5 billion) representing 38 percent of the total. The EC's MOU with Romania was signed on June 23, 2009 and the first installment of the EC loan (€1.5 billion or 20 percent) was released on July 27.

As regards the design of program policies, the IMF took center stage in framing the macroeconomic stance, identifying the financing requirement, and coordinating the institutional players. A key feature of the macroeconomic policy design was the front-loaded fiscal tightening in 2009 (with measures equivalent to 3 percentage points of GDP) to tackle overheating and to establish a credible path toward fiscal viability, seeking to reduce the fiscal deficit below the Maastricht target in 2011.[4] Passage by Parliament of the 2011 budget was a structural benchmark under both the IMF SBA and the EC MOU. As in Hungary, monetary policy in Romania was conducted under an inflation-targeting regime with a floating exchange rate. The IMF team negotiated this aspect of the program; monetary policy did not feature in any of the EC's MOUs. Addressing vulnerabilities in the financial sector was another major program element; here the EC was heavily involved, ensuring consistency with EU directives.

At the time of the first program review mission (August 2009), output contraction was projected to be more severe than initially envisaged (8 percent in 2009 compared with 4 percent originally) with a sharper 2010 recovery anticipated (1¾ percent compared with zero originally). The IMF team proposed to accommodate the bulk (80 percent) of the projected cyclical deterioration in the fiscal deficit in 2009; the additional fiscal adjustments for 2009 and 2010 were 0.6 percentage points of GDP and 0.4 percentage points, respectively. The 2010 fiscal effort came on top of already programmed measures equivalent to 1.4 percentage points of GDP. In the view of Fund staff, Romania's ability to achieve the Maastricht target in 2011 would depend on the strength of the recovery. The EC advocated a larger fiscal adjustment effort in order to maintain the scheduled date (2011) for

[4] While both the IMF and EC focused on the overall deficit of the general government, the IMF definition was on a cash basis to permit timely quarterly monitoring, while the EC used an accrual, ESA-95 definition that was EDP-consistent. The IMF definition typically produced a deficit figure that was approximately ½ percentage point of GDP smaller than the EC figure. This difference could be larger if government payment arrears increased, as did occur; such increases, however, were not allowed under the IMF program. The EC MOU reported both sets of fiscal targets, while the IMF staff reports did not.

achieving the Maastricht target that had been endorsed by the ECOFIN Council. (The public debt ratio was projected to rise to only 34 percent of GDP in 2011, or well below the relevant Maastricht value.)

After discussions with the Romanian authorities by the IMF and EC teams, the output contraction in 2009 deepened to 8½ percent, while the projected 2010 recovery was reduced to ½ percent. To counter automatic fiscal stabilizers, the Romanian authorities adopted fiscal measures equivalent to 0.8 percentage points of GDP (or about 2 percentage points annualized) in 2009 and 2.0 percentage points in 2010. These consolidation efforts were somewhat larger than specified in the IMF's policy note. The IMF's LOI and staff report for the first program review contained no mention of the fiscal target for 2011, although a staff report table contained a figure of –4.2 percent of GDP, exceeding the corresponding Maastricht value. As no EU disbursement was scheduled to correspond with the IMF review/purchase, the EC team did not complete a formal review under the EU's financial assistance program.

Owing to political tensions within the governing coalition, related to presidential elections, the government fell in October 2009. As the "caretaker" government could not adopt a 2010 budget, program reviews were delayed until after the presidential elections held on December 23, 2009. In January 2010, IMF and EC teams returned Bucharest to complete the relevant program reviews. As high-frequency data indicated stronger-than-expected real growth starting in the fourth quarter of 2009, the estimated 2009 output contraction was lessened to 7 percent and an output expansion of 1¼ percent was projected for 2010 (compared to zero at the time of the first review). Nonetheless, pro-cyclical fiscal consolidation measures of 2½ percentage points of GDP, or ½ percentage point more than envisaged at the first review, were agreed in order to maintain unchanged the deficit target of 5.9 percent of GDP for 2010. The Romanian authorities expressed their intention in the IMF LOI (dated February 5, 2010) to reduce the fiscal deficit below the Maastricht limit of 3 percent of GDP by 2012. The Fund staff estimated that to achieve this target, the authorities would need to implement additional fiscal measures equivalent to 1¼ percentage points of GDP in both 2011 and 2012. On this basis, the IMF Board completed both the second and third reviews under the SBA on February 19, 2012.

The EC MOU was signed on February 22, 2010. The ECOFIN Council on February 16, 2010 (or three days before the IMF Board met) endorsed the revised gradual fiscal adjustment strategy agreed by the EC team, including the extension by one year—to 2012—for dipping below the Maastricht limit of 3 percent of GDP for the fiscal deficit. The MOU did not contain an explicit fiscal deficit target for 2011, but it did cite the need to be consistent with achieving a deficit below 3 percent of GDP in 2012. Parliament's passage of a draft fiscal responsibility law, prepared with input from the EC, IMF, and World Bank, was a structural benchmark for both the Stand-By Arrangement and the MOU. Once again, monetary policy was not discussed in the EC

MOU. EU-consistent reforms in the financial sector, prepared with technical assistance from the EC and IMF, were also benchmarks under both programs. The EC disbursed its second installment (€1 billion) on March 11, 2010.

At the time of the fourth program review in mid-2010, Romania's real growth for 2010 was revised downwards to a contraction of 0.5 percent (from +0.8 percent). The fiscal deficit was projected, based upon unchanged policies, to reach 9.1 percent of GDP compared to the programmed 5.9 percent of GDP. Consequently, fiscal measures—primarily on the spending side—equivalent to 4½ percentage points of GDP annualized, were implemented, while the fiscal target for 2010 was lifted to 6.8 percent of GDP. The IMF projected that the fiscal deficit would slip below the Maastricht reference value in 2014. With lower core inflation and fiscal tightening, the central bank reduced interest rates and the IMF staff saw room for further reductions going forward. The IMF Board completed the IMF review on July 2, 2010. The corresponding supplemental MOU was signed on August 2, 2010 and the disbursement took place on September 22, 2010. This MOU revised upwards the fiscal deficit target for 2010 in a manner consistent with the IMF target, but the supplemental MOU did not change, or even mention, the fiscal deficit targets for 2011 or 2012. As a consequence, an implicit, though perhaps not meaningful, difference in fiscal targets emerged.

Though an EC team accompanied the IMF team to Bucharest as part of the SBA review mission, no corresponding EU program review took place. The IMF team revised further downward its growth estimates for 2010 to –1.9 percent, but projected a very sharp recovery in 2011 and 2012 (of 1.5 percent and 4.4 percent, respectively). Notwithstanding the deeper contraction in 2010, the IMF staff and authorities considered the fiscal target (–6.8 percent of GDP) to be within reach. The IMF Board paper did not contain a table with 2012 fiscal projections, but the text stated that "robust economic recovery and continued expenditure restraint could make the achievement of the Maastricht fiscal target feasible by 2012 without further major adjustment measures." Thus, the differences in the fiscal targets for 2011–12 that had emerged at the time of the fourth IMF SBA review had disappeared by the time of the fifth review, avoiding any possible complication for the EU disbursement on September 22. The fifth IMF SBA review was completed by the IMF Board on September 24, 2010.

From a troika standpoint, the remaining six months of Romania's program hold little interest. The reviews were completed as scheduled by the IMF and EC. The Fund Board completed the final program review in March 2011; the Romanian authorities decided not to draw upon the last purchase made available under the IMF SBA, treating it as precautionary. At the same Board meeting (March 2011), the authorities requested cancellation of the existing SBA and the Board approved a new 24-month SBA, which the authorities intended to treat as precautionary. The final two installments of the EU loan were disbursed on March 24, 2011 and June 22, 2011. The EU also entered into a new BOP assistance program with Romania on a precautionary basis.

Although the new EU loan was announced in March 2011, the MOU was signed on June 29, 2011, after the final disbursement of the previous loan.

Overall, cooperation between the EC and IMF was successful and effective, as noted in the IMF staff's EPE for Romania (IMF, 2012a). According to the IMF staff, the cooperation details were similar to those reported in the EPE for Hungary, which were deemed effective by all parties. As in Hungary and Latvia, the IMF team tended to prefer a more gradual path of fiscal adjustment than was spelled out by the Excessive Deficit Procedure and was more willing than EC staff to adjust the fiscal deficit targets upward in response to unanticipated lower economic activity, allowing the automatic fiscal stabilizers to operate. The two teams sorted out these differences among themselves. Both teams were well aware of the different definitions used for their respective fiscal targets and the associated compliance/signaling risks. These risks did not materialize. EU structural funds were not absorbed as programmed, owing to bureaucratic barriers in both Romania and the EU—creating tensions, wasting time, and complicating the conduct of demand management. On the other hand, the IMF, EC, and ECB participated effectively and smoothly in the European Bank Coordination Initiative, or Vienna I/II.

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CHAPTER 6

The IMF and the Euro Area Crisis: The Fiscal Dimension

GEORGE KOPITS

Introduction

At the end of the last century, a number of sovereign European IMF member states joined voluntarily in a monetary union known as the euro area within the broader European Union (EU), while maintaining essentially a decentralized fiscal policy regime. Each sovereign euro area government retained all membership obligations and rights in the IMF. Thus, from its inception through the recent crisis, euro area members have been subject to IMF surveillance both at the collective area level and at the country level. Equally, they continued to be eligible for IMF financial and technical assistance, as warranted.

This chapter evaluates the IMF's role with regard to fiscal policy in the euro area, both at the area level and in selected member countries facing vulnerabilities in their public finances, prior to and during the crisis. The evaluation draws on a review of a large number of IMF staff reports and other documents. In addition, a series of interviews was conducted with more than 50 persons, including current and former members of the IMF staff and Executive Board, staff members of the European Commission (including Eurostat), members of the European Central Bank (ECB) staff and Governing Council, and current and former government officials from France, Germany, Greece, Ireland, and Portugal.

The chapter is organized as follows. The second section provides the background for the rest of the chapter. It highlights the key fiscal issues in a common currency area, the fiscal framework that was adopted by the euro area, and fiscal developments that contributed to the crisis. The third section examines IMF surveillance of fiscal policymaking over a broad range of issues: advice on the fiscal framework and policy stance; macro-fiscal projections; and assessments of transparency, public debt sustainability, and fiscal risks. The fourth section evaluates the design and implementation of fiscal policy in IMF-supported stabilization programs in Greece, Ireland, and Portugal. The evaluation covers financial support, qualitative and quantitative elements of the fiscal adjustment, including structural conditionality, as well as public communication of the fiscal component of the programs. The fifth section covers the modalities and outcomes of the technical assistance that the IMF provided, mainly for developing or strengthening sound practices in public financial management, expenditure policies, and tax policy and administration. The final section concludes and distils tentative lessons.

Fiscal Framework and Trends

Fiscal discipline is a necessary condition for a well-functioning common currency area, especially in the absence of labor market flexibility.[1] The basis for this view is that fiscal space, labor mobility, and real-wage flexibility, viewed as shock absorbers, should be able to help offset asymmetric shocks among member countries, unless their economic structure is very similar and they are fully constituted as an optimum currency area. Within a currency union, given inexorably fixed exchange rates—through a single common currency—among participating countries, adjustments among member economies must take place through fiscal and real-wage changes.

From the perspective of a federal system, subnational governments retain a greater or lesser degree of fiscal autonomy depending on, among other things, intergovernmental relations that may include various tax-transfer arrangements. To prevent free-rider behavior, subnational governments are typically subject to fiscal rules that limit budget deficits and indebtedness. In addition, subnational fiscal behavior may be constrained by a statutory or implicit no-bailout provision[2]—where the term "bailout" denotes financial assistance without conditionality. Under the no-bailout provision, subnational governments are exposed directly to market pressures, which are reflected in a risk premium on their bonds relative to bonds issued by the national government (as, for example, in Canada, Switzerland, or the United States). By contrast, if subnational governments are shielded by an explicit or implicit nationally guaranteed bailout, the risk premium charged by the markets vanishes and the interest yield on subnational bonds moves perfectly in tandem with the yield on the corresponding national bonds (as happened, for example, in Germany and Spain). In either case, fiscal discipline is usually bolstered with centrally- or self-imposed fiscal rules. Mutatis mutandis, a rules-based fiscal framework is similarly relevant for national governments within a monetary union.

[1] As illustrated by recent developments in the euro area, the fiscal condition becomes imperative especially in the absence of effective banking supervision and uniform deposit insurance across member countries, or of an area-wide banking union. In such situations, impaired banks may have to be recapitalized directly or indirectly by the host government, compounding the latter's debt burden.

[2] This point is often overlooked by those who argue that a full-fledged fiscal union is a necessary condition for approaching an optimum currency area. For instance, in a review of the conditions for an optimum currency area and the evidence on whether the euro area meets these conditions, Pasimeni (2014) omits any mention of the no-bailout provision.

In a monetary union of sovereign countries, the need for fiscal discipline is further underscored by nearly full fiscal autonomy and limited wage flexibility. This is the case for the euro area, which is comprised of a diverse group of economies, some of them with a history of fiscal profligacy and burdened by high public indebtedness. In this regard, the crisis of the early 1990s which led to the near-collapse of the exchange rate mechanism (ERM) of the European Monetary System (EMS) could be viewed as a dress rehearsal of the dynamics that would play out if such a crisis were to occur in the euro area. The ERM, initially with a narrow band around a central rate, was to serve as the anchor for macroeconomic policies in participating member states. However, because differences in fiscal and wage behavior and divergent cyclical positions were inconsistent with the constraints of a single monetary policy, the ERM became untenable and the narrow band was abandoned. In the face of the crisis, for EMS member countries with an unsustainable external deficit, the bulk of the correction took place through exchange rate depreciation, rather than through adjustment in nominal wages or fiscal policy. A major lesson from the EMS crisis was that without exchange rate adjustment, and given the downward stickiness of nominal wages for regaining external competitiveness, the adjustment burden would have to fall largely on fiscal policy.

In view of the critical role of fiscal discipline in a monetary union consisting of divergent economies, the Economic and Monetary Union (EMU), established by the Treaty of Maastricht, envisaged a fiscal framework requiring member countries to abide by a relatively stringent set of fiscal rules while subject to an explicit no-bailout clause (Article 104)—much as in a federal system, as outlined above. Presumably, this clause was intended, on the one hand, to gain support for the monetary union from large hard-currency member countries, and on the other, to ensure that member countries would be exposed to market discipline as an additional safeguard.

Under the EMU, details of the fiscal framework were spelled out in the Stability and Growth Pact (SGP), which took effect from 1997 and was revised in 2005, 2011, and 2013 following episodes which revealed its principal shortcoming: namely, weak enforcement (Box 6.1). In principle, the original design of the fiscal rules enshrined in the Pact was deemed to meet seven out of the eight criteria for good practice endorsed by the IMF: definition, transparency, adequacy, consistency, simplicity, flexibility, and efficiency.[3] The enforceability criterion, however, eventually proved to be the Achilles' heel of the Pact. Indeed, the Pact was undermined by certain practices of the ECB as well as the Economic and Financial Affairs Council (ECOFIN) and its subset of euro area members, the Eurogroup, which was the ultimate arbiter in charge of enforcement through peer pressure.

[3] See, for example, Buti and Giudice (2002) for an application of the criteria formulated in Kopits and Symansky (1998) for assessing the EU fiscal rules. These criteria, discussed and endorsed by the IMF Executive Board in 1997, became widely regarded as the guide to good practice for fiscal rules.

Box 6.1 Highlights of the EU Stability and Growth Pact

The original 1997 statute sets for the general government: (i) a budgetary objective of close-to-balance or surplus, under the preventive arm; (ii) limits for the deficit and gross debt of 3 percent and 60 percent of GDP, respectively, and (iii) an excessive deficit procedure with financial sanctions (0.2 percent of GDP deposit) for noncompliance, under the corrective arm.

The 2005 amendment specifies additionally: a country-specific medium-term objective in structural terms; allowance for possible temporary deviation for structural reforms; and allowance for a possible deadline extension in case of unexpected economic events beyond government control with unfavorable consequences for government finances.

The 2011 amendments (the "Six Pack") provide additionally: a benchmark for budget expenditure to grow in line with potential GDP growth; an annual adjustment of at least 0.5 percent of GDP if debt exceeds the limit or if there is a pronounced risk to debt sustainability; a benchmark for debt reduction if debt exceeds the limit, equivalent to an annual average reduction of 5 percent of the excess over the limit over the economic cycle; further allowance for possible temporary deviations and deadline extensions in case of a severe economic downturn in the euro area or the EU as a whole; and early and gradual activation of sanctions in cases of repeated noncompliance with the excessive deficit procedure.

The 2013 revisions (the "Two Pack" and Fiscal Compact) establish additionally: enhanced European Commission coordination and surveillance of draft budgetary plans of euro area governments, subject to a common timeline, to assess compliance with medium-term objective commitments and with EC recommendations for governments under the excessive deficit procedure; incorporation of key features of the SGP, notably the medium-term objectives, into national legislation; preparation of independent national macroeconomic projections; and independent national fiscal monitoring bodies.

Source: European Commission (2013a, 2013b).

From the outset, the ECB treated all euro area members' sovereign obligations uniformly as riskless collateral in its open market operations, regardless of significant differences, for example, between Germany and Greece in their public debt-GDP ratios or their ability to generate primary budget surpluses.[4] (Eventually, a slight discount on lower credit-rated obligations was introduced.) This practice was in stark, albeit implicit, contradiction of the Maastricht Treaty's no-bailout clause. Interviewees for this evaluation broadly agreed that there was what could be characterized as circular behavior among

[4] See the analysis by Buiter and Sibert (2006).

the ECB, credit rating agencies, and financial markets in assessing all euro area sovereign bonds as prime paper.

An additional practice was the accumulation of residual current account imbalances to be offset through the ECB's TARGET settlement system—an integral and necessary component of a common currency area. These imbalances, which were significant and rising sharply from 2007 onward, could, however, turn into an off-budget subsidy in the event of a default. At an extreme, this practice could also be interpreted as a backdoor bailout, without conditionality, in an environment where each state retained fiscal sovereignty.[5]

The upshot was that because of the ECB's uniform rating of euro area government bonds, banks and investors seem to have ignored the no-bailout clause and bid up the price of sovereign bonds issued by high-debt member governments to be used as collateral, thus profiting from a small interest yield on those bonds. Largely owing to this ECB practice—compounded by the disappearance of exchange rate risk—the risk premium on sovereign bonds vanished and lost any link to economic and fiscal fundamentals in each member country.

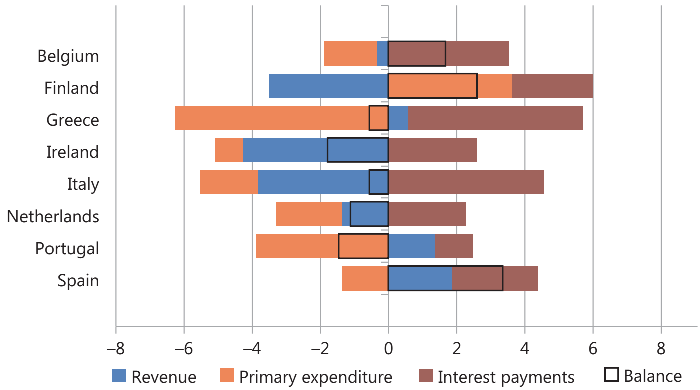
Similarly, the unavoidable buildup of TARGET claims through mid-2012 may have also eased the pressure on sovereign risk premiums. This effect was compounded by the extension of ECB credits under the emergency liquidity assistance (ELA) program, and by the August 2012 announcement of the Outright Monetary Transactions (OMT) program, which signaled a renewed softening of the no-bailout clause. Not surprisingly, the spreads on vulnerable euro area member government bonds have narrowed markedly since the end of 2012.

Over time, governments and markets were lulled into complacency and felt relatively immune to the need to abide by the fiscal rules. As a consequence of the decline in the interest cost, highly-indebted euro area member governments benefited from a windfall gain in their budgets and a corresponding sizable increase in fiscal space. But only a few of them allocated this gain to a reduction in public debt; most others squandered it by increasing primary expenditure (especially on public sector wages) or by cutting taxes. This is illustrated for governments whose interest bill has contracted by more than 1 percent of GDP following the establishment of the EMU (Figure 6.1). Between 1998 and 2005, Greece, Ireland, Italy, the Netherlands, and Portugal allocated their interest savings to finance additional outlays or tax cuts. By contrast, in Belgium, Finland, and Spain, the interest saving was fully reflected in a reduced budget deficit.

[5] See Sinn (2014) for an extensive documentation of this practice. From a monetary history perspective, Bordo (2014) argues that the euro area would have collapsed in the absence of TARGET.

Figure 6.1. Euro Area Countries: Net Contribution to General Government Balance, 1998–2005

(Cyclically adjusted, as percent of GDP)



Source: Banque Nationale de Belgique (2006).

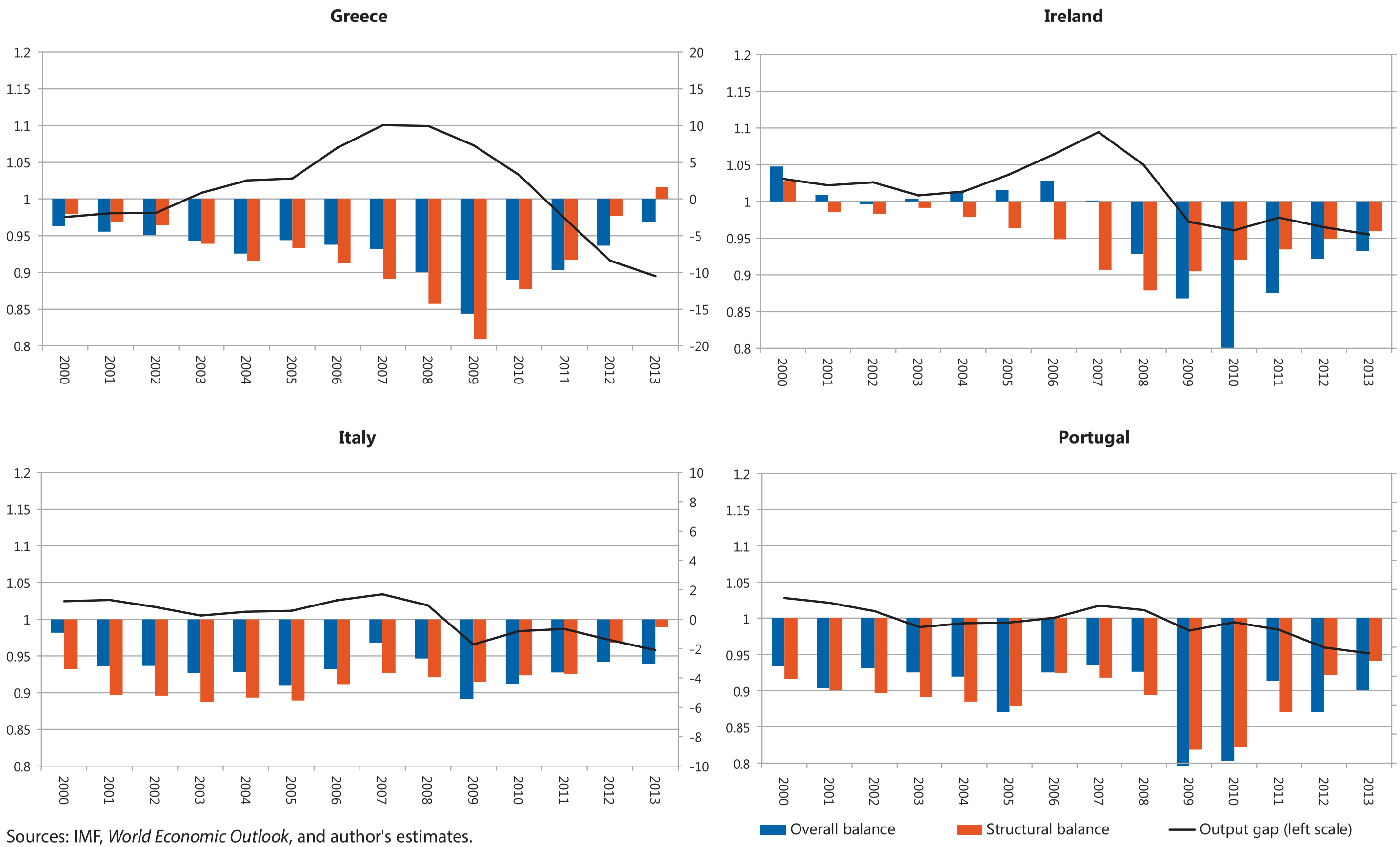
Unlike the nominal stringency of the deficit rule, the Pact did not stipulate sanctions for insufficient surpluses during an upswing in economic activity. At most, the Commission applied moral suasion in member countries to adopt a countercyclical contractionary fiscal stance to help offset the upswing, as in the case of Ireland in the early 2000s. This apparent asymmetry of the Pact failed to prevent some euro area members from pursuing a procyclical fiscal expansion during the so-called Great Moderation. The fiscal expansion was reflected by structural deficits, in excess of headline deficits (or a surplus in the case of Ireland), when the output gap was mostly in positive territory or zero (Figure 6.2). Thus measured, admittedly in hindsight, the expansionary stance is evident in Greece, Ireland, Italy, and Portugal over much of the past decade.

The deficit and procyclical biases were reinforced in 2004 by the demonstration effect of the failure of the Council and the Eurogroup to enforce sanctions against France and Germany, the largest member countries, under the EDP for violating the deficit ceiling—effectively ignoring the Commission's November 2003 recommendation to place these countries under enhanced surveillance. This event remained a testament to an essential defect of the peer review mechanism as practiced in the Council. Arguably, it caused irreparable damage to the credibility of the Pact, encouraging frequent breaches of the fiscal criteria by euro area member governments. Frequently, member governments failed to observe the deficit ceiling and the mandatory decline in the debt ratio to the prescribed ceiling, as well as the ensuing EDP, and were not sanctioned.

In a further manifestation of deficit bias, some countries tried to avert a breach of the deficit ceiling with stopgap policy measures (the first example was Italy's introduction of a refundable income-tax surcharge, to qualify for entry to the euro area) and accumulation of contingent liabilities (for instance, in the form of public-private partnership projects in Portugal) that

Figure 6.2. Euro Area Countries: General Government Balance and Output Gap, 2000–13

(In percent of actual or potential GDP)



Sources: IMF, *World Economic Outlook*, and author's estimates.

showed up in future deficits. In some cases, creative accounting practices and misreporting by governments[6] occurred with tacit consent by the EU authorities. For the most part, this behavior can be explained by pressure on governments to meet the fiscal reference values, including through various forms of repressed deficits, as predicted by Goodhart's law.[7]

Failure to enforce the EDP was accompanied by an optimistic bias in medium-term macro-fiscal projections[8] of a number of euro area member governments in yearly stability programs submitted to the EC. These programs were seen by some governments as fulfilling a reporting obligation that could soon be forgotten—a symptom of time inconsistency—rather than as a binding commitment to undertake budgetary measures that would lead to realization of the projected outcome. In some instances, notably in France and Germany in 2004, promises made by governments to exit the EDP became an elusive policy goal that was not subject to accountability and enforcement through prescribed sanctions.

In sum, several deficiencies in the enforcement of the fiscal framework have led to continued fiscal profligacy in a number of euro area countries that can be traced to before the introduction of the euro. These deficiencies reflect a significant deficit bias, procyclical expansionary bias, optimistic bias, and time inconsistency, particularly in the fiscally most vulnerable countries, namely, Greece, Italy, and Portugal.

Revisions of the Stability and Growth Pact in 2005, 2011, and 2013, intended to correct these deficiencies, have been subject to criticism by policy analysts. In principle, the allowance for structural reform measures in determining compliance with the rules, the emphasis on the structural balance or surplus, instead of the balance or surplus over the cycle; the introduction of benchmarks for expenditure growth; and the adoption of a numerical yearly reduction in the debt ratio are steps intended to strengthen the fiscal rules. In practice, the difficulty of measuring these metrics in real time can render them ineffectual.[9] More generally, the increased complexity of the rules[10] poses a major challenge for policymaking and for monitoring and enforcing compliance with the revised fiscal framework.[11]

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[6] Creative accounting included cash-based recording of expenditure, off-budget transactions, and non-reporting of losses of certain state-owned enterprises. Alt, Lassen, and Wehner (2014) provide documentation and analysis of such practices.

[7] According to Charles Goodhart, a numerical indicator (such as a monetary aggregate target or a budget deficit ceiling) ceases to be reliable once it is declared an official policy target or rule. Along similar lines, Summers (2013) observed that a budget deficit that is repressed artificially has perverse consequences—much as does inflation repressed through price controls.

[8] See Frankel and Schreger (2013).

[9] See real-time estimates of the structural balance for a large number of countries in Ley and Misch (2013).

[10] Recent publications of the European Commission (2013a, 2013b) are intended to help navigate through the maze of rules, regulations, and practices, which currently underlie the SGP.

[11] For a critical evaluation, see Barnes, Davidsson, and Rawdanowicz (2012); and Koester, Mohl, and van Riet (2012).

Surveillance

Responsibility for monitoring compliance with the EU fiscal framework rests primarily with the EC as regards member country policies and with Eurostat as regards public finance accounts and statistics. The Council (and the Eurogroup within it), however, is the sole authority for enforcing the framework, pursuant to the Treaty and the Pact.

The surveillance function of the IMF overlaps with, but in no way substitutes for, the mandate of the Commission. IMF surveillance over public finances focuses principally on their consequences for each member's external balance and, ultimately, for the stability of the international monetary system. Thus, in the case of the euro area, whereas IMF surveillance is supposed to oversee and promote fiscal discipline and public debt sustainability in each member country, EC surveillance is limited to observance of the fiscal framework per se, which is seen as paramount to preserving the integrity of the common currency area. To this effect, the IMF has held yearly consultations under Article IV not only with each euro area member government but also, since 1999, with the EC and the ECB.

On the basis of the discussion in the section "Fiscal Framework and Trends," above, the track record of some euro area member countries points to a number of deficiencies that would have merited close attention in IMF surveillance: a pronounced deficit bias, expansionary procyclicality, optimistic bias, and time-inconsistency. The combination of these deficiencies could have been expected to lead not only to a problem of unsustainable public debt, but also to widening fiscal and external imbalances (if the fiscal dissaving was not offset with private saving), exposing these countries to a fat-tail sovereign risk that would be captured by financial markets only with a considerable recognition lag.

This leads to a number of basic questions in evaluating the IMF's surveillance of euro area fiscal policies. Did the IMF take a backseat to (or rely excessively on) the Commission and Eurostat in monitoring fiscal policies in the euro area? Did the Fund deploy adequate staff resources to conduct oversight of fiscal policymaking in the euro area? In light of the heightened importance of fiscal policy as an adjustment tool under a fixed exchange rate regime, did IMF advice identify and focus on the fiscally vulnerable economies in the euro area and, more generally, on the underlying inconsistencies and weaknesses in the enforcement of the EU-wide framework? Was IMF advice supported by in-depth analysis, as well as by sufficiently forceful, timely, and well-communicated warnings? More specifically, was the IMF sufficiently thorough and candid in evaluating the transparency and veracity of public accounts, projections, and reporting practices; in assessing public debt sustainability; and in monitoring fiscal risks?

As a preface to addressing these questions, it should be noted that from the inception of the euro area, the prevailing groupthink in academic circles[12]

[12] Perhaps the best known theoretical analysis of this hypothesis can be found in Blanchard and Giavazzi (2002).

and among public officials[13] was that current account deficits—and as a corollary, government budget deficits—do not matter within a currency union. As confirmed in interviews with current and former senior euro area officials, not only the EC and ECB but the IMF as well subscribed to the view that a sudden stop of capital inflows to countries experiencing increasing external deficits was practically inconceivable within the euro area. The Fund's attitude,[14] remarkable insofar as the Fund was the institution with the most experience in dealing with balance of payments crises, was summed up in an external report on IMF surveillance: "Rather than fully exploiting its comparative advantage, based on its international experience, the IMF fell victim to a 'Europe is different' mindset" (Pisani-Ferry, Sapir, and Wolff, 2011).

By and large, in the fiscal area, the IMF and EU institutions operated in tandem as regards diagnostic and policy recommendations, with very few exceptions concerning specific euro area member countries. Following the onset of the crisis, however, the three institutions established cooperation under the so-called troika arrangement with the objective of jointly designing, overseeing, and supporting adjustment programs launched in member countries.

Surveillance of the Euro Area

Broadly speaking, the quality of IMF surveillance of fiscal policy for the euro area as a whole, conducted mainly through Article IV consultations, was on balance appropriate. While treating the euro area common currency area—the outcome of a collective political action by participating governments—as a given, IMF staff did on several occasions weigh the advantages and disadvantages of the euro area and flag challenges in the enforcement of the fiscal framework.[15]

Although there was no formal arrangement between the IMF and the ECB and EC, it seems to have been implicitly understood that IMF surveillance would support the EU institutions in their oversight responsibilities insofar as the EC and ECB staffs had limited operational experience in monitoring macro-fiscal policymaking—both institutions' analytical capacity in the fiscal

[13] In 2000, the then-Governor of the Bank of Portugal expressed succinctly the prevalent view: "Without a currency of our own, we shall never again face the balance of payments problems of the past. There is no macroeconomic monetary problem and no restrictive measures need to be taken for balance of payments reasons. No one analyses the macro size of the external account of the [state of] Mississippi or of any other region belonging to a large monetary union" (Constancio, 2000).

[14] As an exception, prior to the adoption of the euro, the Fund's Executive Board discussed the modality and conditions of a hypothetical use of Fund resources by a euro area member country in case of balance of payments need; see IMF (1998).

[15] For example, the Fund staff observed that "crux of the SGP problem was not so much designing 'optimal' but rather 'enforceable' fiscal rules. The SGP's basic design . . . remains broadly appropriate" IMF (2004: 29).

area notwithstanding. Accordingly, Fund staff appeared at times to have felt that the primary responsibility for oversight was with EU institutions not only concerning compliance with the SGP, but also regarding overall fiscal performance. This was particularly the case with regard to monitoring the accuracy of national and public sector accounts of EU member countries, which was deemed to be under the tutelage of Eurostat.

According to IMF staff members interviewed, bilateral Fund surveillance of the euro area in the pre-crisis and crisis periods, particularly in the fiscal area, was limited in two aspects. First, partly as a result of staff downsizing, the European Department (EUR) experienced considerable turnover, especially at senior staff level, including the position of EUR director. This contributed to some loss in operational continuity and in institutional memory. Second, surveillance and program work was carried out for the most part by EUR and the Strategy, Policy, and Review Department (SPR), with only occasional input from the other departments.[16] This was especially the case when it came to application of up-to-date analytical tools for measuring the structural balance and for assessing fiscal risk—the latter being an area where the Fiscal Affairs (FAD), Monetary and Capital Markets (MCM), and Research (RES) Departments had developed substantial expertise. In all, FAD input was rather limited: reviews and comments on fiscal issues in draft Board papers on advanced economies in general and euro area members in particular were sporadic, and FAD staff participation in area department missions was rare.[17]

A review of IMF Article IV staff reports since 1999 suggests that, while supportive of the initial design features of the SGP, the Fund was critical of the lack of sufficient national ownership and lax enforcement of the Pact and of the reforms to it that were introduced in 2005 and 2012.[18] However, the IMF could have been far more forceful in highlighting some of the deep-seated inconsistencies in the application of Treaty obligations, which began at the outset and damaged the credibility of both the Treaty and the Council, and created moral hazard for member governments and financial markets.

A major inconsistency was the failure by the Council to levy sanctions on governments that ignored the EDP, especially France and Germany in 2003. This negligence had a lasting demonstration effect on other member governments' fiscal behavior. Fund staff simply observed that "France and Germany—traditional bastions of fiscal discipline in the euro area—showed

[16] This seems to have been symptomatic of the silo behavior and mentality prevailing in the Fund, observed in IEO (2011).

[17] Routine FAD review of draft staff reports on advanced economies tapered off over the past decade and was formally discontinued—resumed only after the crisis—through an interdepartmental accord in 2010 in the interest of saving staff resources.

[18] On several occasions, the Fund explored ways to improve the architecture and implementation of the SGP. Most recently, the staff proposed establishing a closer fiscal union for the euro area to prevent crises; see Allard and others (2013).

little inclination to live up to their commitments to achieve underlying balance" and that "the Council decided to hold the EDP against France and Germany in abeyance" IMF (2004: 27–28).

Another inconsistency was the ECB's uniform treatment of euro area sovereign bonds as collateral, which could be viewed as de facto disregard for the no-bailout clause. The only, rather belated and oblique, reference to such practice this evaluation could find was in the staff report for the 2011 Article IV consultation on euro area policies, which noted that, "The crisis has changed a basic paradigm of the euro area, namely, that all sovereign debt of euro area member countries is equal" (IMF, 2011a: 12). In the event, it would have been useful if the IMF had raised a critical voice on this practice publicly and in a timely fashion.

On the positive side, the IMF did reiterate repeatedly the importance of complying with, and converging to, the euro area reference values on public deficits and debt. From 2002 through 2008, it consistently recommended an annual fiscal adjustment of 0.5 percent of GDP (net of temporary measures and allowance for automatic stabilizers) for euro area governments that had exceeded the reference values.[19] Also appropriate was the Fund's recommendation for improving fiscal governance by translating key features of the fiscal framework to the national level and adapting them to local needs. Equally, calls for reforming public pensions and health-care schemes to ensure fiscal sustainability were timely in view of rapid population aging in most European countries.

A selection of the IMF's major policy recommendations in the fiscal area reveals that their quality and relevance seem rather uneven (Box 6.2). For example, despite their possible conceptual appeal, the suggested introduction of a financial activities tax and a limited form of common eurobonds or bills would have benefited from elaboration of specifics and trade-offs. Somewhat controversial was the IMF's advocacy of a discretionary fiscal stimulus to counter the adverse impact of the financial crisis on the real economy. Although this recommendation was carefully nuanced in terms of composition and timing, fiscal stimulus as a cure for what was seen as a recession—a novel initiative from the Fund—was questionable for fiscally vulnerable countries that faced mounting public indebtedness and were reluctant to undertake structural reforms.[20]

Overall, the intensity of surveillance and exhortations by the Fund (and the EU) appeared to be driven to a large extent by market pressures. On the fiscal front, the Fund seemed complacent in the initial years of the

[19] In 2002, the recommendation was directed to the three largest euro area member countries (France, Germany, and Italy), but from 2003 onward it was extended to all euro area members that did not meet the "close-to-balance or surplus" requirement.

[20] For example, Tanzi (2013) compared this advice to prescribing steroids, for symptomatic relief, to a patient suffering from a serious illness. IEO (2014) observed that the IMF did not sufficiently tailor its macroeconomic advice to fit individual country circumstances.

Box 6.2. Euro Area: IMF Advice on Fiscal Measures

"The staff continues to subscribe to the standard that countries with weak underlying positions take ex ante discretionary fiscal policy actions to achieve a ½ percent of GDP a year of structural consolidation measures. . . . Budgets in 2004 need to look hard at achieving longer-term goals, eschewing tax increases or one-off measures in favor of multiyear actions to curb current spending, especially on transfers and public sector employment, thereby fostering sustainability and creating room for necessary tax cuts over time" (IMF, 2003: 32).

"In the staff's view, popular dissatisfaction pointed to the need . . . for strengthening or establishing independent, non-partisan fiscal councils [to] assess policies, provide more forward-looking perspectives, help rally popular support for adjustment, better identify policy failures, and mark up reputation costs" (IMF, 2005: 25).

". . . tax policy should not be used to hamper adjustment to rising energy and food prices. Looking further ahead, stronger national fiscal rules and domestic governance mechanisms could help achieve more predictable and efficient fiscal policies in countries that struggle with relatively high public deficits and debt" (IMF, 2008: 22).

"While fiscal policy will need to continue to support economic activity in 2010, it is essential to embed short-term actions in credible medium-term consolidation programs to address solvency concerns. . . . The composition of the fiscal stimulus is seen to be as critical as its size, and coordination is essential. The key is to ensure that fiscal incentives boost activity over the relevant time frame, while seeking lasting benefits to productive capacity. The length and severity of the downturn justify greater weight on investment projects that typically have long lags but bring substantial longer-term benefits. Tax cuts, on the contrary, could be implemented quickly, but are likely to have more modest impact" (IMF, 2009b: 5, 21).

". . . fiscal adjustment plans need to be strengthened considerably. They should focus structural expenditure cuts on distortive and ineffective programs, such as the elimination of certain price and production subsidies, and a shift from universal to targeted social transfers which would preserve spending by low income earners, while boosting confidence in the return to sustainable spending patterns. Ambitious entitlement reforms—such as measures aimed at increasing the effective retirement age—are essential to deliver large credibility gains at a lesser cost in terms of short-term growth [sic]. In contrast, across-the-board cuts in investment programs should be avoided. In some countries, comprehensive tax reforms should aim at broadening the tax base, reducing distortions and improving compliance. In this respect, the coordinated introduction of a Financial Activities Tax would be helpful" (IMF, 2010b: 13).

"The directive on national fiscal frameworks will encourage prudent national fiscal behavior. . . . The directive could be made more effective by requiring systematic disclosure of information on state-owned corporations and public-private partnerships, spelling out good practices for fiscal rules, escape clauses and budget controls, and extending the list of fiscal risks beyond contingent liabilities. Other critical elements of budgetary frameworks such as budgetary unity and the need for a top-down sequence in budget preparation would be most welcome" (IMF, 2011a: 18).

"Introduction of a limited form of common debt with appropriate governance safeguards can provide an intermediate step towards fiscal integration and risk sharing. Such debt securities [sic] could, at first, be restricted to shorter maturities and small size and be conditional on more centralized control. . . . Common bonds/bills financing could, for instance, be used to provide the backstops for the common frameworks within the banking union" (IMF, 2012a: 26).

"Over the medium term, ideas to simplify and strengthen fiscal governance framework should be explored. Consideration should be given to a more parsimonious framework with a single objective and an economically operational lever. The credibility of the rules would be enhanced by much stronger enforcement mechanisms. Boosting the ability of the center to fund public infrastructure projects—such as cross-border investments in transportation, communications and energy networks—would help lay the foundations for sustained growth" (IMF, 2014b: 25).

euro area as sovereign risk premiums narrowed and then vanished, but this attitude turned into alarm when financial markets experienced turbulence, reflected in the gyrations of the sovereign risk premium. Instead, the Fund's surveillance should have addressed the fundamentals of fiscal policy long before market sentiment deteriorated, with a view to preventing a possible shift from an apparently good equilibrium to a bad one—as viewed from a multiple-equilibrium perspective.[21]

Surveillance of Vulnerable Member Countries

Although staff reports on euro area policies made occasional references to member country policies, for the most part they tended to downplay individual country vulnerabilities via aggregation for the euro area as a whole. Surveillance of individual member countries, mainly through Article IV consultations held yearly with the national authorities, was rather superficial. In particular, the Fund could have exercised much more intense monitoring of highly indebted governments that had a trail of fiscal problems and exhibited a deficit bias almost continuously up to the financial crisis. On this basis, countries that entered the euro area with public debt barely meeting the EMU reference values, such as Greece, Italy, and Portugal, deserved special attention from the very start of euro membership.[22]

[21] An explanation and test of this shift in the euro area can be found in De Grauwe and Ji (2013).
[22] In Italy, the deficit reference value was met with recourse to various creative accounting maneuvers, including introduction of a tax surcharge that was reimbursed following euro area accession. See Spaventa and Chiorazzo (2000) and Reviglio (2001). In the case of Greece, it was discovered several years later that the deficit reference value was reached through gross misrepresentation of fiscal data—discussed below.

For starters, the Fund could have questioned the suitability of some fiscally vulnerable countries for euro membership.[23] Its failure to do so seems to have been largely prompted by political sensitivities. In particular, there was sufficient evidence to argue that Greece was not ready to join the euro area—not only on the grounds of insufficient real economic convergence (given its markedly lower income level and different economic structure relative to the other euro area members), but also because of foreseeable difficulties in complying with the requirements of the fiscal framework given its past record of fiscal profligacy.

In addition, in the early years of the euro area, the Fund missed the opportunity to critically assess member countries that failed to allocate a significant portion of their windfall gains from lower interest costs to a reduction in public debt and concomitantly create fiscal space for countercyclical action in the event of an economic downturn.

Although the surge in economic activity over the past decade may have been difficult to detect while it was happening, in the wake of a brief downturn at the outset, the Fund could have paid more attention to the procyclical fiscal expansion that fiscally vulnerable euro area countries were pursuing. In general, however, despite occasional references to the structural budget balance, discussions with the authorities focused mostly on the headline balance. In retrospect, the expansionary stance was evident not only in Greece, Italy, and Portugal, but also in Ireland—which eventually also became fiscally vulnerable. In all these countries, the structural deficit increasingly exceeded the headline deficit against the backdrop of a rising output gap—evidence of a procyclical fiscal expansion and a positive fiscal impulse, which was most pronounced in Greece and Ireland (Figure 6.2 above).

Ireland and Spain stand apart from the other countries in the sense that the root cause of their sizable macroeconomic imbalances was a financial bubble, manifest mainly in a jump in real estate asset prices. The bubble fed a seemingly favorable revenue performance that masked a significant structural deficit that was not readily observable. The boom in tax revenue encouraged these countries to embark on a procyclical increase in expenditure on wages and pension benefits, as well as tax subsidies.[24]

This problem was particularly pronounced in Ireland, where, contrary to ECOFIN's concern about the expansionary stance, the Fund staff downplayed the issue in view of a headline budget surplus in 2001.[25] Since the beginning

[23] This view, especially with regard to Greece, was shared by IMF staff and Board members alike who were interviewed for this evaluation.

[24] This policy stance was best summarized in a quote from former Irish Finance Minister McCreevy (2002): "When I have it I'll spend it. When I don't I won't."

[25] In a rare display of difference in views in EU and IMF surveillance, Fund staff stated that ". . . the rising budget surplus fed public desires for additional tax cuts and spending increases. Shaped by these circumstances, the 2002 Budget gave rise to an opinion by the European Council in February critical of the procyclical fiscal stance. Subsequent indicators point to a welcome slowing of the economy, however, reducing the potential risks from the fiscal stimulus" (IMF, 2001a).

of the past decade the staff had expressed misgivings about the evolving real estate boom underlying the strong economic growth but, based on standard EC estimates of the output gap and structural balance, as well as the low recorded public debt ratio, considered that the fiscal accounts were broadly in equilibrium. It was only in 2009 that the staff reversed its view—based on a methodological shift, already available a number of years earlier, which revealed a change in the 2006 structural balance from a small surplus to a deficit of 7 percent of GDP[26]—and alerted the authorities about the need for a drastic fiscal consolidation.

In the case of Spain, the effect of the financial bubble on fiscal performance was more difficult to detect, for it was reflected primarily in a rise in subnational government revenue from fees charged on construction and development permits, and only to a lesser extent in capital gains from the surge of real estate prices and a resulting rise in income tax revenue. In all, the damage to the financial system and to the public sector accounts was milder, more gradual, and better managed than in Ireland.

As noted above, the conduct of macro-fiscal policies in euro area countries was further beset by a strong optimistic bias in the budgetary projections that were incorporated in these countries' annual medium-term stability programs submitted to the EC. However, the projections prepared by the IMF and reported in the *World Economic Outlook* since 1999 for Greece, Ireland, Italy, and Portugal exceeded the actual balance by a significant margin. By contrast, the projections for the euro area as a whole tracked consistently the actual balance (Figure 6.3). These projections can be interpreted as representing official IMF endorsement of the optimistic bias of several fiscally vulnerable euro area members.

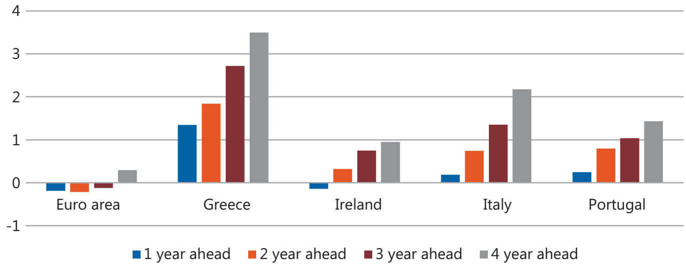
There are several explanations for the optimistic bias. One of them is simply optimistic projections of key underlying macroeconomic variables (especially output and interest rates). Another consists of optimistic assumptions on spending control or effective tax elasticities. The third is time-inconsistency in the implementation of the policy measures promised by these member governments to achieve the medium-term objective in compliance with the statutory limit on the budget deficit under the Pact.

In Greece, weak fiscal performance was further aggravated by gross misreporting of national and public sector accounts.[27] The main sources of

[26] IMF (2009a) adopted the approach reported in Kanda (2010), along the lines developed much earlier by Jaeger and Schuknecht (2004). In essence, the revised estimate of the structural balance sought to incorporate the ongoing asset price boom in the calculation of the underlying output gap.

[27] According to IMF staff members interviewed, the Greek authorities were usually evasive when asked about the gaps and inconsistencies in fiscal statistics, claiming that they had provided all the required information to Eurostat. (After the disclosure of the first misreporting, EUR staff had contacts with Eurostat at the desk level.) However, according to a senior Eurostat official,

Figure 6.3. Euro Area Countries: General Government Balance Forecast Errors, 2000–08
(In percent of GDP)



Note: Forecast errors are calculated as the difference between forecast values for each year and actual values for that same year, measured in the following year, so as to avoid the effect of subsequent revisions of actual data.

Sources: IMF, *World Economic OutLook* and author's estimates.

understatement of deficits were incomplete coverage of the losses of hundreds of public pension funds and state-owned enterprises, and unreported military outlays. This was largely attributable to data manipulation under political influence—exacerbated by a culture of opacity and promoted by certain legal constraints[28]—to meet the budget deficit reference value, first, to qualify for entry in the euro area and then, to demonstrate compliance with the Pact. On two occasions, following elections in 2004 and late 2009, the Greek authorities revealed that general government deficits and debt had been understated by a sizable margin. On the first occasion, the understatement facilitated Greece's entry into the euro area. On the second, the revelation spooked financial markets and caused a jump in the sovereign risk premium, which in turn—together with the authorities' failure to take corrective action—resulted in a sudden stop in capital inflows the following year.

During much of the past decade, Fund staff expressed far less concern about the reliability of Greece's fiscal accounts than was warranted. The IMF's fiscal transparency report for Greece went as far as to declare that the country "in recent years has made progress in meeting requirements of the fiscal transparency code. . . . At the central government level, Greek budget

the data that the agency received from Greece were not in a form that could be used for verification. Moreover, neither the Council nor the Eurogroup had granted authority to Eurostat to investigate primary data sources to verify the information provided by the Greek government, even after the misreporting in 2004.

[28] In Greece, revelation of data or information by a public official is prosecutable under legal restrictions that inhibit transparency in the public sector. A case in point is the prosecution of the former head of the Greek statistical authority ELSTAT for disclosing government data to official international institutions.

processes give assurances of integrity about fiscal data through independent audit and recently strengthened statistical reporting" (IMF, 2006). Within the Fund, senior staff and management paid scant attention to repeated warnings by staff teams about the dismal condition of Greece's public sector accounts, according to staff members who were interviewed for this evaluation. It was only in 2009 that the Fund (and the EC) openly criticized the quality of Greek fiscal statistics for the first time; and in 2010 that the IMF found Greece in breach of members' reporting obligations under Article VIII, Section 5, of the Articles of Agreement—a decision that could have been made several years earlier.

The IMF, with the support of EU institutions, could have stepped up the monitoring of public finances in the vulnerable economies by shortening the Article IV consultation cycle before the onset of the crisis. Indeed, there was a strong case for applying enhanced surveillance to some of the fiscally vulnerable euro area members, particularly Greece, given the unreliability of its fiscal data. Enhanced surveillance was only considered briefly with regard to Italy in late 2011,[29] in response to market pressure and the ECB's threat of suspending transfers under emergency liquidity assistance. Support for higher-frequency and more in-depth surveillance by the Fund would have been most helpful coming from EU institutions, especially Eurostat, which operated with considerable lags in rendering an opinion on government statistics and overlooked well-known loopholes in the measurement of general government balance and debt.[30]

At the onset of the recession in 2009, the Fund recommended that euro area member governments, among others, undertake a discretionary fiscal stimulus of some 2 percent of GDP as a countercyclical move. This advice—though qualified for certain vulnerable economies with scant or no fiscal space—was welcomed by political leaders in some of these countries. In Portugal and Spain, the recommended stimulus, adopted in the run-up to elections, was deemed ill-timed and ill-advised, given the already sizable fiscal imbalance.[31] In both countries, the resulting overall deficit reached 10 percent of GDP, equivalent to an impulse of about 5 percentage points from the preceding year in structural terms.

As part of its surveillance of macro-fiscal policies, far more positive were the IMF's frequently voiced recommendations of specific structural reform

[29] According to Leipold (2011), in the wake of the G20 meeting in Cannes, the Fund was instructed to conduct quarterly staff visits to monitor the implementation of measures promised by the Italian government. The proposed enhanced surveillance was abandoned three months after the public announcement, following the succession of the Berlusconi government by the Monti government.

[30] A notable example is the exclusion from government deficit- and debt- data of losses incurred by state-owned enterprises where more than one half of revenue originates outside the public sector—unless recapitalized with an equity transfer by the government.

[31] See, for example, Dhar (2014).

measures intended to regain or strengthen medium- to long-term debt sustainability in vulnerable euro area members. The following areas were most often singled out for reform or improvement: fiscal governance; tax policy and administration; public financial management, including expenditure control; public pensions; and state-owned enterprises. In some cases, the Fund formulated recommendations on the basis of technical assistance provided by FAD staff—as discussed in the section "Stabilization Programs" below.

Assessment of Fiscal Sustainability and Risk

In order to evaluate the Fund's role in trying to avert a crisis, it is necessary to examine its efforts in assessing the sustainability of, and risks facing, the member country's public finances.[32] A critical component of surveillance consists of helping anticipate and communicate in a timely manner the probable impact of shocks on public finances, and to advise the government on steps to mitigate or neutralize the impact of such shocks. Ultimately, insofar as feasible, the objective should be to alert the authorities as to the country's vulnerability to a so-called fat-tail risk of outright default.

Since the early 2000s, for the most part, Fund staff reports have included a debt sustainability analysis consisting of a quantitative scenario of the public debt-to-GDP ratio over a medium-term horizon, in which the underlying drivers and macroeconomic assumptions are not always fully stated. In addition to a baseline scenario, the reports provide an illustrative chart showing deviations from the baseline under an assumed change in the growth rate, interest rate, exchange rate, and realization of contingent liabilities. This basic template has been applied in most Article IV consultations with member countries, and its coverage was recently expanded to include an assessment of debt structure and liquidity issues.[33] (Obviously, for euro area members, no exchange rate change was simulated.) It is noteworthy, however, that from 2005 through 2008, Article IV staff reports for Greece did not include a public debt sustainability analysis.

Given the arbitrary character and methodological limitations of the template, efforts have been under way for more than a decade in the Fund to develop more realistic and objective methods of sustainability-cum-risk assessment, drawing on macroeconomic and financial analysis.[34] In some variants, these initiatives sought to incorporate stochastic methods in the intertemporal public sector balance sheet, incorporating the government's exposure to contingent liabilities. Such methods were available for application to vulnerable euro area countries but they were ignored in the ongoing policy

[32] This task is an integral part of Fund surveillance, as noted by the IEO, insofar as it "consists of monitoring the global economy and that of member countries to help head off risks to international monetary and financial stability, alert member countries to potential risks and vulnerabilities, and advise them of needed policy adjustments" (IEO, 2011).

[33] For the initial template and its modification, see IMF (2002, 2011b, respectively).

[34] Kopits (2014b) provides a review of the literature, as well as the results of a recent OECD survey of country practices as regards specific, general, and systemic fiscal risks.

dialogue between the Fund and the national authorities in assessing fiscal risk. Instead of applying improved debt sustainability analysis, Fund staff continued to rely on the template, even during the crisis.

An exception to the substandard approach to risk assessment was the staff's estimate of the intertemporal balance sheet of Greece's public sector in 2009, which was calculated in terms of the present value of the future stream of major assets and liabilities, including contingent liabilities, in addition to a comprehensive accounting balance sheet (IMF, 2009c). This exercise, without apparent traction in the Article IV consultation discussion and subsequently abandoned—reportedly at the request of the authorities—served to illustrate Greece's sizable fiscal insolvency about half a year before the loss of access to financial markets. Ideally, such an exercise could have been supplemented with a value-at-risk analysis, developed much earlier by Fund staff.[35]

The debt sustainability analysis template was supplemented effective 2013 with a so-called risk assessment matrix (RAM) summarizing the staff's subjective view of the likelihood of specified shocks and their impact on the economic and financial performance of the euro area. Against the RAM's advantage of communicating results in non-technical terms, however, are its obvious shortcomings as a numerical indicator of fiscal risk.[36] Equally, fiscal risk narratives in the IMF's multilateral surveillance vehicles, including the *Fiscal Monitor*, cannot compensate for the absence of regular and comprehensive risk assessments in the context of annual Article IV consultations with specific countries or groups of countries. In addition, an internal "vulnerability exercise" for advanced economies, undertaken by the staff at regular intervals since 2012, is of limited value insofar as the resulting assessments are not disclosed to the national authorities or to the general public.[37] In recent pilot assessments of fiscal transparency, however, the potential loss from specific fiscal risks involving tax measures, expenditure programs, and contingent liabilities was estimated for Ireland and Portugal.[38]

Stabilization Programs

The IMF-supported programs under scrutiny in this evaluation are: the initial three-year Stand-By Arrangement (SBA) for Greece (cancelled after two years); a three-year arrangement under the Extended Fund Facility (EFF)

[35] The estimate of negative net worth of the public sector for Greece (totaling nearly 400 percent of GDP even before correcting the data for misreporting!), however, was so large that it obviated the application of a formal value-at-risk analysis, developed by Barnhill and Kopits (2003), to calculate fat-tail risks.

[36] Staff views on the likelihood of specified shocks were classified as "low" for less than 10 percent probability, "medium" for 10–30 percent probability, and "high" for greater than 30 percent probability. For a critical discussion of the RAM, see Robinson (2014).

[37] Such confidential treatment is questionable, for example, in the case of bank stress tests conducted by major central banks.

[38] See IMF (2013c, 2014c).

for Ireland; and a three-year Extended Arrangement for Portugal. The subsequent three-year Extended Arrangement for Greece falls outside the scope of the evaluation.

Typically, when a country suffers a sudden stop in market financing of sovereign paper—as experienced by Greece, Ireland, and Portugal in 2010–11—the loss of liquidity must be offset by financing from various (mostly external) official and private sources. If the country is concurrently in default (or near default) of its obligations, the insolvency is remedied with public debt restructuring, usually in the form of a rescheduling of existing liabilities and in some cases accompanied by debt relief (so-called haircut) on those liabilities. An orderly process had been developed over the years prior to 2010 in which financing, including debt restructuring, became an integral part of the negotiation and design of any IMF-supported SBA or Extended Arrangement.

More generally, financing is one of three pillars of a fiscal stabilization program; the other two pillars are macro-fiscal adjustment and structural fiscal measures. The relative weight of each pillar depends on a number of factors, including the supply of funding, public debt sustainability, the size of the gross financing need, the extent of tax and budget distortions (with a direct or indirect bearing on the external position), and the availability of non-fiscal instruments, notably the exchange rate. These pillars are examined in turn in the following sections.

Financial Support

In the early phase of the crisis, as financial markets were spooked by developments in the vulnerable euro area member countries and by the initial resistance of supranational institutions to provide stop-gap financing, sovereign risk premiums jumped and kept rising in these countries. However, the upward pressure on spreads began to abate under the effect of multiple ECB facilities that provided indirect financing to governments mainly through the banking system.[39] In addition to the steady buildup of TARGET claims, the ECB (or the Eurosystem) began to extend refinancing credit through Long-Term Refinancing Operations (LTROs), credits under emergency liquidity assistance (ELA), and purchases of government bonds through the Securities Markets Program (SMP). But it was not until 2012, with the announcement of the Outright Monetary Transactions (OMT) program by the ECB, accompanied by a Greek debt restructuring, that spreads on vulnerable euro area member government bonds narrowed markedly, as the markets interpreted these steps as a renewed relaxation of the no-bailout clause.[40]

[39] Sinn (2014) offers a thorough analysis of excessive reliance on these facilities and their implications.
[40] Arguably, these and other forms of EU financial assistance can be justified if a member state faces “difficulties or is seriously threatened with severe difficulties caused by exceptional occurrences beyond its control,” under Article 103a of the Treaty, in effect overriding the no-bailout clause in Article 104.

Thus, in an approach that was rather unusual in a sovereign financial rescue operation, the ECB became the principal channel of financing for vulnerable EU member countries during much of the euro crisis.

In comparison to past crisis episodes in other countries, the adjustment programs introduced in Greece, Ireland, and Portugal can be characterized as among the most complex; they belong to a category of their own in a number of aspects, including the financing pillar. Following loss of access to financial markets in the first half of 2010, Greece became the first case where it was incumbent on the EU institutions and the IMF, possibly with the cooperation of private creditors and in negotiation with the national authorities, to consider various forms and magnitudes of financing. Unlike in previous crises, a major challenge emerged for the various parties—occasionally operating with conflicting interests—to put together a financing package without recourse to debt restructuring.

Many outside observers in the academic and banking communities, as well as within the Fund (including some members of the Executive Board), expressed serious skepticism about the exclusion of debt restructuring for Greece,[41] and to a lesser extent for Ireland and Portugal. They pointed to a convincing prima facie case based on the sharp jump in the public debt ratio—by nearly one half in Greece and Portugal and a quadrupling in Ireland, between 2007 and 2009—which had resulted mainly from the erosion in the effective tax base (due to the significant contraction of output), and to a much lesser degree, from recapitalization of the banking system (due to the surge in impaired banking assets).[42] The general case for debt restructuring was further strengthened by fresh evidence on the growth-depressing effect of public debt ratios approaching 100 percent.[43]

Nevertheless, from the outset and well into the program period, the EC and ECB resisted any form of debt restructuring, as did the crisis-hit euro area governments. The EU institutions and their major member governments were opposed to debt restructuring, apparently in order to enforce the no-bailout provision and to protect their banks' balance sheets.[44] The IMF, partly because of fear of contagion to its members, went along with this position.[45]

The programs that were approved for Greece, Ireland, and Portugal were constrained by the availability of official balance of payments support to euro area member governments on the scale required in each case. Thus the IMF

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[41] See the list of critical commentators in IMF (2013b).

[42] Even in Ireland, bank recapitalization was estimated to have totaled less than one-fourth of the increase in public debt according to Donovan and Murphy (2013) and about two-fifths according to Fund staff.

[43] See Reinhart and Rogoff (2009). Their results were subsequently corroborated by Cecchetti, Mohanty, and Zampoli (2011).

[44] This was corroborated in interviews with former Fund Executive Directors.

[45] See Kincaid (2017) and Schadler (2017).

was persuaded to lend amounts far in excess of country limits expressed in terms of membership quota—in fact, without precedent in its history—by invoking the exceptional access criteria. Initially, EC financing could be provided only by diverting some funds from earmarked windows and by drawing on the newly created European Financial Stability Facility and European Financial Stabilization Mechanism, which was succeeded in 2012 by the European Stability Mechanism as a permanent firewall for euro area members facing financial difficulties. But as sovereign risk premiums continued to spike for the vulnerable countries in the course of 2011, a relatively generous debt-restructuring agreement with private sector involvement—defined as voluntary, to avoid declaring a formal default by a euro area economy—was approved for Greece the following year. These steps, along with significant backdoor ECB financing, helped bring about a temporary decline in sovereign bond spreads.

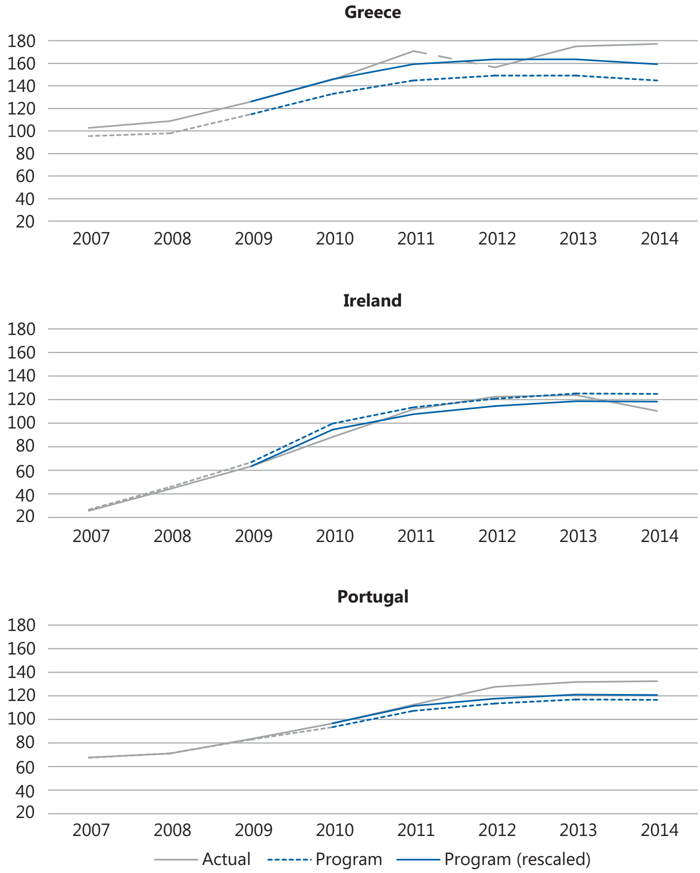
In part to justify granting Greece exceptional access to IMF resources, the Fund had to satisfy itself on several criteria, including a high probability that public debt was sustainable over the medium term. Given prevailing uncertainties regarding debt sustainability, the IMF sought to bolster the case for exceptional access by invoking the newly devised criterion of a "high risk of international spillover effects."[46] In an attempt to show that over time Greece's public debt would be sustainable, the Fund prepared a medium-term baseline debt scenario on the basis of what its own ex post evaluation would later acknowledge were excessively optimistic macro-fiscal assumptions.[47] A similar exercise was repeated at the beginning of each of the other two programs as well, though underpinned by relatively more realistic assumptions.

In both Greece and Portugal, the actual trajectory of the public debt ratio was significantly higher than projected—rescaled to incorporate data revisions—under the initial programs (Figure 6.4). Even with the 2012 debt restructuring, Greece's public debt exceeded the projected stock by a wide margin by 2013. By contrast, by the end of the adjustment program, Ireland's debt ratio had actually been contained below the projected ratio on an apparently sustainable path.

[46] On the Fund's Greek rescue operation, including insights into the inter-institutional and interpersonal dynamics, see a comprehensive discussion by Schadler (2013).

[47] Specifically, the underlying assumptions included a relatively rapid resumption of growth and a turnaround in the primary balance from deficit to surplus over the scenario period, all on the strength of structural reform measures assumed to be launched during the program; see IMF (2010a, 2013b).

Figure 6.4. Greece, Ireland, and Portugal: Actual and Projected Public Debt Ratios, 2007–14
(In percent of GDP)



Note: Projections have been rescaled to fit revised actual base-year data. The original actual data and projections at the beginning of the program are shown by broken lines.

Sources: IMF, *World Economic Outlook* and author's estimates.

Scale and Composition of the Adjustment

The IMF-supported stabilization programs that were launched in May 2010 in Greece, in December 2010 in Ireland, and in May 2011 in Portugal were unique in several respects. First, these programs were constrained by a common currency, limited nominal wage flexibility (though with some slowdown in wage growth during the programs), and low inflation. As noted above, these constraints imposed an extraordinary adjustment burden on fiscal policy. Second, the programs were undertaken in the face of stagnant external demand and financial fragmentation, which acted as impediments to export performance and capital inflows, respectively. And third, the program required unprecedented support and tutelage—both in scale and coordination—from the IMF, the EC, and ECB, which became known as the troika. This posed a singular operational challenge for all three institutions.[48]

Internally, the three programs differed in two important respects: the degree of local ownership and institutional constraints. These factors had important implications for the design and implementation of the fiscal components of the adjustment, for the credibility of the authorities' policy commitments, and ultimately, for the outcome of the adjustment effort.

In Ireland, from the outset of the crisis, there was strong and widespread local ownership of the adjustment effort, which the government had launched before the arrival of the troika. Indeed, the authorities reacted with conviction in the face of an extraordinary rise in the budget deficit to more than 30 percent of GDP and in the public debt ratio by nearly 100 percent—two-thirds stemming from the fall in tax revenue due to the collapse of asset values and one third from the recapitalization of the banking sector.

In Portugal, by the beginning of 2011, the government's initial denial of the crisis gave way to negotiation of an Extended Arrangement that was honored by the succeeding coalition government—though without completing the final review, whereby the program lapsed without the final disbursement. The resulting implicit consensus among political parties as well as other stakeholders lasted until the fall of 2012, when the government made a failed attempt to shift a portion of the social security payroll tax obligation from employers to employees—as part of an internal "fiscal devaluation" and to offset the budgetary cost of a Constitutional Court decision to annul a proposed expenditure-saving measure—without consulting social partners. Following an equally failed attempt (in line with an initial commitment under the program) to shift part of the employers' payroll tax to an increase in the value-added tax (VAT),[49] the government opted for a significant hike in the personal income tax. Subsequently, opposition parties withdrew support for the program and pledged to reverse some fiscal measures if elected.

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[48] According to several current and former staff interviewees, communication was sporadic not only among the troika participants, but also within the Fund.

[49] The government expected that the shift in the payroll tax burden to employees would have an equivalent positive budgetary effect because of the saving in the government's own gross wage bill (which would be transferred to public sector employees). This was the type of fiscal devaluation initially envisioned in the IMF-supported program. This idea was inspired by Blanchard (2007) and had been implemented with mixed success several decades earlier in Italy ("*fiscalizazzione degli oneri sociali*"); see the analysis in Kopits (1982). Internal simulations by EC staff with the QUEST model indicated that neither proposal would have any effect on Portugal's competitiveness; instead, the tax saving would be absorbed mainly as a windfall in Portugal's nontradable sector. In the end, despite its conceptual attractiveness to improve external competitiveness and its hoped-for beneficial fiscal impact, the proposed partial shift of the employers' payroll tax was opposed even by employers because of its potential adverse consequences for labor relations.

In Greece, following a period of denial that lasted well into 2010, the political leadership never really identified itself with the policy requirements of the program. As reported by various interviewees, successive governments blamed the outside world, to a greater or lesser degree, for the hardships imposed by the fiscal measures under the program. Lack of ownership throughout the program was a serious handicap to successful implementation.

Whereas in Ireland institutional constraints were minimal, in Greece, and to a lesser degree in Portugal, they posed a major stumbling block in the design and delivery of the fiscal adjustment. Despite being classified as an advanced economy by virtue of its euro area membership, by all accounts Greece's institutional capacity in the judicial process, tax administration, expenditure control, and statistical services was below that in practically any other European economy. In Portugal, apart from some weaknesses in public financial management, the program was affected by several decisions by the Constitutional Court—some of them unforeseen at the time of legislation—which struck down certain fiscal measures that the Court interpreted as being contrary to the acquired rights of citizens, especially public employees, that were enshrined in the Constitution.

Given the extent of their fiscal imbalances and accumulated public debt, in the context of the common currency and real wage rigidity, all three countries faced a major fiscal adjustment need. Therefore, inevitably, each program entailed a large-scale front-loaded budgetary consolidation, which was rendered onerous by the lack of access to market financing and by the stagnant economic environment in major trading partner countries. While the EU institutions, particularly the ECB, insisted on compliance with the statutory deficit ceiling of 3 percent of GDP by the end of the program period, the Fund's objective was to restore public debt sustainability. The resulting fiscal targets were seen by staff as a compromise between the two positions.

In both size and speed, the envisaged adjustments ranked among the largest in recent decades[50]—with the possible exception of the recent adjustment in Latvia, also undertaken under a hard exchange rate peg. Most outside observers and some inside the Fund expressed the view that the fiscal adjustment was probably excessive, but for the most part unavoidable not only because of the regional economic contraction but also because of the limits on financing available from private and official sources.[51] Nonetheless, some observers, including within the Fund, questioned whether the extent of the fiscal adjustment should have been as procyclical—apparently designed using

[50] See Tsibouris and others (2006).

[51] The external financing constraint, including the initial reluctance to undertake large-scale debt restructuring, was the reason given by some interviewees for the over-optimism of the macro-fiscal forecasts and long-term debt projections for Greece by IMF management and senior staff to justify the SBA for Greece at the Executive Board.

low underlying fiscal multipliers.[52] The debate over the size of the multipliers, though of interest from an analytical point of view, was regarded as of limited practical relevance, given the need to meet a very large financing requirement under each program because early debt restructuring was ruled out.

With far less justification, however, for both Greece and Portugal, the nominal deficit ceiling was frequently revised in the course of the program, often in tandem with GDP, which contracted more than anticipated. The latter was tantamount to disallowing the operation of automatic stabilizers, thus aggravating the procyclicality of the fiscal stance, which in turn widened the nominal deficit and exacerbated the contraction—a self-defeating approach, much like the case of a dog chasing its own tail. By contrast, in the case of Ireland, no such revisions were undertaken during the program and the stabilizers were permitted to operate, possibly contributing to the fiscal correction and an earlier recovery.

All told, the actual primary fiscal adjustment ranged from 9 percent of GDP in Greece to 10½ percent of GDP in Ireland, with Portugal recording 9½ percentage points. However, the annual retrenchment was comparatively much larger in Greece insofar as the Greek program lasted two years, while in the other two countries the retrenchment took place over a three-year period. Remarkably, in each case, the actual adjustment deviated by less than 1 percentage point from the initially programmed adjustment (Table 6.1).[53]

The composition of the fiscal consolidation varied significantly across the three programs. Whereas in Portugal the adjustment in the primary budget deficit was split evenly between revenue hikes and spending cuts (contrary to the initially programmed reliance on mostly across-the-board expenditure cuts), in Greece two-thirds of the consolidation took place in the form of increased revenue. By contrast, in Ireland almost the entire adjustment consisted of

Table 6.1. Greece, Ireland, and Portugal: Fiscal Adjustment During the Program
(In percent of GDP)

	Greece	Ireland	Portugal
Primary balance, projection	9.6	10.9	8.9
Primary balance	8.9	10.5	9.5
Revenue (excluding interest)	5.8	1.1	4.7
Expenditure (excluding interest)	–3.1	–9.4	–4.8

Sources: IMF staff reports and *World Economic Outlook*.

[52] Blanchard and Leigh (2013) found evidence that fiscal multipliers were underestimated and growth forecasts were optimistic in the adjustment programs. In fact, the multiplier of 0.5, assumed uniformly for all three programs on the basis of OECD estimates, ignored the wide range of multiplier values across countries under different conditions. The assumed value was particularly low for Greece, given its relatively closed economy.

[53] It should be noted that Table 6.1 is based on calendar year data (2010–12 for Greece, 2009–13 for Ireland, and 2011–14 for Portugal), which do not coincide with the program period. In the case of Ireland, 2009 was used as the base year for the calculation, rather than 2010 when primary expenditures included the one-off capitalization of the banking sector.

expenditure reductions. Thus, except in Ireland, the composition of the adjustment is likely to have had an unfavorable impact on output.[54]

A closer look at composition reveals additional doubts regarding the quality of the adjustment in terms of longer-run effects on economic growth and public debt sustainability. It is well known that increments in property taxes and indirect taxes on goods and services are less distortionary than hikes in income and payroll taxes; also, in general, tax-base broadening is far preferable to statutory tax rate increases.[55] On the expenditure side, cuts in wages, pensions, and subsidies are preferable to cuts in productive investment; furthermore, rationalization of the public sector work force to retain productive employees, and targeting of social benefits, can actually be favorable to growth.

From this perspective, program implementation was in some instances harmful to growth and, as a corollary, inimical to debt sustainability. For example, the reliance in Greece and Portugal on tax rate increases (and less on tax-base broadening), investment spending cuts, and across-the-board wage freezes or reductions (rather than trimming the workforce) seems to have been a strategy favored on political grounds by the authorities and endorsed at least tacitly by the Fund.[56] In Portugal the Fund backed the merger of certain defined-contribution private pension funds with the defined-benefit public pension system—thus compounding the future public debt burden with additional contingent liabilities for the sake of a short-run reduction in the budget deficit. Also, to ensure compliance with the deficit ceiling, the Portuguese authorities imposed a heavy income-tax surcharge, apparently endorsed by the Fund.

Admittedly, when confronted with solvency and liquidity problems, "policymakers may not be in a position to select an optimal tradeoff between quality and speed of adjustment" (Tsibouris and others, 2006). Yet, as indicated above, repressed deficits—through recourse to contrived short-run measures rather than sound policies—just like repressed inflation, are usually distortionary and self-defeating for restoring public debt sustainability.

Structural Conditionality

Structural fiscal measures comprised an integral component of the adjustment programs in Greece and Portugal, and to a much lesser extent in Ireland, reflecting mainly differences in institution-building needs among the three countries. From the Fund's perspective, structural conditionality in the three programs, which was mainly in the fiscal and financial areas, was

[54] According to Alesina and Ardagna (forthcoming), the higher the proportion of a fiscal adjustment achieved by expenditure cuts, the more likely its favorable impact on activity. Similarly, Perotti, Strauch, and von Hagen (1998) found that at least 70 percent of a successful adjustment is comprised of expenditure cuts.

[55] See the evidence for OECD member countries in Kneller, Bleany, and Gemmel (1999).

[56] Across-the-board wage freezes or cuts were perhaps justified given the very generous wage awards in the previous decade.

to be determined by its likely contribution to medium- to long-run fiscal sustainability and economic growth, as well as by the objective of introducing internationally accepted standards of good practice. By contrast, for the EU institutions, which were responsible for other areas, structural conditionality was formulated primarily to comply with EU single-market regulations. Accordingly, whereas in the Fund programs most structural measures were macro-critical, in the EU programs they were not.

Along these lines, while the Irish EFF-supported program contained only eight prior actions and structural benchmarks in the fiscal area, the Portuguese EFF-supported program prescribed 30 structural conditions (more than one-half of them in the form of prior actions) and the Greek SBA 27 structural conditions (fewer than one-fourth in the form of prior actions) in this area (Annex Tables 6.A1, 6.A2, and 6.A3). Unlike in Ireland and Portugal where the conditions were set over a three-year period, the structural conditions in Greece had to be met within two years. Actually, the number of measures required of Greece appears considerably higher when taking into account that each condition includes multiple measures in considerable detail.

In Ireland, the two key fiscal structural measures were (i) the adoption of a sound rules-based fiscal framework and an independent fiscal council, enacted in the Fiscal Responsibility Law, and (ii) the development of an effective medium-term budgetary strategy, with binding multiyear expenditure ceilings. Both conditions were met in a timely fashion.

By contrast, the SBA-supported program for Greece and the EFF-supported program for Portugal each included an extraordinary number of structural fiscal measures—even though these were not binding performance criteria[57]—when compared to other Fund-supported programs. According to IMF staff members and country officials interviewed for this evaluation,[58] the proliferation of measures in successive quarterly reviews of these two programs was in response not only to administrative weaknesses but also to mistrust in the authorities' commitment to reform.[59] The multiplicity of measures to be undertaken almost simultaneously, at times without adequate prioritization, imposed a considerable implementation burden on the government personnel.[60] Many structural measures were supported by recommendations from Fund technical assistance, as discussed in the next section.

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[57] In 2009, Fund conditionality was streamlined so that structural measures could no longer be specified as performance criteria (with which compliance by a specified target date is necessary for disbursements). Prior actions of course had to be met at the time of Board approval or review of a program, whereas deviation from structural benchmarks could be permitted through waivers granted on a discretionary basis.

[58] No authorities from Greece were interviewed for this chapter.

[59] According to Fund staff members involved in negotiations with the authorities in Greece, the structural reform measures that were incorporated in laws passed by Parliament were so riddled with loopholes that it was necessary subsequently to specify additional prior actions to close the loopholes.

[60] This view was stressed by a senior Portuguese official in charge of implementing budgetary reforms.

In Portugal, most measures involved improvements in public financial management and an expenditure review, whose implementation was much slower and less comprehensive than initially envisaged. Major legislative actions encompassed the amendment of the budgetary framework, local government finances, and public pensions. In addition, tax and customs administration were streamlined in some operational and structural aspects. For the most part, these steps were completed as programmed, though in some cases with considerable delay. Several measures, especially those intended to prune social entitlements and to reverse the generous increases in government wages and pensions granted in previous years, were shelved and replaced by a significant increase in the income-tax burden, including a surcharge plus a solidarity levy.[61] The government explained the Constitutional Court's decisions as a reason for substituting tax hikes for expenditure cuts. Others who were interviewed for this evaluation argued, on the other hand, that the government could have anticipated some of the Court's decisions on the basis of past precedents and prepared backup spending cuts in the event of a possible adverse ruling.[62] The fiscal devaluation, consisting of a reduction of the employers' share of the payroll tax for social security, to be offset by an increase in the value-added tax (VAT) rate or some other equal-revenue measure, was the only benchmark that did not materialize under the program—as discussed above.

In Greece, structural conditionality covered the entire gamut of public finances, including public financial management, taxation, subnational governments, state-owned enterprises, and public pensions. On the whole, progress was fitful and subject to reversals for various reasons, most of which were beyond the control of Fund staff. A major factor was the high turnover of senior officials. Indeed, lack of local managerial continuity, coupled with frequent political interference, prevented the completion of many tasks envisaged in the program, despite the appreciation of the IMF staff's work voiced by the technical personnel at government ministries and agencies. For example, tax administration was without a head for more than a year; more recently, a highly competent head (so described by IMF and EC staff) was removed after a year in office for unexplained reasons.

Perhaps the most successful fiscal reform during the Greek program was achieved in public pensions, with technical assistance from the Fund and the EC. Specific steps envisaged toward restoring the solvency of the pension

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[61] In 2013, the average effective tax rate is estimated to have increased by more than 6 percentage points to over 16 percent (in addition to the 11 percent social security tax) on gross personal income. The corresponding increase in the top income bracket was 12 points to nearly 52 percent.

[62] In Ireland, the government consulted with the court before introducing potentially contentious measures to ensure judicial validation.

regime included: an increase in the standard and early retirement ages, a reduction in the statutory wage-to-pension replacement rate, cuts in marginal accrual rates, an extension in the calculation of the pension base to lifetime earnings, and indexation of pensions to inflation. Some of these measures await full implementation; in addition, a large number of pension schemes have yet to be unified under the central system. Another area of some progress has been the creation of a fiscal council, which in its initial phase was highly political, but has more recently been replaced by an independent institution attached to Parliament.

A measure that stands out in the Greek case was the government's apparent commitment to privatize state-owned enterprises and other state-owned property—at the behest of the Fund staff—with proceeds valued at 50 billion euros in the fourth review. Although intended primarily to help close the immediate financing gap, the privatization would have conferred lasting benefits in terms of increased efficiency in the corporate sector. In retrospect, the targeted amount proved unrealistic. Lack of broader support and adequate technical preparation blocked this initiative during the program period.[63]

Overall, structural conditionality in Greece's adjustment program was widely viewed as a means to build much-needed institutions that would pave the way for public debt sustainability. In essence, the goal—elusive at best—seems to have been a regime shift toward improved governance in the public finances, characterized by institutions that ensured transparency and predictability in fiscal policymaking.

Public Outreach

The success of a large-scale fiscal adjustment hinges to a large extent on public support, which in turn depends on timely availability of information on the design and implementation of its components, and—even more important—on their underlying rationale and anticipated socioeconomic impact.[64] The need for transparency and communication becomes crucial

[63] According to internal government calculations at the time, the state owned about 100 properties with a book value that was estimated at 300 billion euros and with a market value of some 70 billion euros. On this basis, the objective of selling assets worth 50 billion euros was deemed feasible by some Fund staff members interviewed. In the opinion of EC staff, the targeted proceeds from privatization were highly unrealistic. Privatization, in any event, encountered strong opposition from various interest groups, according to interviews with IMF staff.

[64] According to the Executive Board, "The primary responsibility for communicating policy intentions and program content to the public rests with the authorities themselves, but the IMF can play an important supporting role. Many staff missions are already engaged in communication with the public, and this activity has often proved to be helpful. Generalizing that type of activity could reap dividends, but it would need to be a genuine two-way exchange that respects a country's circumstances; is carried out in coordination with the authorities, and avoids perceptions of the Fund as overly intrusive" (IMF, 2001b).

where public support and/or government ownership are scant or altogether absent. This is particularly the case with regard to structural and stop-gap measures in the fiscal area, as taxes and subsidies are typically among the most visible measures and touch directly the welfare of households and enterprises. On this score, the track record of the national authorities and the troika was uneven across the three countries.

Ironically, the program's objective, rationale, and fairness were most transparent and most effectively communicated by the authorities and IMF representatives in Ireland, where the extent of local ownership was the highest. Openness and frequent media contacts may have contributed significantly to the success of the program. In anticipation of, and during, the program, government leaders regularly explained the fiscal strategy and policy measures and their likely impact, as well as the steps to alleviate adverse repercussions. With encouragement by the authorities, Fund staff held press conferences at regular intervals, after most program reviews, to brief the public on progress under the program.

In Portugal, contacts between the IMF staff and the public were less frequent but intensified at a later phase in the program, as a new IMF mission head met with various media representatives almost after every visit. In one instance, the head of a technical assistance mission on public financial management participated in a televised parliamentary budget committee meeting, which was well received by the legislators and the media.

Lack of transparency and public outreach was most pronounced in Greece on several counts. For one, the flow of information from the government to the general public and to the IMF and the EC on fiscal developments was rather infrequent and incomplete.[65] For another, this was paralleled by the lack of communication from the IMF and EU institutions to the public. Following a press conference held in February 2011 in Athens, the troika had no more contacts with the local media.[66] In addition, a culture of opacity prevailed around the Greek program both within the Fund and toward the general public.[67] These developments not only failed to generate local ownership for the program, but rather contributed to weaken it further.

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[65] The problem was compounded by the risk faced by government employees in being charged for treason for having provided information to foreigners. Under a recently enacted law, any government official who served in the period 2009–14 may be summoned to appear in front of a special investigative committee to testify about releasing information to foreigners.

[66] The press conference by the troika team was widely regarded as counterproductive, attributed mainly to the surprise announcement of the privatization of state-owned assets, without prior negotiation or preparation—as indicated above. From then on, the only contacts with the media consisted of background press interviews with senior IMF staff.

[67] Several interviewees observed that the limited flow of information within members of the mission for Greece might have prevented fuller exploration of alternative approaches. Some recalled tensions within the troika and between the IMF and the national authorities.

A related area was the apparent lack of sufficient concern expressed publicly by the IMF and EU institutions in addressing the social costs of the programs, possibly as compared to a counterfactual no-adjustment scenario. Although in the design of fiscal measures under the program, Fund staff paid attention to protecting the more vulnerable segments of the population, this concern was not adequately communicated. Focusing publicly on the distribution of the adjustment burden (say, by income level or sectors), along with suggested targeted fiscal measures to alleviate hardship for those seriously affected, can help create greater support for an adjustment. In general, national authorities in the program countries did little to quantify or communicate the social and economic effects of the programs. As an exception, the Irish authorities published an initial appraisal of the impact of the pre-troika fiscal adjustment on low-income households and of a package of measures intended to alleviate it. In Greece after the evaluation period, the new Parliamentary Budget Office published estimates of the distributional consequences of the fiscal adjustment (Greece, Parliamentary Budget Office, 2014). The Fund could have done more to discuss and circulate publicly estimates of the distributional effects of the adjustment in Greece and Portugal, possibly during the program.[68]

Technical Assistance

From the beginning of the crisis, FAD staff were called upon to provide specialized technical assistance (TA) with utmost urgency over practically the entire range of public finances, on a scale comparable only to the task faced during the post-socialist transition of the 1990s. The bulk of the assistance was concentrated in Greece, followed by Portugal, while the need for TA in Ireland was minimal—as illustrated by a tally of missions for each country by major area of fiscal policy and administration (Table 6.2).

In Greece, the dearth of institutional capacity in the public finances compared to that in other EU members (including most post-socialist members that joined since 2004) first became apparent in 2005 when, at the authorities' request, the FAD fielded TA missions in social security, public financial management, and taxation. By the onset of the crisis in early 2010, FAD staff members who headed TA missions to Greece rated the country's institutional capacity in public finances as comparable to that of a low-income developing economy. Parenthetically, the staff's surprise at the low level of administrative, professional, and statistical capacity in the fiscal area attests

[68] For Greece, measurement of the distributional impact was admittedly complex. According to the ex post evaluation of the SBA by the IMF (2013b), the impact on job losses was rather uneven between public and private sectors. On the other hand, micro simulations by Avram and others (2013) on the basis of a tax-benefit model suggest that the net direct impact of the fiscal consolidation on household disposable income, as measured by changes in the Gini coefficient, was favorable. These results are briefly summarized in IMF (2014a, Box 1).

Table 6.2. Greece, Ireland and Portugal: IMF Technical Assistance, 2005–14
(Number of missions)

	Greece	Ireland	Portugal	Total
Macro-fiscal framework	1		1	2
Public finance management	21	1	8	30
Treasury operations	2			2
Expenditure policy (including review)	11	2	2	15
Tax policy	15		2	17
Tax (including social security) administration	63		8	71
Fiscal transparency, ROSCs	2	1	2	5
Total	**115**	**4**	**23**	**142**

Note: ROSCs = Reports on the Observance of Standards and Codes.
Source: IMF Fiscal Affairs Department, technical assistance reports.

to the weakness of pre-crisis surveillance (including in fiscal transparency) and the insufficient transmission of country-specific information between consecutive missions.

Besides the obvious need for structural reform encompassing practically all aspects of public spending and taxation, as well as extra-budgetary operations (including social security, subnational governments, and state-owned enterprises), Greece's fiscal adjustment hinged on speedy progress in institution building across a wide spectrum. In particular, fiscal consolidation could not be undertaken without some elementary steps toward establishing effective tax collection and budgetary control. In addition to TA missions, this effort entailed continuous hands-on assistance by a large team of resident experts and multiple follow-up staff visits. In principle, the Fund staff provides TA at the request of a member government, quite separately from any program conditionality. But, given the magnitude of the institution-building task in Greece, it was necessary to rely on TA recommendations to formulate structural fiscal measures for purposes of prior action and structural benchmarks. FAD and EUR staff reported that they worked closely and productively in this endeavor but, given the magnitude of the task and the limited window of opportunity for lasting progress, TA in the fiscal area should have been better prioritized during the program.

FAD's technical assistance advice to Greece, as reflected in its mission reports, was on the whole sound, candid, and timely.[69] But the delivery of TA was handicapped by insufficient prioritization; ad hoc decision making,

[69] The only exception was in the area of fiscal transparency, on which—as staff members themselves admitted—missions were conducted on a superficial and legalistic level. Reports on the Observance of Standards and Codes (ROSCs) were ridden with euphemistic characterizations, presumably to avoid embarrassing the authorities in public, especially as evidenced by the pre-crisis report (IMF, 2006). A more candid analytical approach was adopted only during the crisis (IMF, 2012b).

with moving targets in multiple initiatives that occasionally had a tenuous bearing on macro-fiscal adjustment; and severe limits on Greece's capacity to absorb TA due to the lack of adequate institutional and political support. By and large, at a technical level, the Greek counterparts had a receptive attitude toward TA. However, according to FAD staff members, the willingness of Greek officials to cooperate was undermined by lack of support from the political authorities—which was due to a large extent to frequent leadership changes at ministries and administrative agencies, and to a general atmosphere of distrust.[70]

The task at hand was further complicated by difficulties in coordinating with the Task Force for Greece (TFGR), which was established in 2011 under the umbrella of the EC to identify and coordinate the technical assistance that Greece needed in order to meet the terms of the EU/IMF program. The Task Force relied heavily on consultants from EU member countries to provide TA, some of which FAD staff found to be unhelpful to Greece's immediate needs. In the area of tax administration, for example, a national TA provider underplayed the need for autonomy of tax administration, whereas FAD staff considered autonomy essential for generating much-needed government revenues and for withstanding the extraordinary pressures exerted continuously by interest groups and political parties on the tax authorities. TFGR coordinators, on their part, argued that IMF TA experts did not sufficiently appreciate the continental European approach to public finances and that they focused mainly on organizational and managerial issues and elucidating good practices rather than on providing hands-on training for staff at various levels. In the views of several IMF staff members, the need to coordinate with the TFGR added an extra hurdle to the efficient delivery of TA.[71] Results have been uneven at best. By the second year of the program, some progress had been achieved in tax administration and in the reform of public pensions, but these achievements in part unraveled after the program period.

In Ireland and Portugal, both management and delivery of TA were much easier in both substantive and operational aspects. In fact, FAD TA to Ireland was peripheral insofar as the fiscal adjustment could be implemented with

[70] The reluctance of government officials to provide data was widely ascribed to a fear that they would be taken to task, and possibly accused of treason, for revealing information that could be detrimental to the national interest—as evidenced by the felony charges brought against the head of the statistical office in 2013.

[71] Perhaps the only comparable exercise was the large-scale TA that the IMF provided in 1990 to the former Soviet Union, involving cooperation among four international financial institutions. In that case, there was a clear division of labor among clearly demarcated areas, with the Fund taking responsibility for TA in the public finances (headed by the author), monetary policy, and the foreign exchange and payments system. See IMF, IBRD, OECD, and EBRD (1991).

practically no need for institution building. In both countries, the IMF was the sole provider of TA in public finances, with relatively limited input from EU institutions. Moreover, the authorities welcomed Fund assistance and were cooperative at all levels. For these and perhaps other reasons, TA was far more successful in Ireland and Portugal than in Greece. In Portugal, advice in tax administration was implemented and headway was made in improving public financial management.

Summary and Major Lessons

This assessment of the Fund's role in the fiscal aspects of the euro crisis reveals a mixed track record. Overall, whereas pre-crisis fiscal surveillance was for the most part not effective, the fiscal components of the stabilization programs, as well as the related TA provided by the Fund, may be regarded on balance as positive under the prevailing circumstances in the euro area. The evaluation of the experience before and during the euro area crisis offers a number of lessons, some of which corroborate those derived from an earlier evaluation of IMF performance in the run-up to the crisis.[72] A number of weaknesses, and concomitant lessons, noted herein have been remedied or are in the process of being corrected.

Fund surveillance of public finances in euro area member countries during the decade up to the beginning of the crisis was characterized by complacency as well as by a "Europe is different" mindset. While IMF fiscal advice for the euro area as a whole was broadly appropriate, assessments of the fiscal stance, transparency, sustainability and risks in fiscally vulnerable countries were rather superficial and mechanistic. Undue reliance was placed on vigilance by EU institutions in monitoring and enforcing the rules-based fiscal framework enshrined in the Stability and Growth Pact. The Fund adopted the prevailing conventional wisdom that external imbalances did not matter within the euro area. Although IMF staff stressed the need for fiscal discipline in euro area members, it did not highlight the possibility that fiscal imprudence could lead to a debt crisis in a currency area. Arguably, light surveillance of euro area member countries contributed directly or indirectly to the metastasis of the financial crisis into a full-fledged public debt crisis in at least three euro area members.

Lessons for the Fund from the pre-crisis surveillance experience are rather straightforward. First, fiscal surveillance needs to be applied with uniform

[72] The concluding observations of the IEO evaluation of Fund performance prior to the global financial crisis were summarized in IEO (2011) under four headings: analytical weaknesses, organizational impediments, internal governance problems, and political constraints. Along similar lines, it can be argued that such features in Fund fiscal surveillance contributed to its failure to help prevent the euro crisis.

rigor and candor across advanced, emerging market, and developing economies, with full awareness that, under certain conditions, current account deficits driven by persistent government budget deficits or private sector overborrowing, or both, may well result in a sudden stop in financing from abroad. This lesson cannot be overemphasized for members of a currency union, insofar as any remedial action, following a crisis, must be borne largely by an extraordinary fiscal adjustment. Second, surveillance should probe the fiscal fundamentals and identify critically any deficit or expansionary procyclical bias in the conduct of fiscal policy and excessive optimism in fiscal forecasts, rather than be guided by market perceptions reflected in sovereign risk premiums. Third, countries that are deemed fiscally vulnerable over a prolonged period should be subject to enhanced surveillance, which could help detect weaknesses in fiscal institutions. Furthermore, if a government is found to have repeatedly misreported or suppressed basic public finance statistics, it should be declared in breach of Article VIII. Fourth, Fund staff should employ state-of-the-art techniques for estimating the structural budget balance (e.g., with the underlying output gap augmented by asset prices) and assessing fiscal sustainability (e.g., complementing the standard template with estimates of an intertemporal public sector balance sheet) and risk (e.g., complementing the risk-assessment matrix with stochastic methods such as the value-at-risk approach). The decision of the Fund to respond to the euro crisis without a candid and realistic assessment of fiscal sustainability and financing need (to determine the case for exceptional access and debt restructuring) created a considerable burden on Fund resources and, arguably, a large fiscal adjustment for the crisis-hit euro area countries, especially Greece.

The Fund-supported euro area stabilization programs were constrained in several important respects: membership in a common currency area, stagnant external demand, and financial fragmentation within the euro area. In addition, the programs in Greece and Portugal were subject to institutional impediments and weak or eroding ownership. These conditions placed an extraordinary burden on fiscal adjustment, institution building, and public communication, particularly in Greece and Portugal. But the ensuing size of the adjustment may have been excessive in these countries, where the assumed underlying fiscal multipliers were too small and the automatic stabilizers were prevented from operating during the course of the program. Also, the composition of the adjustment in some programs was biased in favor of tax-rate increases rather than pruning expenditures. The attempt to correct for the latter with growth-supporting structural fiscal conditionality was less than successful, partly because of the apparent lack of prioritization in the face of institutional impediments. Fund technical assistance, which was mainly intended to support the structural fiscal reform measures, could have been delivered at a pace and in a manner that were more commensurate with the local resources and environment, especially in Greece. All along, the Fund did not use communication channels effectively, except in Ireland.

The Fund's experience with the fiscal aspects of the euro crisis provides a number of lessons as regards financial assistance, program design and implementation, structural conditionality, communication, and technical assistance. First, financial support should be predicated on a realistic analysis of the sustainability of public debt and, if necessary, on a debt restructuring adequate to bring about fiscal sustainability within a reasonable time horizon; in turn, such analysis and prerequisites can help tailor and phase a realistic fiscal adjustment. Second, in the design of the scale and time-path of the fiscal adjustment it is necessary to avoid insofar as possible an excessively procyclical stance; in any event, automatic stabilizers should be permitted to operate in the course of a given program year. Third, in general, the adjustment should have a heavier expenditure component than tax component, while productive investment outlays and broadening the effective tax base should be favored. Fourth, structural fiscal conditionality, as well as any supporting technical assistance, should be adequately paced and well prioritized, taking into account local implementation capacity as well as institutional and cultural impediments, and spelling out ex ante adequate fallback options in the event that such impediments materialize. Finally, managing an effective and frequent public outreach and promoting transparency are essential ingredients for the success of an adjustment, especially in countries where the authorities' credibility and public support are limited.

Annex Table 6.A1. Greece: Structural Fiscal Conditionality Under the SBA, May 2010–March 2012

Prior Actions	Test Date	Status
Reduce public wage bill by cutting bonuses/allowances; and pension bonuses (except minimum pensions).	Start	Met
Increase standard VAT rate from 21 percent to 23 percent and reduced rate from 10 percent to 11 percent and excise tax rates on alcohol, tobacco, and fuel with a yield of at least €1.25 billion in the remainder of 2010.	Start	Met
Appoint staff team and leader in GAO responsible for general government in-year cash reporting.	Start	Met
Parliament to approve medium-term budget strategy (MTFS).	4th review	Met
Government to legislate key fiscal-structural reforms in an MTFS Implementation Bill.	4th review	Met
Government to complete key actions to implement the various measures approved in the context of the first MTFS reform bill and anticipated in the second set of reform bills, including the reform of the public sector wage grid and the closure and/or merger of extra-budgetary funds.	5th review	Not applicable
Government to enact spending reductions (including pensions and earmarked spending and advanced removal of the heating fuel subsidy); revenue measures (including reducing PIT thresholds and reductions).	5th review	Not applicable

Structural Benchmarks	Test Date	Status
Adopt and start to implement a reorganization of sub-central government with the aim to reduce the number of local administrations and elected/appointed officials (*Kalikrates*).	June 10	Met
Submit to Parliament amendments to Law 2362/1995 to (i) require the Ministry of Finance to present a three-year fiscal and budget strategy, (ii) introduce top-down budgeting with expenditure ceilings for the state budget and multi-year contingency margins, (iv) require a supplementary budget for any overspending above the contingency, and (v) introduce commitment controls. The amended law should be immediately effective, including in the context of the 2011 budget.	June 10	Met
The National Actuarial Authority to produce a report to assess whether the parameters of the new system significantly strengthen long-term actuarial balance.	June 10	Met with delay
Adopt a comprehensive pension reform that reduces the projected increase in public spending on pensions over the period 2010–60 to 2½ percent of GDP.	September 10	Met
Establish a commitment register in all line ministries and public law entities. Begin publishing monthly data on general government in-year fiscal developments (including arrears).	September 10	Met
Publish 2009 financial statements of the ten largest loss-making public enterprises, audited by chartered accountants, on the official website of the Ministry of Finance.	September 10	Met
Put in place an effective project management arrangement (including tight Ministry of Finance oversight and five specialist taskforces) to implement the anti-evasion plan to restore tax discipline through: strengthened collection funds—of the largest debtors; a reorganized large taxpayer unit focused on the compliance of the largest revenue contributors; a strong audit enforcement and recovery of tax arrears—coordinated with the social security program to defeat pervasive evasion by high-wealth individuals and high-income self-employed, including prosecution of the worst offenders; and a strengthened filing and payment control program.	September 10	Met
Publish a detailed report by the Ministry of Finance in cooperation with the single payment authority on the structure and levels of compensation and the volume and dynamics of employment in the general government.	December 10	Met with delay
Adopt new Regulation of Statistical Obligations for the agencies participating in the Greek Statistical System.	December 10	Met with delay
Pass legislation to: (i) streamline the administrative tax dispute and judicial appeal processes; (ii) remove impediments to the exercise of core tax administration functions (e.g., centralized filing enforcement and debt collection, indirect audit methods, and tax returns processing); and (iii) introduce a more flexible human resource management system (including the acceleration of procedures for dismissals and of prosecution of cases of breach of duty).	February 11	Met with delay
Appointment of financial accounting officers in all line ministries and major general government entities (with the responsibility to ensure sound financial controls).	March 11	Met with delay
Publish the medium-term budget strategy paper, laying out time-bound plans to address: (i) restructuring plans for large and/or lossmaking state enterprises; (ii) the closure of unnecessary public entities; (iii) tax reform; (iv) reforms of public administration; (v) the public wage bill; and (vi) military spending.	April 11	Met with delay

(*Continued*)

Annex Table 6.A1. (Continued)

Structural Benchmarks	Test Date	Status
Articulate a strategic plan of medium-term revenue administration reforms to fight tax evasion.	June 11	Met with delay
Publish three consecutive months of consistent arrears and consolidated general government fiscal reports (excluding small local governments).	June 11	Met with delay
Adopt the necessary changes to enact the plan to reform the general government personnel system.	June 11	Met with delay
Government to enact legislation in the context of MTFS implementation (phase II) to: (i) introduce pension adjustment bill stipulating freezes through 2015, introducing individual social security numbers, caps, means testing, and rationalizing benefits of pension funds; (ii) introduce single public pay scale bill, temporarily freeze automatic progression, and halve productivity allowance; and (iii) close 40 small public entities, merge 25 more small entities, and close an additional 10 large entities under line ministries and in the social security sector.	August 11	Met with delay
Government to achieve quantitative targets set under its anti-tax evasion plan.	December 11	Not applicable
Parliament to approve a tax reform package, including (i) a simplification of the code of books and records, (ii) the elimination of several tax exemptions and preferential regimes under the corporate income tax and the VAT; (iii) simplification of the VAT and property tax rate structures; and (iv) a more uniform treatment of individual capital income.	March 12	Not applicable
Government to undertake a thorough review of public expenditure programs to identify 3 percent of GDP in additional measures (including a 1 percent of GDP buffer of potential additional measures).	June 12	Not applicable
Government to meet newly introduced and more ambitious targets for audits and debt collection and the resolution of administrative appeals.	December 12	Not applicable

Annex Table 6.A2. Ireland: Structural Fiscal Conditionality Under EFF, December 2010–December 2013

Prior Actions	Test Date	Status
Submit the 2011 budget to Dáil Éireann	Start	Met
Ensure strict budget neutrality of the jobs initiative in 2011 and over the period to 2014 by specifying fully costed offsetting measures	2nd review	Met
Submit the 2012 budget to the Oireachtas	4th review	Met
Submit the 2013 budget to the Oireachtas	8th review	Met
Structural Benchmarks	**Test Date**	**Status**
Establish a Budget Advisory Council	June 11	Met
Introduce a medium-term expenditure framework with binding multi-annual expenditure ceilings with broad coverage and consistent with the fiscal consolidation	July 11	Met
Submit to Parliament, as part of the Fiscal Responsibility Bill, a legal framework for the Fiscal Advisory Council ensuring its independence	December 11	Met
Publish 2014 budget	October 13	Met

Annex Table 6.A3. Portugal: Structural Fiscal Conditionality Under EFF, June 2011–June 2014

Prior Actions	Test Date	Status
Prepare a comprehensive inventory of the existing tax expenditures (including all types of exemptions, deductions, and reduced rates), by type of tax, along with their costing estimates.	Start	Met
Establish temporary task force of judges to clear tax cases worth above euro 1 million.	Start	Met
Approve a standard definition of arrears and commitments.	Start	Met
Prepare a comprehensive report on 10 state-owned enterprises (SOEs) posing the largest potential fiscal risks to the state. The report would cover (i) concrete plans, per enterprise, for reducing its operational costs, consistent with an average cut of at least 15 percent in the sector over 2009 levels; (ii) a planned revision of the tariffs.	Start	Met
Issue an instruction to general government units requiring that from January 1, 2012, (i) commitments must be controlled against available funds recorded in the accounting system and evidenced by authorized commitment documents (“cabimento”) bearing valid commitment numbers; (ii) all other commitments would be considered illegal and not eligible for payment; and (iii) any public official incurring such illegal commitment or expenditure will be subject to specified penalties in accordance with the budget framework law.	1st review	Met
Issue an instruction to general government units to ensure that systems and procedures will comply, by end-December 2011, with the revised budget execution rule, as set out in the above instruction.	1st review	Met
Parliamentary approval of a 2012 budget consistent with the program.	2nd review	Met
Pass a resolution of the Council of Ministers on a strategy document to clear the stock of domestic arrears of the general government and SOE hospitals, establishing the governance arrangements for prioritization and payment decisions.	3rd review	Met
Submit to Parliament the 2013 budget consistent with the program.	5th review	Met
Adopt by the Council of Ministers and publish the medium-term fiscal framework that includes fully specified measures to meet the 2014 deficit target.	7th review	Met
Submit to Parliament the supplementary budget that includes measures needed to meet the 2013 fiscal objective.	7th review	Met
Submit to Parliament a draft 2014 budget consistent with the general government deficit target of 4 percent of GDP.	9th review	Met
Submit to Parliament a draft law or a budget provision to implement the single wage-scale PER measure.	9th review	Met
Submit to Parliament a supplementary budget to enact the necessary changes to the existing extraordinary solidarity contribution on pensions (CES), consistent with the general government deficit target of 4 percent of GDP.	10th review	Met
Approve the decree law on the increase in the beneficiaries' contributions to the special health insurance schemes (ADSE, SAD, and ADM).	10th review	Met
Specify fiscal measures consistent with achieving the general government deficit target of 2.5 percent of GDP in 2015.	11th review	Met

(*Continued*)

Annex Table 6.A3 (*continued*)

Structural Benchmarks	Test Date	Status
Finalize calibration of fiscal reform to reduce unit labor costs via deficit-neutral reduction in employers' share of social security contributions.	July 11	Not met
Publish a fiscal strategy document for the general government which will specify four-year medium-term economic and fiscal forecasts, supporting analysis and underlying assumptions, and four-year costings of new policy decisions.	August 11	Met
Conduct and publish the results of a survey of arrears of general government entities and SOEs for all categories of expenditure as of end-June 2011.	August 11	Met
Based on assessment from EU/IMF technical assistance on the budgetary implications of main public-private partnership programs, recruit a top tier international accounting firm to complete a more detailed study of public-private partnerships and identify areas for deeper analysis by an international consulting firm.	December 11	Met with delay
Prepare a report on SOEs based on forecast financial statements assessing their financial prospects, potential government exposure, and scope for orderly privatization.	February 12	Met with delay
Revise and submit to Parliament the draft regional public finance law.	March 12; reset to December 12	Met with delay
Develop a specific program for unwinding Parpublica.	April 12	Met
Develop a public financial management strategy covering the next three years, to be attached to the 2013 budget.	September 12	Met
Implement a full-fledged Large Taxpayer Office to cover audit, taxpayer services, and legal functions concerning all large taxpayers, including the adoption of account managers.	December 12	Met
Update projections of the medium-term energy tariff debt path and identify policy options to eliminate the tariff debt by 2020.	June 13	Met
Submit to Parliament a draft law on the redesigned mobility pool.	June 13	Met
Submit to Parliament a new draft public administration labor law that will aim at aligning current public employment regime to the private sector rules, including for working hours and holiday time, and termination of tenure.	July 13	Partially met
Submit to Parliament a legislative proposal that increases the statutory retirement age to 66 years.	July 13	Met with delay
Submit to Parliament a legislative proposal that aligns the rules and benefits of the public sector pension fund (CGA) to the general pension regime.	July 13	Met with delay

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PART III

Three Country Cases: Greece, Ireland, and Portugal

CHAPTER 7

The IMF's Role in Greece in the Context of the 2010 Stand-By Arrangement

CHARLES WYPLOSZ AND SILVIA SGHERRI

Introduction

In April 2010, Greece became the first euro area country to request financial support from the IMF. The IMF joined the European Commission (EC) and the European Central Bank (ECB)—thus constituting what informally came to be known as the troika—in providing emergency financing, with the Fund's contribution taking the form of a €30 billion three-year Stand-By Arrangement (SBA) approved in May. This was canceled and replaced in March 2012 by a four-year arrangement under the Extended Fund Facility (EFF).

With the decision to engage in an exceptional-scale, multi-year financial assistance program for Greece, the IMF embarked on an unprecedented venture. This was the first time since World War II that an advanced, financially developed, and financially open economy had attempted to adjust within a currency union. Other countries (such as St. Kitts and Nevis, Benin, and Burkina Faso) had adjusted within a currency union, but they were far less financially integrated. This was also the first instance since the mid-1970s of IMF financial assistance to a country using a reserve currency.

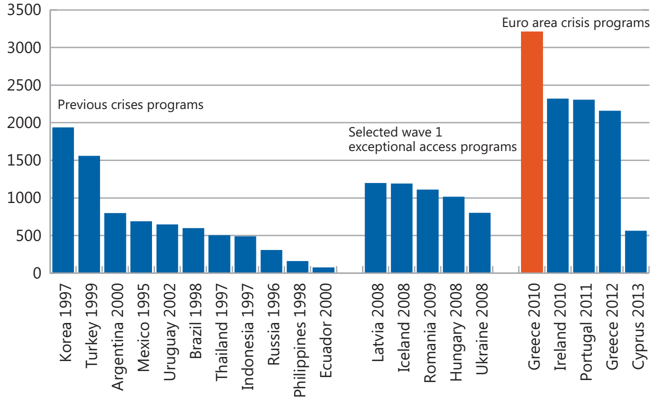
Access to Fund resources was the largest in IMF history (Figure 7.1). The loan itself, at more than 3,200 percent of Greece's IMF quota, was the largest non-precautionary Fund arrangement ever approved relative to quota. Indeed, by the start of the program, Greece had built up much larger imbalances than was typical in countries that had sought IMF assistance, and unlike in many IMF programs the official assistance provided was intended to substitute entirely for markets in financing sovereign borrowing needs (Pisani-Ferry and others, 2013).

A new pattern for cooperation was established. Not only was Greece a developed economy belonging to a monetary union, but the adjustment program was implemented at a time when both the euro area and the global

The authors would like to thank, without implication, Harris Dallas and Nikos Vettas for reviewing an earlier version of this chapter and providing constructive and substantive inputs.

Figure 7.1. Access to IMF Resources

(*Percent of quota at time of program approval*)



Source: IMF, Monitoring of Fund Arrangements (MONA) Database.

economy were undergoing a severe financial crisis and the euro area still lacked "firewalls" to prevent financial contagion. The implementation of the Greek program thus involved intense collaboration with the regional partners who were also providing conditional financial assistance. The modalities of assistance had to be established in real time in the midst of the crisis, in close cooperation between the European institutions and the IMF.

The constraints imposed by the unique circumstances, and the scale of financial commitments, raise important questions about the modalities of the IMF's engagement and the design of the program. The IMF's involvement in Greece has been extensively analyzed by numerous academic experts and official bodies, including the IMF.[1] For example, the IMF's ex post evaluation of Greece's 2010 SBA (IMF, 2013c) concluded that while the IMF-supported program succeeded in achieving strong fiscal consolidation and in allowing Greece to remain in the euro—with relatively well-contained spillovers on the

[1] For official evaluations of the IMF's role in the Greek crisis, see the European Parliament Report (Karas and Ngoc, 2014); the Policy Note underpinning the European Parliament Report (Sapir and others, 2014); the report by the European Court of Auditors (ECA, 2015a, 2015b); and the IMF's ex post evaluation for the 2010 SBA (IMF, 2013c). Accounts of negotiations behind important decisions in the context of the Greek crisis include: Walker, Forelle, and Blackstone (2010a, 2010b); Walker and Forelle (2011); Bastasin (2012); Irwin (2013); Spiegel (2014); and Blustein (2015). Articles from academic institutions and think tanks include: Pisani-Ferry (2011); Tsoukalis (2011); Pisani-Ferry, Sapir, and Wolff (2013); Panagiotarea (2013a); Palaiologos (2014); Pelagidis and Mitsopoulos (2014); and Xafa (2014). Generally, the literature has been quite critical of the IMF's handling of the Greek crisis: see for instance, Warner (2011); Seitz and Jost (2012); Panagiotarea (2013a); Sterne (2014); Palaiologos (2015); Donnan (2015); Lee (2015); Ito (2015); El Erian (2015); Wroughton, Schneider, and Kyriadikou (2015).

global economy—it did not succeed in restoring Greece's growth, reforming the economy, restoring Greece's market access, or ensuring debt sustainability as it had set out to do. The country's ownership was limited; the recession was much deeper than expected, with exceptionally high unemployment; and the burden of adjustment was not sufficiently spread across different strata of the society.

This chapter assesses the IMF's experience with surveillance and financial assistance in Greece, with a view to drawing lessons that can serve as a basis for debate and reform initiatives for the IMF's future operational work. The chapter focuses only on the decisions of the IMF itself, not on those of other official partners involved, and does not seek to assess the actions of European institutions or Greek authorities. Even so, it must be acknowledged that disentangling the decisions of the IMF from those of its partners is often quite difficult, given that program outcomes were ultimately determined by joint actions of all agents involved.

The assessment is complicated by a variety of factors. The judgment cannot be based on outcomes alone because of the circumstances under which the program was designed, which were bound to make economic adjustment in Greece particularly challenging. Nor can it be based on a comparison between forecasts and outcomes, because the latter were affected by unforeseen developments in the euro area environment. Nor can it be based on a comparison with what an alternative strategy might have delivered, because it is impossible to construct a counterfactual and to benchmark the program against it.

The assessment is based on interviews and a review of internal documents. To gather evidence, a number of decision makers were interviewed and a large volume of internal IMF documents were reviewed. The interviewees included the previous Managing Director of the IMF and former members of the IMF Executive Board, management, and senior staff; former officials of the Greek government and central bank; and former officials of European institutions such as the European Commission, the European Parliament, and the European Central Bank. In addition, the authors met with market participants, civil society representatives, academics, and members of think-tanks to seek their views.

The chapter is organized as follows. The second section provides background on the Greek crisis and the third section evaluates the effectiveness of IMF surveillance during the pre-crisis years. The following sections take up the story from 2010, evaluating the IMF's financial assistance to Greece under the SBA-supported program. The fourth section addresses issues related to the IMF involvement in financial assistance to Greece, and the decision-making process within the IMF as well as within the troika, and the fifth section discusses issues in the design of the SBA-supported program. The sixth section focuses on the key follow-up issues that have become controversial—including weakening program performance and lack of program adjustment; limited program ownership; debt sustainability issues and private sector involvement. The final section concludes by drawing some lessons for the IMF's future operational work.

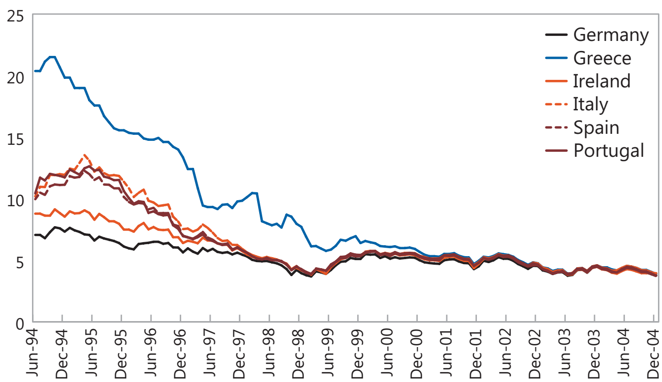
Background

European financial integration and the underpricing of default risk gave Greece easy access to cheaper, longer-term borrowing. Greece was the twelfth country to join the euro, in 2001, and was among those countries that gained the most from euro adoption (Fernandez-Villaverde, Garicano, and Santos, 2013): as bond markets no longer had to worry about high inflation or exchange rate risk, borrowing costs were falling sharply (Figure 7.2). Lower real interest rates and easier credit constraints fueled private sector dissaving and an accumulation of foreign liabilities that took place mainly through the banking system. The Greek economy grew by an average of 4 percent a year until 2007. Between 2001 and 2007, Greece's reported current account deficit averaged 9 percent a year, compared to a euro area average of 1 percent. The current account deficit widened to almost 15 percent of GDP in 2007, while external debt reached 140 percent of GDP.

For the government budget, debt refinancing at more favorable terms meant that the ratio of net interest costs to GDP halved from the period 1992–2000 to the period 2001–07, dropping from 11.5 percent of GDP in the mid-1990s to 5 percent of GDP in the mid-2000s (Figure 7.3). Net public savings thus improved slightly after Greece's accession to the European Economic and Monetary Union (EMU). But the ballooning of net private spending more than offset the improvement in public finances, resulting in a strongly deteriorating current account position (Figure 7.4; Table 7.1).[2] These developments were

Figure 7.2. Long-Term Government Bond Yields

(*In percent*)

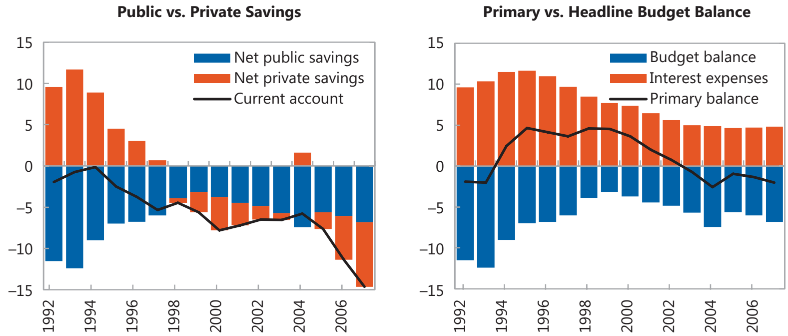


Source: Thomson Reuters Datastream.

[2] For recent studies highlighlighting the key role played by intra-euro area capital flows and foreign borrowing in explaining Greek current account imbalances, see also Holinski, Kool, and Muysken (2012); Baldwin and Giavazzi (2015); and Baldwin and others (2015).

Figure 7.3. Greece: Current Account vs. Public and Private Savings, 1992–2007

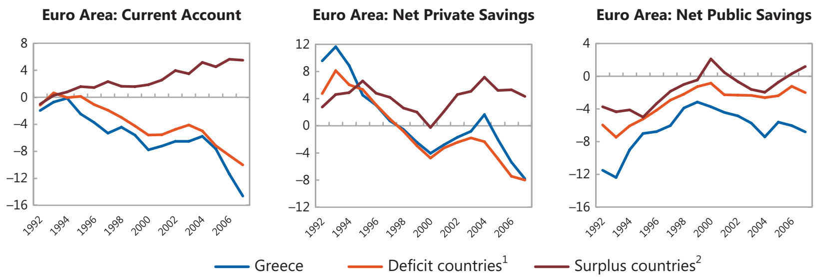
(*In percent of GDP*)



Source: IMF, *WEO*.

Figure 7.4. Euro Area: Current Account Developments, 1992–2007

(*In percent of GDP*)



Source: IMF, *WEO*.

[1] Greece, Ireland, Portugal, and Spain.

[2] Austria, Finland, Germany, and the Netherlands.

Table 7.1. Euro Area: Current Account vs. Public and Private Savings

(*In percent of GDP*)

	Current Account		Net Private Savings		Net Public Savings	
	1992–2000	2001–07	1992–2000	2001–07	1992–2000	2001–07
Greece	–3.6	–8.5	3.5	–2.7	–7.1	–5.8
Deficit countries[1]	–1.8	–6.5	2.2	–4.3	–4.0	–2.2
Surplus countries[2]	1.2	4.4	3.6	4.8	–2.4	–0.4

Source: IMF, *WEO*.

[1] Greece, Ireland, Portugal, Spain.

[2] Austria, Finland, Germany, and the Netherlands.

largely driven by Greece's financial integration upon entry into the euro area and the consequent increase in the availability of credit and financial assets. Aggressive risk-taking by European banks and the procyclical effect of the common monetary policy in the euro area may also have played a role in amplifying financial and economic imbalances in Greece and across euro area members.

Net public savings from euro adoption were eroded by fiscal indiscipline. In the face of lower refinancing costs, the primary budget balance (that is, excluding interest payments), which had been in surplus in the run-up to euro membership, turned into a deficit, starting in 2003—supporting the view that, once safely inside the euro, Greece relaxed its fiscal grip. Fiscal policy was highly procyclical, using cheap foreign borrowing to finance a significant expansion of government primary spending—mainly on wages and pensions (see also Kopits, 2017). The general government deficit soared to 15.6 percent of GDP (after incorporating data revisions), up from 4 percent of GDP in 2001. Public debt ballooned to 129 percent of GDP at end-2009 (after incorporating data revisions), with 75 percent held by foreigners. As noted in the IMF's 2009 Article IV consultation shortly before the onset of the crisis, Greece also had significant contingent liabilities due to borrowing by public enterprises under state guarantee, and the pension system had become underfunded as a result of increasingly generous entitlements and population aging. An examination by IMF staff of the intertemporal balance sheet revealed a highly negative net worth for the public sector: that is, a severe case of sovereign insolvency (IMF, 2009b).

A very weak record of compliance with the European Stability and Growth Pact and repeated misreporting of budgetary data characterized Greece's years inside the euro.[3] Serious concerns about the quality of Greek budgetary statistics flared up in 2004 when upward revisions to the fiscal deficit numbers raised questions about whether Greece had ever met the Maastricht criterion of an annual fiscal deficit no greater than 3 percent of GDP. Based on the revised data for 2003, the European Commission initiated the Excessive Deficit Procedure (EDP) for Greece in May 2004. In June 2007, the European Council abrogated the initial Decision 2004/917/EC on the existence of an excessive deficit.[4]

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[3] Panagiotorea (2013b) provides a well-documented account of the evolution of Greece's economic policymaking during the years from euro accession to the financial crisis, from the first examples of statistical misreporting detected in 2001 to the progressive loss of fiscal discipline in 2005–09, eventually leading to the reckoning of decades of uncontrolled electoral spending.

[4] Under Article 104(7) of the Treaty, the Council established the deadline of November 2004 for the Greek government to take effective action, with a view to bringing the excessive-deficit situation to an end by 2005. In January 2005, the Council decided, according to Article 104(8) and on the basis of a Commission recommendation, that Greece had not taken effective action in response to the recommendation made under Article 104(7). A month later, in February 2005, the Council proceeded, in accordance with Article 104(9), to give notice to Greece to take the measures for deficit reduction judged necessary to bring the situation of an excessive government deficit to an end, extending the deadline for the correction by one year, to 2006. In October 2006, without

Greece's reliance on external financing left the economy highly vulnerable to shifts in investor confidence. Although spreads on Greek ten-year bonds over German Bunds jumped from 50 basis points to 300 basis points after the Lehman shock in September 2008, the Greek economy initially weathered the crisis relatively well; Greek banks were free of the toxic mortgage securities that felled other banks and the government had been able to continue accessing new funds from international markets. More fundamentally, though, the outbreak of the global liquidity crisis endangered the continued financing of Greece's growth model, given its high vulnerability to sudden stops in private capital flows.

Investors' trust was shattered by data revisions. After the October 2009 Greek election, the new socialist government led by Prime Minister George Papandreou announced that fiscal problems were significantly larger than the previous administration had admitted. The projected budget deficit for 2009 was nearly doubled, from 6.7 percent to 12.8 percent of GDP (the actual figure would later climb to 15.6 percent in April 2010). Public debt estimates were also revised sharply upwards. Two of the three main credit-rating agencies, Fitch and Standard & Poor's (S&P), cut their rating on Greek bonds and gave warning that a further downgrade was likely. As a debt standstill by Dubai World—a state-backed property venture in the Middle East—made bond investors more nervous about sovereign risk, Greek bond spreads started to widen again. In mid-December the government responded with a fresh plan to cut the deficit. Bond markets were unconvinced. So were the rating agencies: Fitch and S&P cut Greece's grade again, from A– to BBB+.

Pre-Crisis Surveillance

This section examines the effectiveness of IMF surveillance in Greece from 2000 to 2009, a period during which Greece's macroeconomic imbalances gradually built up before erupting into a full-blown crisis. The assessment is based on the IMF's analysis and policy advice contained in Article IV reports, reports from the Financial Sector Assessment Program (FSAP), and Reports on the Observance of Standards and Codes (ROSCs) from 2000 to 2009, as well as on interviews undertaken for the evaluation.

previously notifying the Commission or other countries' finance ministers, Greece proposed a 25 percent revision of its annual gross domestic product for the 2000–06 period, because the National Statistical Service had included parts of the black economy in the revised national accounts. As a result, the official figure for the general government deficit in 2006 fell to 2.6 percent of GDP: 3.5 percentage points lower than in the base year 2003. With revenues and expenditure contributing almost equally to this reduction, the excessive deficit stood corrected. The Commission suggested that sizable revisions in government accounts since 2004 were the outcome of measures taken to improve the collection and processing of government finance statistics, in line with the Council Recommendation of July 5, 2004 and Decision of February 17, 2005. Eurostat subsequently validated the Greek budgetary figures that were reported in October 2006 and April 2007.

Analysis, Advice, and Traction—What Did the Fund See and Call For?

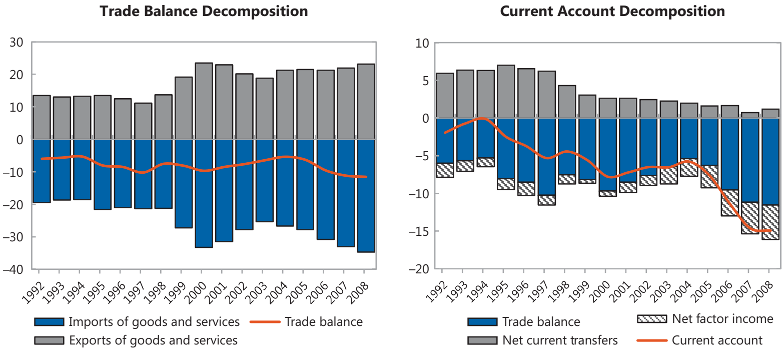
According to interviews with former Greek officials, the Fund correctly identified the key vulnerabilities in the Greek economy in the context of its annual bilateral surveillance exercises and issued relevant warnings about Greece's weak fundamentals throughout the decade preceding the crisis, although with little traction. The Fund provided recurrent warnings about "large and widening current account deficits;" urged "continued fiscal consolidation and social security reforms to foster sustainable public finances over the medium term;" called repeatedly for "structural policies to strengthen growth, competition, and accelerate real income convergence;" and alluded frequently to weaknesses in Greece's statistical data. According to interviewees, the IMF's policy advice remained relevant after the program relationship with Greece began in May 2010, and its underlying analysis formed the backbone of the macroeconomic framework of the IMF/EU-supported adjustment program. At the same time, most interviewees interpreted the persistence of the same weaknesses in the Greek economy year after year as evidence that the Fund's advice lacked traction and the capacity to follow up on the implementation of policy reforms in the context of its surveillance mandate.

After Greece's EMU accession, the IMF constantly pointed to widening external imbalances, real overvaluation, and steady deterioration in terms of trade, but did not highlight the risks that would become paramount in the crisis to follow. Already in the context of the 2000 Article IV consultation—in the wake of Greece's euro area entry—the staff explicitly questioned the authorities' view that the widening current account imbalances could be fully justified by fundamentals (e.g., elimination of exchange rate risk, and low per capita income compared to Greece's trading partners): staff estimates pointed to current account deficits in excess of the "norm" by some 2 percentage points of GDP. Throughout the decade, reflecting wage and service cost pressures, inflation was consistently 1–2 percentage points higher in Greece than in EU trading partners. By 2009, measures based on relative consumer prices and unit labor costs indicated that the real effective exchange rate had appreciated by 20–37 percent since Greece's entry into the euro area. Correspondingly, staff estimates based on CGER methodologies referred to sizable real overvaluation in the range of 20–30 percent.

The staff analysis of Greek—as well as intra-euro area—current account imbalances tended to ignore the underlying financial flows but instead typically focused on the diverging competitiveness among euro area members. It also failed to see that trade imbalances were driven more by buoyant domestic demand—funded by private debt—than by weak export performance (Figure 7.5). In the same vein, the staff's interpretation typically failed to acknowledge that, despite weak competitiveness, employment was high. Growth dynamics, driven by low real interest rates and the resulting excessive domestic demand, were not identified as unsustainable (Wyplosz, 2013).

Figure 7.5. Greece: Current Account and Trade Balance Decomposition, 1992–2007

(*In percent of GDP*)



Source: IMF, *WEO*.

Most importantly—in staff's view—the deterioration in net foreign financial asset positions was not deemed to constitute an immediate concern.[5] While current account divergences and the resulting deterioration in net foreign financial asset positions were often mentioned in national Article IV consultations, near-term concerns about the vulnerability of the economy to sudden shifts in market sentiment and abrupt liquidity tightening—although explicitly acknowledged by the staff—were tempered by the view that euro membership would make them significantly less severe and likely manageable. This was a view widely shared in the policy and academic community (Pisani-Ferry, Sapir, and Wolff, 2011).

The IMF also failed to warn about the potentially negative implications of having high debt and "competitiveness adjustment" needs. In a monetary union, the basics of debt dynamics change as countries forgo monetary policy and the exchange rate as adjustment tools. A country with a high debt-to-GDP ratio and low competitiveness faces the challenge that any "competitiveness adjustment" may increase the real burden of debt. As a consequence, the market's tolerance of what constitutes a sustainable level of debt diminishes. This means that, as alarm bells, current debt stock levels are more relevant than unfavorable medium-term debt-creating flows (Wyplosz, 2013).

[5] The 2007 Article IV consultation, for example, concluded that "availability of external financing was not a concern." The main reason given for this position was the belief that external deficits can always be funded in a monetary union. This view was implicitly based on two assumptions. First, private lending to private agents in any member country was believed to be well diversified, ruling out sudden stops. Second, national public debts were deemed to be safe. In reality, private investors eventually doubted that the "no-bailout clause" would be applied if a country were to face a sudden stop affecting both private and public borrowers (Wyplosz, 2013).

To correct deep-rooted underlying fiscal imbalances, IMF staff reports saw the need to restore the health of public finances and improve tax administration as top priorities. In line with EU commitments regarding deficits and debt reduction, since 2005 the IMF had called every year for sustained reductions in the structural deficit to achieve a balanced budget by 2010 and a budget surplus position beyond 2010. In light of the very high projected costs associated with the aging population, staff reports repeatedly urged the authorities to move expeditiously to implement proposals to reform the health care and the pension system. The staff also underscored the importance of dealing with a deep-rooted culture of tax evasion, a large unrecorded economy, and entrenched corruption—but once again without much effect. In this context, staff reports also emphasized the need to improve tax administration, overhaul public procurement, and develop an explicit medium-term budget framework that would lay out a consistent and realistic set of economic assumptions, deficit objectives, expenditure ceilings, and specific policy measures. The reports on several occasions strongly encouraged the provision of Fund technical assistance on tax administration and public expenditure management.

Country authorities who were interviewed for this evaluation concurred that the lack of implementation was—in hindsight—a major hindrance to the effectiveness of Fund advice. It is not clear what tools the Fund may have had available to ensure that measures would be implemented in the context of its surveillance mandate. Providing more technical assistance, to build capacity at an earlier stage, might have possibly helped later to tailor an adjustment program in such a way as to assure its implementation once agreed. But the lack of political willingness and ownership of objectives on the Greek side—a staff's perennial concern as clearly flagged in internal documents—raises doubts that further support for capacity building would have achieved better program implementation.

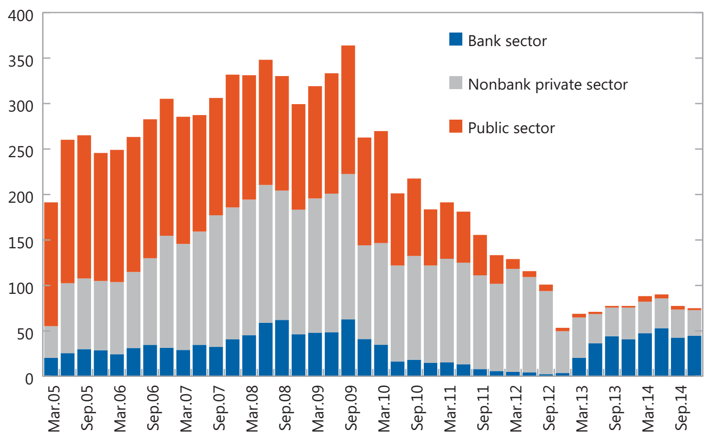
IMF staff persistently pointed to statistical data weaknesses, which it saw as hampering the assessment of economic developments and some aspects of IMF surveillance itself. In 2004, as noted earlier, gross misreporting of national and public sector accounts from as far back as 1997 was revealed. The IMF called into question the reliability of Greece's statistical data and their adequacy for surveillance on several occasions—namely, in the context of the data module of its 2003 Report on the Observance of Standards and Codes (IMF, 2003d) and its update (IMF, 2005b); as well as in the context of its 2004 Article IV consultation (IMF, 2005a). In addition, IMF staff identified significant problems in fiscal reporting and public financial management in the context of the fiscal transparency module of the 2006 Report on Observance of Standards and Codes (IMF, 2006c). As noted by Pisani-Ferry, Sapir, and Wolf (2011), the findings of the 2006 fiscal report were unfortunately not adequately reflected in the subsequent Article IV reports and the repeated warnings by mission teams about the dismal condition of Greece's public sector accounts were thereby downplayed. As a result, IMF staff "took a generally approving stance with only occasional expressions of mild concern" (IEO, 2016), and no IMF action or decision was taken with respect to the 2004 misreporting, though in 2010, in relation to the newer misreporting, the IMF found Greece in breach of its obligations under Article VIII of the Articles of Agreement.

On financial sector issues, the lack of exposure of Greek banks to toxic structured products, their large deposit base, and their access to ECB funding helped ease the IMF staff's worries about asset quality deterioration against the background of a weaker economic environment, higher liquidity risks, and lower capital adequacy. All the IMF surveillance reports reviewed (including the 2006 FSAP report and the August 2009 staff report) and the market participants who were interviewed for this evaluation reached the conclusion that Greek banks were initially well capitalized, profitable, and soundly supervised (see also Véron, 2016). This analysis, however, failed to fully appreciate the risks associated with the rise in intra-euro area banking lending and did not tease out the potentially self-reinforcing linkages within the financial system and between specific sectors' vulnerabilities.

All in all, the IMF—like nearly all other external and domestic observers—did not foresee either the nature or the extent of the massive economic and financial crisis that would hit Greece from 2009 onwards. The scenario that eventually unfolded—soaring gross financing needs and debt service costs associated with a retrenchment of portfolio investment and foreign bank lending, the transmission of sovereign weakness to the financial sector due to banks' sizable exposures to Greece's sovereign debt, a dramatic credit crunch, and plummeting budgetary receipts on the heel of a deep economic recession and soaring unemployment—was not considered (Figure 7.6).

Figure 7.6. Consolidated Foreign Banks' Exposures vis-à-vis Greece

(*Ultimate risk, by sector; percent of Greece's GDP*)



Source: Bank for International Settlements, consolidated banking statistics.

Systemic Risks and Implications of Greece's Euro Area Membership

The IMF—like most observers—was late in recognizing the risk of a sudden stop in Greece's capital inflows, whereby cross-border capital flows came to a halt in an environment of diminished risk appetite caused by the global financial crisis (Merler and Pisani-Ferry, 2012a; Baldwin and others, 2015). The IMF—like most observers—downplayed the role of the rise in cross-border lending in driving the crisis. It did not fully appreciate the consequences of the reversal of such a process: namely, the effects on capital flows and credit supply conditions when the globally active European banks deleveraged in the aftermath of the Lehman collapse (Shin, 2011). Overall, the Fund's surveillance in Greece suffered from similar problems to its surveillance in general in the run-up to the crisis (IEO, 2011), failing to pay sufficient attention to risks of contagion and spillovers and posing too much confidence in the inherent stability of the private sector economy and in the ability of monetary authorities to deal with financial market corrections.

The implications of Greece's euro membership were critically downplayed during pre-crisis surveillance. The fallout from the sudden stop was amplified in euro area country members by: (i) the absence of a central bank to provide sovereign lender-of-last-resort support in its own currency; (ii) the predominance of bank financing; and (iii) the vicious feedback between banks and sovereigns (Baldwin and Giavazzi, 2015). In particular, the lack of fiscal risk sharing arrangements and of a banking union, combined with the lack of exchange rate flexibility, made individual euro area member states vulnerable to sovereign debt crises that had the potential to spill over to banking systems and the real economy. This vicious link between banking risk and sovereign risk was not adequately recognized by IMF pre-crisis surveillance; nor were the fragilities in the euro area architecture brought to light (De Grauwe, 2012; Wyplosz, 2014; Dhar and Takagi, 2017).

The integration of the bilateral and multilateral strands of surveillance in the context of euro area country members had been posing a challenge to the IMF since the introduction of the euro, and may have ultimately hindered the detection of cross-border linkages and related systemic risks in the region (Watson, 2008; Pisani-Ferry, Sapir, and Wolf, 2011).[6] At the launch of the euro, the IMF had adopted a double-track approach for the

[6] Since the global financial crisis, the Fund has taken steps to address this problem. In July 2012, the Executive Board adopted an Integrated Surveillance Decision that strengthened the legal basis for surveillance in a highly integrated world economy. This decision enables more systematic coverage of spillovers from members' economic and financial policies in Article IV consultations and better integrated surveillance at the bilateral and multilateral levels. It is designed to help the IMF to engage members at an earlier stage in the buildup of risks and vulnerabilities, and to encourage them to be mindful of the impact of their policies on other countries and on global stability.

surveillance of euro area countries (Executive Board Decision No. 11846 (8/12), December 9, 1998). Specifically, surveillance of euro area members' fiscal, financial, and structural policies was carried out at the national level and discussed with individual country authorities, while euro-area-wide policies—including monetary and architectural issues—were discussed at the area level. Policy recommendations that were developed in the euro area Article IV consultations were rarely translated into concrete country-specific policy advice. Conversely, problems identified at the national level were not generally brought to the attention of the broader euro area policy community. In this way, the Fund's expertise for integrating surveillance at the national, regional, and global level was left largely unexploited in the years preceding the crisis, and the IMF failed to properly account for spillover risks.

Anticipating the design of a crisis management and resolution regime for the euro area should have been a strategic issue for the IMF. The architecture of the euro area—at least initially—relied on the primacy of crisis prevention (such as the prevention and correction of excessive public deficits), but no procedures—not even agreed principles—were in place for crisis management and resolution. No formal provision precluded individual euro area members from seeking financial assistance from the Fund. Nor had the IMF developed a relevant procedure, nor even an understanding of when and how it might become involved. Most specifically, the IMF staff did not explore the possibility of refining the Fund's operational framework for lending to individual members of currency unions to account—for instance—for issues such as the imposition of conditionality on policies that are under the control of supranational institutions like the ECB (Tan, 2017). Had IMF management and staff considered the implications of euro area membership for program design with the Executive Board in the six months prior to Greece's SBA request, the staff would have had a better understanding of the specific constraints it would face in an IMF-supported program for a euro area member.

Program Preparation

Circumstances and Modalities of IMF Involvement in Greece

Proper assessment of the design of the SBA-supported program for Greece requires understanding of the circumstances that led to the initial IMF's decision to provide exceptional access financing to Greece, amid misgivings about Greece's medium-term debt sustainability. This decision was made against an environment that rendered crisis management and resolution particularly difficult. Greece was the first country in need of financial assistance inside an economic and monetary union whose architecture was not yet fully developed. And, as the crisis developed on the heels of the 2008 global financial crisis, the economic and market environments were still unstable.

Contagion from Greece to other euro area sovereign issuers was a major concern given the considerable exposure of euro area banks to euro area sovereign debt.[7] As explained by Merler and Pisani-Ferry (2012b), the reason why European banks hold so much government debt is twofold. First, the European financial system remains largely bank-based, with banks playing a key intermediary role, mirrored by the size of their assets. Second, government bonds are appealing because they can easily be used as collateral (both in the interbank market and for central banks' emergency lending) and because the Basel regulatory framework allows for zero-risk weight of bonds issued by euro-area governments.

In the buildup to the Greek crisis, such exposures created a toxic interaction between sovereign and bank balance sheets. A weakening of the sovereign balance sheet has the potential to raise concerns about the solvency of banks, whereas banking sector problems weaken sovereign balance sheets because of the (often implicit) government guarantees provided to the financial sector. Given the systemic importance of European banks, a risk of a sovereign default endangering the soundness of the European banking system would have posed a serious threat to global, not only European, financial stability.

The fundamental challenge was hence to break the noxious link and establish a "firewall" that would keep turmoil from spreading, by showing markets that Europe had both the resources and the institutional infrastructure to respond if any other euro area country came under speculative attack. In this context, the euro area began creating a financial safety net for its member countries and overhauling its own institutional design. This led to the creation of the new lending facilities—the European Financial Stability Facility (EFSF), European Financial Stabilization Mechanism (EFSM), and European Stability Mechanism (ESM)—that ultimately provided the greatest part of the financing for Ireland, Portugal, Spain, and Cyprus (Annex 7.1).[8]

[7] EU banks' stress test results—publicly released on July 23, 2010—revealed the location of Greek sovereign debt on a bank-by-bank basis. Greek sovereign bond holdings for 84 of the 91 participating EU banks—from balance sheet data dated March 31, 2010 (that is, preceding the launch of the ECB's Securities Markets Program)—amounted to about €81.5 billion. This was about 60 percent of the €183 billion total outstanding claims (ultimate risk basis) of the European banks against Greece, as reported by the Bank for International Settlements at the end of 2010Q1—confirming that substantial non-sovereign exposures related to Greece also existed. Large cross-border exposures to Greek sovereign debt (defined as an exposure above 5 percent of tier-one capital) were reported for Germany, France, Belgium (all with systemically important banks), Cyprus, and Portugal. Greek banks' heavy exposure to the sovereign debt of their own country was also confirmed at €56 billion, representing 226 percent of their tier-one capital. See Kirchegaard (2010) and Blundell-Wignall and Slovik (2010) for important details on the EU stress test and bank-specific sovereign debt exposures.

[8] The EU lending instruments established since 2010 to preserve financial stability in Europe comprise: (i) the European Financial Stabilization Mechanism (EFSM), an EU financial assistance feature available to all 27 member states; (ii) the European Financial Stability Facility (EFSF), a temporary credit-enhanced special-purpose vehicle with minimal capitalization created to raise funds from the capital markets (via an investment-grade rating) and provide financial assistance to distressed euro area members at comparatively lower interest rates; and (iii) the European Stability Mechanism (ESM), an intergovernmental organization under public

The IMF was kept on the sidelines when approaches to dealing with the developing crisis in Greece were initially being debated in Europe in late 2009 and early 2010 (Blustein, 2015). In January 2010, the euro area authorities ruled out the possibility of seeking IMF financing. The Greek authorities concurred. Nevertheless, the new Greek government requested the Fund's technical assistance to improve tax administration and public financial management policies and IMF Fiscal Affairs Department missions visited Athens in early 2010.[9] At the same time, Greece committed to a fiscal consolidation plan via the 2010 Stability Program with the European Commission, with the aim of cutting the deficit from 12½ percent of GDP in 2009 to 8¾ percent of GDP in 2010, and by a further 3 percentage points in 2011 and 2012 (the so-called 4-3-3 plan). But the plan failed to win back the confidence of investors.

The IMF was eventually called in. At the European summit on March 25, 2010, euro area member states pledged "to provide financial assistance to Greece in concert with the Fund, if necessary, and if requested by Greece's government" (European Council, 2010). IMF involvement was reportedly a key condition for some European creditor countries' willingness to compromise and agree to the creation of a safety net mechanism. Some economists have also argued that the conditionality attached to an IMF loan would lend additional impetus to reform and provide both the Greek government and the EU with an outside scapegoat for pushing through politically unpopular reforms. The EU, too, would make policy reforms a condition for its lending, but the IMF was seen as more independent than the EU, and more experienced in resolving debt crises (Nelson, Belkin, and Mix, 2010; *The Economist*, 2010b).

The modalities of cooperation between the IMF and the European institutions were largely ad hoc, established in real time in the midst of the crisis. Given the limited formal guidance on modalities for collaboration, ample flexibility existed in the IMF to tailor joint work to Europe's specific circumstances. At the same time, it has been noted that too much flexibility might have given rise to perceptions of differentiated treatment and greater uncertainty about the provision of financial assistance, given that objectives and processes differed among the institutions involved (IMF, 2013c). Conditional assistance from the IMF is meant "to give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity" (Article I of IMF Articles of Agreement). Thus, in providing financing to a country member, the Fund has no other objective than (i) correcting the imbalances that led the member

international law. For discussions on the new EU architecture designed to avert a financial crisis, see for example Olivares-Caminal (2011) and Boeckx (2012). IMF (2013a) provides a broader overview of regional financing arrangements and scope for IMF coordination.

[9] In addition, in early 2010 the IMF's Monetary and Capital Markets Department provided financial sector advice to the national central bank.

country to request assistance; and (ii) ensuring that the country will be able to repay the loan, without resorting to measures that are harmful to it or to other Fund members. The EU, on the other hand, is a political system. Its still evolving lending framework—and underlying conditionality—is geared towards members that are threatened by severe financing problems, with the main objective of safeguarding the stability of the system as a whole. Such diverging goals may potentially create disagreements, as the IMF is fundamentally more concerned about the impact of policy demands on the debtor country's medium-term debt sustainability, whereas European institutions are inherently more concerned about the impact of the program on the stability of the region and the risks of contagion to other member states.

Former IMF senior staff members and country authorities stated to the IEO that IMF involvement was justified by the need to preserve global financial stability. And several otherwise critical stakeholders argued that it was not in the interest of the global community—or thereby of the Fund—to abstain from engaging in a region that posed a serious threat to global stability. Seen in this perspective, the European objective of putting the stability of the euro area ahead of the specific needs of Greece was congruent with the Fund's responsibilities and the interest of the majority of its membership.

While negotiations and discussions about an IMF/EU bailout package for Greece continued, investors' jitters spiked again in April 2010 when Eurostat released its estimate of Greece's budget deficit. At 13.6 percent of GDP, this estimate was almost a full percentage point higher than the previous estimate, released by the Greek government in October 2009.[10] The new revelation raised renewed questions about Greece's ability to repay large debt obligations falling due on May 19, 2010.

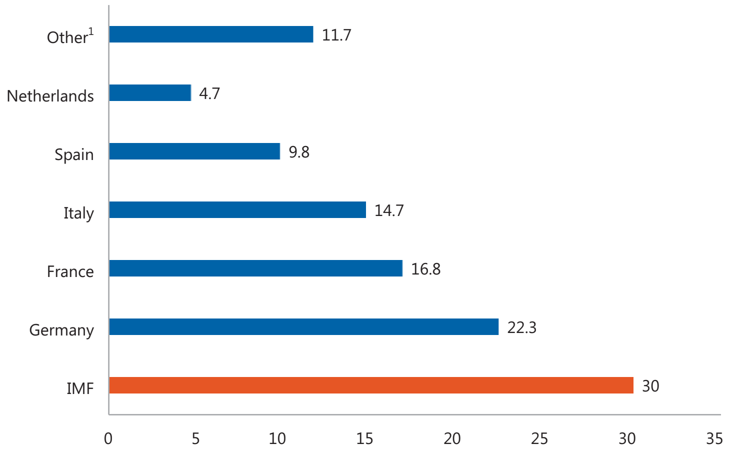
On April 23, 2010, the Greek government formally requested financial assistance from the IMF and other euro area countries. In late April 2010, the spread between Greek and German ten-year bonds reached a record high of 650 basis points. On April 27, 2010, S&P downgraded Greek bonds to "junk" status.

On May 2, 2010, the Eurogroup and the IMF simultaneously announced a three-year, €110 billion stabilization plan for Greece (Figure 7.7). Euro area countries were to contribute €80 billion in bilateral loans to be pooled by the EC under the Greek Loan Facility, pending the parliamentary approval needed in some countries. The IMF was to provide a €30 billion loan (equivalent to SDR 26.4 billion and 3,212 percent of quota) at market-based interest rates under a three-year Stand-By Arrangement that was approved by the Board on May 9. The first disbursements were made available before the debt-service payment obligations of the Greek government fell due on May 19.

[10] As noted earlier, in May 2010 the IMF found Greece in breach of members' reporting obligations under Article VIII, Section 5 of the Articles of Agreement.

Figure 7.7. Financial Assistance to Greece: Relative Contributions

(In billions of euros)



Sources: IMF; EU Commission; and ECB.

[1] Includes Belgium, Austria, Portugal, Finland, Ireland, Slovakia, Slovenia, Cyprus, Luxemburg, and Malta.

Debt Sustainability Issues

Given the revolving nature of IMF financing, debt sustainability is crucial. The IMF can only provide financing to a member country whose economic policies are deemed adequate to resolve its balance of payments problems within a reasonable timeframe. Fund financing cannot solve a solvency problem: the member must undertake sufficient adjustment, reduce the present value of its obligations, or a combination of these, to maintain medium-term sustainability.

Debt is judged sustainable when a borrower is expected to be able to continue servicing its debts without an unrealistically large correction to its income and expenditure. This judgment determines the availability and the appropriate scale of IMF financing. When a member requests Fund financial assistance, the IMF assesses whether the authorities' policies are consistent with ensuring debt sustainability. This assessment is based on a debt sustainability analysis (DSA) that incorporates alternative scenarios and stress tests (Box 7.1).

In the vast majority of IMF-supported programs in emerging market and advanced economies, a combination of policy adjustment and financing from public and private sources has been sufficient to preserve sovereign debt sustainability. Programs seek to strike an appropriate balance between adjustment and financing. Financing—including from the IMF—aims at smoothing adjustment and making it less costly for both the member concerned and the international community. IMF financing is usually a part of total financing. Other creditors, official or private, are also generally expected to

Box 7.1. IMF Debt Sustainability Analysis

The IMF's advice on macroeconomic policies—in the context of either IMF-supported programs or surveillance—is anchored in the analysis of a country's capacity to finance its policy objectives and service the ensuing debt without unduly large adjustments, which could compromise its stability. To this end, the IMF has developed a formal framework for conducting sustainability analyses for public and external debt as a tool to better detect, prevent, and resolve potential crises. This debt sustainability analysis (DSA) framework became operational in 2002. The framework for public debt sustainability analysis[1] for advanced and emerging market economies was reformed in 2011 and guidance to staff on the implementation of the new framework[2] was introduced in May 2013. A new public DSA template[3] was published in March 2014.

The objective of the framework is threefold:

- Assess the current debt situation, its maturity structure, whether it has fixed or floating rates, whether it is indexed, and by whom it is held.
- Identify vulnerabilities in the debt structure or the policy framework far enough in advance so that policy corrections can be introduced before payment difficulties arise.
- In cases where such difficulties have emerged, or are about to emerge, examine the impact of alternative debt-stabilizing policy paths.

The framework consists of two complementary components: the analysis of the sustainability of total public debt and that of total external debt. Each component includes a baseline scenario, based on a set of macroeconomic projections that articulate the government's intended policies, with the main assumptions and parameters clearly laid out; and a series of sensitivity tests applied to the baseline scenario, providing a probabilistic upper bound for the debt dynamics under various assumptions regarding policy variables, macroeconomic developments, and financing costs. The paths of debt indicators under the baseline scenario and the stress tests allow the analyst to assess the vulnerability of the country to a payments crisis.

DSAs should not be interpreted in a mechanistic or rigid fashion. Their results must be assessed against relevant country-specific circumstances, including the particular features of a given country's debt as well as its policy track record and its policy space.

[1] Available at https://www.imf.org/external/np/pp/eng/2011/080511.pdf.
[2] Available at https://www.imf.org/external/np/pp/eng/2013/050913.pdf.
[3] Available at https://www.imf.org/external/pubs/ft/dsa/templ/dsatempl2.xlsm.

contribute to the financing of the program. The extent of private sector involvement (PSI) is typically reflected in assumptions about private sector capital flows (and their composition, e.g., bonds; bank loans with various characteristics) and rollover by creditors, based on the expected impact of the IMF-supported program on private sector sentiment. PSI can also be made more explicit, such as when banks committed to maintain their exposure in recent programs in Central and Eastern Europe.

If the IMF determines that debt sustainability cannot be preserved through credible and sustainable policy adjustment by the borrowing member, it cannot provide financing unless steps are taken to restructure the debt and restore sustainability. In other words, if the debt is found unsustainable, it will have to be restructured one way or another. And, in such a case, it is better for the debtor, creditors, and the entire financial system that the restructuring be carried out in a prompt, predictable, and orderly manner (Hagan, 2014).

In the case of requests for exceptional access to Fund resources, a higher evidentiary test is required: that the member's public debt should be sustainable in the medium term "with a high probability" (see next section). Such debt sustainability requirement applies throughout the period of the financing arrangement. In the case of Greece's exceptional access under the 2010 SBA, the IMF's debt sustainability analyses—which were conducted every three to six months after the beginning of the program in May 2010—suggested that, even under optimistic assumptions, risks to Greece's debt sustainability remained high.

Thus, it is not surprising that the IMF's initial decision to provide exceptional financing to Greece without first seeking a restructuring of Greece's sovereign debt was a particularly contentious issue. As evident in the internal review process for the SBA request, management and key senior staff were divided on their assessment of Greek debt sustainability (see also next section). However, with the fallout from the Lehman collapse of September 2008 still fresh in policymakers' memory, there were concerns about a potential credit event spreading to other members of the euro area and more widely to a fragile global economy.[11] Ultimately, the Managing Director's judgment was to go along with the decision that had already been reached among European policymakers, namely, to attempt to restore Greece's financial and macroeconomic stability through official financing, fiscal adjustment, and structural reforms.

As it turned out, the decision not to seek preemptive debt restructuring fundamentally left debt sustainability concerns unaddressed, magnified the required fiscal adjustment, and thereby—at least in part—contributed to a large contraction of output and a subsequent loss of Greek public support for the program. The IMF's ex-post evaluation of the Greek SBA observed: "not tackling the public debt problem decisively at the outset . . . created uncertainty about the euro area's capacity to resolve the crisis and likely aggravated the contraction in output. An upfront debt restructuring would have been better for Greece although this was not acceptable to the euro partners." (IMF, 2013c.)

[11] A similar ambivalence is reflected in the minutes of the Executive Board meeting of May 9, 2010, which approved the SBA request. Several EDs expressed concern over the high risks to Greece's debt sustainability, but the majority (by voting power) focused on the gravity of contagion risk.

Introducing an Exemption to the Exceptional Access Policy

Providing exceptional access for Greece—at more than 3,000 percent of quota— involved substantial financial risks for the Fund. IMF lending above normal limits entails enhanced scrutiny by the Fund's Executive Board and requires that the member's public debt should be sustainable in the medium term with a high probability, in accordance to the 2002 Fund's exceptional access policy (Box 7.2). The policy was originally designed to protect the IMF's decision-making process in exceptional access cases from undue political influence and—by limiting the room for discretion—make the IMF less vulnerable to pressures to provide exceptional access where there are misgivings about debt sustainability.

In the case of Greece, stating that the member's public debt was sustainable in the medium term with a high probability was not possible, in the staff's judgment. A compromise thus emerged during the internal review process. Instead of certifying that Greece had a high probability of debt sustainability, the staff decided to state that "on balance" the country's debt appeared to be sustainable. In addition, an exemption to the exceptional access policy was introduced, dropping the high-probability requirement for crises that posed risks of "systemic spillovers." Since all countries must be treated evenhandedly, this exemption was made applicable to all future cases, not just Greece. Only with this clause could the IMF provide financial support to Greece at the proposed access level.

The need to change the debt sustainability criterion of the exceptional access policy was not disclosed to the Board until the staff report had been circulated. Arguably, this could have been justified by the urgency of the situation at the time but—according to the evidence obtained by the IEO—management had been considering different alternatives for the modification to the exceptional access policy since, at least, end-April. Yet the Board was not consulted or informed during this period. The policy change was embedded in the report requesting the Greek SBA and, therefore, was to be implicitly approved along with the formal and explicit request for Fund resources. Neither management nor staff drew the attention of the Board to

Box 7.2. IMF 2002 Exceptional Access Lending Framework

Access to IMF financial resources is guided by a member country's need for financing and its capacity to repay, and by its track record in using IMF resources. Within these guidelines, the IMF can lend amounts above normal limits on a case-by-case basis.[1]

Prior to 2002, the exceptional access policy was designed to be very flexible, with no criteria established as to what these circumstances were and why they should be considered particularly exceptional. The decision to lend to Argentina in 2001, and Argentina's subsequent debt default, served as the final catalyst for a broad review of the Fund's exceptional access policy. Drawing on the Prague

Framework for Private Sector Involvement endorsed by the International Monetary and Financial Committee (IMFC) at the Annual Meetings in Prague in 2000, the 2002 Exceptional Access Framework provides that IMF lending above normal limits entails enhanced scrutiny by the Fund's Executive Board.[2] At a minimum, a member facing a capital account crisis must meet the following four substantive criteria to justify exceptional access:

(i) The member is experiencing exceptional balance of payments pressures on the capital account resulting in a need for IMF financing that cannot be met within the normal limits.
(ii) A rigorous and systematic analysis indicates that there is a high probability that the debt will remain sustainable.
(iii) The member has good prospects of regaining access to private markets within the time IMF resources would be outstanding.
(iv) The member's policy program provides a reasonably strong prospect of success, including not only the member's adjustment plans but also its institutional and political capacity to deliver that adjustment.

The 2002 framework also established stronger procedures for decision making on exceptional access to reinforce safeguards and enhance accountability:

(i) Prompt and systematic Board consultations on program negotiations, notably through confidential informal briefings. In this context, Executive Directors are provided with a short note outlining the following: a tentative diagnosis of the problem; the outlines of the needed measures; the basis for judgment that exceptional access may be necessary and appropriate, with a preliminary evaluation of the four substantive criteria; and the likely timetable for discussions. Informal meetings will provide the basis for consultation with capitals and the issues that emerge will be addressed in a further informal session. Management is expected to consult with the Board specifically before concluding discussions on a program and before any public statement on a proposed level of access.
(ii) A higher burden of proof in program documentation. Staff reports proposing exceptional access must include: a consideration of each of the four criteria; a thorough discussion of the balance of payments need and the proposed access; a comparison of the proposed access with other metrics aside from quota; and systematic and comprehensive information on the member's capacity to repay the Fund. The Board is also provided with an assessment of risks to the IMF arising from the exposure and its effect on IMF liquidity.
(iii) An ex post evaluation of the program within one year of the end of the IMF arrangement.

Consistent implementation of the framework for exceptional access policy was considered essential to heighten the degree of clarity and predictability for both members and markets about the Fund's response in crisis resolution.

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[1] Normal borrowing limits were doubled in 2009 to give countries access of up to 200 percent of quota for any 12–month period, and cumulative access over the life of the program of up to 600 percent of quota, net of repayments.

[2] See "Access Policy in Capital Account Crises" (SM/02/246; 7/30/02); the Acting Chair's Summing Up (BUFF/02/159; 9/20/02); "Access Policy in Capital Account Crises—Modifications to the Supplemental Reserve Facility and Follow-Up Issues Related to Exceptional Access Policy" (SM/03/20; 1/14/03); and the Acting Chair's Summing Up (BUFF/03/28; 3/5/03).

the proposed decision itself or to the fact that the exceptional access criteria would effectively be modified by approving the SBA (De Las Casas, 2017).

The introduction of the "systemic exemption" had several shortcomings which revealed themselves over time. As noted in IMF (2016b), "[f]irst, the exemption did not prove reliable in mitigating contagion. And this is understandable. Insofar as the exemption left market concerns about underlying debt vulnerabilities unresolved, the exemption was unlikely to instill market confidence in the program and thereby limit contagion. Second, by replacing maturing private sector claims with official claims, it increased 'subordination risk' for private creditors—that is, the risk that private claims would rank lower than official claims in the case of an eventual default—making it more difficult for the country to regain market access. Third, for the two reasons above, the systemic exemption entailed substantial costs and risks for the member country and the IMF. In particular, it delayed the restoration of debt sustainability, impaired the prospects of success for the country's economic policy program, and eroded safeguards for IMF resources." For these reasons, the 2016 reform of the IMF's exceptional access policy removed the "systemic exemption" (Box 7.3).

The exceptional access policy requires the continued satisfaction of the debt sustainability criterion throughout the period of the arrangement. However, there is no requirement to spell out the assessment that the criterion is met at every program review. In this context, the staff reports for the first three reviews of the SBA remained silent on the issue. The staff report for the fourth review of the SBA reiterated that "significant uncertainty around the baseline projection does not allow the staff to deem debt to be sustainable with high probability" and that "meeting the high probability test is not required under the revised exceptional access policy when there is a risk of international systemic spillover effects, as is now the case in Greece." It also indicated that "involvement of the private sector and/or stronger official sector support" were being considered as a strategy to place debt on a more sustainable path (IMF, 2011d). In the staff report for the fifth review of the SBA—when an agreement on PSI and stronger official sector support had already been reached—there were no more references to systemic spillover effects. Instead, it was noted

Box 7.3. IMF 2016 Exceptional Access Lending Framework

In January 2016, the Executive Board approved reforms to the IMF's exceptional access lending framework to make it more calibrated to members' debt situations, while avoiding unnecessary costs for the members, creditors, and the financial system as a whole. These reforms were put forward in a 2015 staff paper "The Fund's Lending Framework and Sovereign Debt—Further Considerations." The Board's January 20, 2016 decision followed a preliminary Board discussion on this topic in June 2014 (Press Release No. 14/294).

The reforms aimed at improving the IMF exceptional access policy in three ways. First, they removed the systemic exemption introduced in May 2010. Second, they gave the IMF appropriate flexibility to make its financing conditional on a broader range of debt operations, including the less disruptive option of a "debt reprofiling"—that is, a short extension of maturities falling due during the program, with normally no reduction in principal or coupons. Third, they clarified the criterion related to market access.

The current, reformed policy—like the old one—prescribes that when debt is clearly sustainable, the IMF will continue to use its catalytic role and provide financing support to the member without requiring any debt operation. When debt is clearly unsustainable, a prompt and definitive debt restructuring will continue to be required to restore debt sustainability with "high probability."

However, for countries where debt is assessed to be sustainable but not with a high probability, the 2016 policy allows the IMF to grant exceptional access without requiring debt reduction upfront, as long as the member also receives financing from other creditors (official or private) during the program. This financing should be on a scale and terms that (i) helps improve the member's debt sustainability prospects, without necessarily restoring debt sustainability with "high probability"; and (ii) provides sufficient safeguards for IMF resources. The choice of the most appropriate option, from a range of options that could meet the two conditions noted above, would depend on the member's specific circumstances.

In situations where the member retains market access, or where the volume of private claims falling due during the program is small, sufficient private exposure could be maintained without the need for a restructuring of their claims. In situations where the member has lost market access and private claims falling due during the program would constitute a significant drain on available resources, a reprofiling of existing claims would typically be appropriate. This could allow a somewhat less stringent adjustment path while also reducing the required amount of financing from the IMF. Under the new policy, financing from official bilateral creditors, where necessary, could be provided either through an extension of maturities on existing claims and/or in the form of new financing commitments.

The new policy would also allow the IMF to deal with rare "tail-event" cases where even a reprofiling is considered untenable because of contagion risks so severe that they cannot be managed with normal defensive policy measures. In these rare cases, the IMF could still provide large-scale financing without a debt operation, but would require that its official partners also provide financing on terms sufficiently favorable to backstop debt sustainability and safeguard IMF resources. This could be done through assurances that the terms of the financing provided by other official creditors could be modified in the future if needed (say in the event of downside risks materializing). If official partners could not provide such assurances (or if the member's debt was deemed unsustainable at the outset), the terms of official financing would have to be sufficiently favorable to restore debt sustainability with high probability.

In addition, the Board confirmed that the third criterion—which requires a member to have prospects for regaining market access—remains binding even when there are open-ended commitments of official support for the post-program period. It also clarified that the timeframe within which a member is expected to regain market access has to be consistent with the start of repayment of its obligations to the IMF, not just when the last one is due, as implied by the old formulation of the criterion.

that "the sustainability of Greece's debt depends on prolonged support from Greece's European partners at low interest rates, and deep restructuring of private sector debts with near-universal participation of creditors" (IMF, 2011e).

Program Design

Overall Design Issues

As noted, upfront debt restructuring was off the table. So was imposing conditionality on monetary policy, which was under the competency of the ECB. To be sure, the ECB provided substantial and extraordinary liquidity support during the course of the SBA. For example, from May 2010, it suspended the link between sovereign credit ratings and eligibility of collateral for refinancing operations and it intervened directly in the government bond market under the Securities Markets Program. It also began to accept uncovered bank bonds guaranteed by the government as collateral eligible for refinancing operations. But these efforts alone did not keep the turmoil from spreading. The unanimously recognized imperative was to establish credible firewalls for Europe, including via stronger supportive actions by the ECB, but—in the event—such bolder actions remained off the table.[12]

Nor did foreign private creditors credibly commit to maintain their exposures in Greece at the outset of the program. The lack of action in this area is apparently at odds with what had been done in previous IMF-supported programs in emerging Europe in response to the 2008 global financial and economic crisis, where the IMF sought a form of PSI from the outset.[13] Replicating a similar initiative in Greece was not deemed to be viable, as was noted by the staff response to questions from Executive Directors at the IMF Board meeting on May 9, 2010.[14] To be sure, while Eastern European

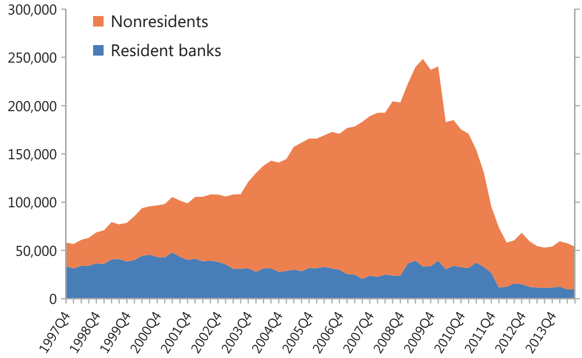
[12] It has been noted that by setting limits on its potentially unlimited actions, the ECB undermined its stated intentions and reinforced market fears (Wyplosz, 2014; De Grauwe, 2012). The ECB President's "whatever it takes" speech in July 2012 proved the power of unlimited central bank commitments: without any need for actual intervention, the announcement succeeded in quietening markets and steering the crisis away from its acute phase.

[13] In particular, in partnership with other multilateral institutions, the IMF actively participated in the Bank Coordination Initiative when this was launched in January 2009 (Takagi and others, 2014). The large presence of foreign-owned banks in several Eastern European countries made PSI especially necessary, whereas the small number of large players enhanced its feasibility and success (De Haas and others, 2012).

[14] "Let me turn to the issue of private sector involvement. We had considerable discussion on that. Several Directors have mentioned the Bank Coordination Initiative that the Fund is using when we have programs with other countries in the region, like Romania, Serbia, and Hungary. That Bank Coordination Initiative is not applicable in this case, because in these countries the issue is really one of exposure of home banks to the subsidiaries in these countries. It is relatively easy to get those home banks and their regulators into a room together with Fund staff and other stakeholders, and try to come up with a commitment to maintain exposure. In the

Figure 7.8. Greek Sovereign Bonds' Holdings

(*In millions of euros*)



Source: Merler and Pisani-Ferry (2012b).

countries confronted mostly liquidity problems that could be effectively handled through creditors' coordination, Greece faced underlying debt vulnerabilities that made creditors' coordination much harder.

As market concerns about Greece's underlying debt sustainability were left unresolved, expectations of future debt restructuring were widely held by private investors. Indeed, as shown by the Bruegel database of sovereign bond holdings developed in Merler and Pisani-Ferry (2012b), Greek government bonds' holding patterns changed rapidly after 2009Q4, with the share of nonresident holders of Greek sovereign debt—in large part, the original bank lenders—declining markedly (Figure 7.8). Predictably, by the time the PSI was finally implemented in spring 2012, most large foreign banks had sold their stakes to official institutions and Greek banks, which in turn had to be bailed out.[15]

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case of Greece, the issue is not primarily of maintaining exposure of home banks to subsidiaries, but claims on holders of Greek government bonds. These holdings are, it appears, widely spread and this points to major complications. We do in fact not have very good information on who holds these papers. This is one of the reasons why the mechanism that is in place might not yet be up to what we would desire. But, as we heard this morning from Mr. Fayolle, Mr. Stein and other Directors, efforts are ongoing in Europe to encourage banks to maintain exposure, and I think this is something where efforts are still developing. This will be supplemented by an effort by the government, by the Minister of Finance. He is asking for our support in this regard, to organize a road show to essentially present the program in financial capitals to disseminate information about it and keep financial capitals informed about progress under the program. Overall, I recognize that safeguards in this area are not fully up to what we would want, but I think that this is still developing."

[15] As noted by the IMF's ex-post evaluation of the Greek SBA (IMF 2013c), "A delayed debt restructuring also provided a window for private creditors to reduce exposures and shift debt

In the absence of greater financing from the European partners or upfront debt restructuring, correcting the major disequilibria in the Greek economy was bound to be a titanic challenge. Greece's combination of excessively large public and private debt, an overvalued real exchange rate, a fragile government apparatus, languishing political ownership, and a weak and closed business sector meant that the required adjustment was bound to be of extraordinary size and prove very challenging.

Ultimately, the design of the Greek rescue was perceived as fragile, while no credible firewall was yet in place to keep Greece's woes from spreading. In exchange for financial assistance, Greece submitted a three-year plan aimed at cutting its budget deficit from 13.6 percent of GDP in 2009 to below 3 percent of GDP in 2014. The plan anticipated that the debt-to-GDP ratio would peak at 149 percent in 2013 and gradually decline thereafter. As worryingly high as a debt-to-GDP ratio of 149 percent could be, keeping it from soaring even further depended on three bets paying off: (i) the Greeks would implement the structural and fiscal consolidation measures as promised; (ii) those measures would engender the promised benefits for confidence and growth; and (iii) those confidence effects would allow the Greek sovereign to regain market access by the end of the SBA. In short, the sustainability of public debt was highly vulnerable. It is not surprising, then, that markets began to panic again a few days after the package was unveiled. By May 7—the day of the Euro summit during which the ECB was invited to buy bonds of the riskiest governments—yields on Greek sovereign bonds were above 12 percent.

The IMF staff made it clear that the program supported by the SBA was ambitious and subject to considerable risks. Internal IMF documents show that, from the beginning, very serious concerns were raised about debt sustainability and the fragility of the program. Problem is that by founding the program on a very risky strategy, the IMF and European political leaders destined it to have a very slim chance of success.[16]

into official hands. As seen earlier, this shift occurred on a significant scale and limited the bail-in of creditors when PSI eventually took place, leaving taxpayers and the official sector on the hook." Yet, it did not take long for the Fund to argue that there was a need to go further and contemplate also the restructuring of official assistance loans. Looking ahead, if Greece is eventually offered a debt write down by its official creditors, the cost will eventually be borne by all European taxpayers. The socialization of private losses is commonly seen as a cardinal sin that financial assistance programs should strive to prevent.

[16] According to Pisani-Ferry, Sapir, and Wolff (2013), "Political reluctance in Europe to start debt restructuring, the fear of potential moral hazard effects and the absence of effective mechanisms to contain its possible financial fall-out made this option unappealing. The alternative, nearly-concessional lending within the framework of a large and long-lasting assistance programme, was not politically palatable either. This conundrum led the IMF and the EU to bet on the materialisation of optimistic tax revenue and privatisation assumptions. Instead of

The program did not appear to enjoy adequate financing assurances. At each review, the Fund must ensure that the member has secured firm financing commitments to implement the intended policies—at a minimum for a period of 12 months—and that there are good prospects for full financing until the end of the program. Conditional on the program's macroeconomic framework, IMF financial assistance under the SBA and the European financial commitment under the Greek Loan Facility met both conditions. But when outcomes began to deviate significantly from program assumptions, no additional financing was committed, casting doubts on whether the prospects for full financing until the end of the program were sufficiently strong.[17]

The Frontloading of Fiscal Adjustment

Quantitative conditionality focused on comprehensive monitoring of fiscal performance.[18] As shown in Annex 7.2, the quantitative performance criteria included ceilings on the primary deficit of the central government budget and changes in the financial assets of the social security funds and local governments; the level of primary current expenditure; and new government guarantees.[19]

The program envisaged an exceptionally strong, front-loaded fiscal effort through 2013 (Figure 7.9). It contemplated adjustment measures worth 11.1 percent of GDP in cumulative terms through 2013, with additional remedial measures in 2014 to reduce the deficit to below 3 percent of GDP. This large adjustment was presented as indispensable to bolster confidence and regain market access. In fact, it was needed to put the debt-to-GDP ratio on a

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formulating a robust programme capable of withstanding adverse economic, political and financial developments, they did just the opposite. It is no surprise that these optimistic assumptions were not vindicated by events."

[17] In this respect, the internal review process reveals strong and increasing concerns on the side of IMF staff starting as early as end-January 2011, when the need for a definite change in strategy became clear.

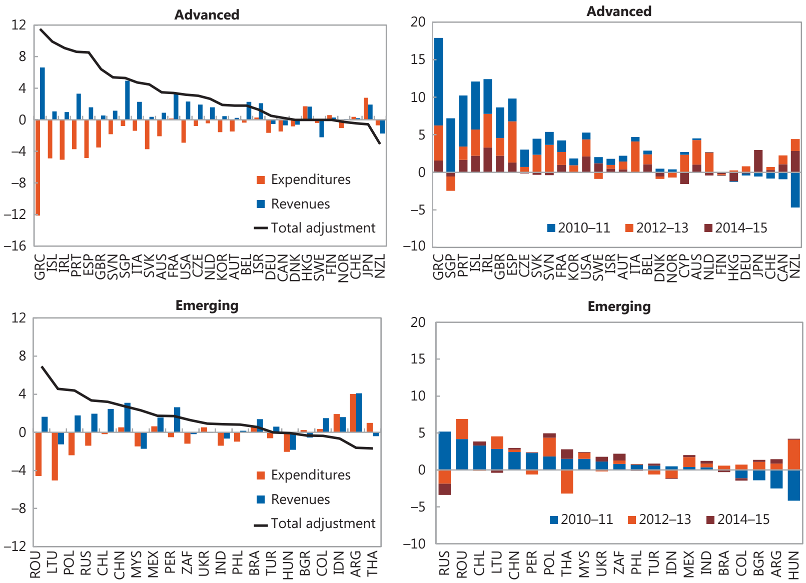
[18] IMF conditionality can take different forms and usually includes both quantitative performance criteria (measurable conditions that the country must meet, in order to complete a review) and structural benchmarks (often non-quantifiable reform measures that are critical to achieve program goals and are intended as markers to assess program implementation during reviews). A fact sheet on IMF's conditionality is available at https://www.imf.org/external/np/exr/facts/conditio.htm. For the operational implications of the 2002 Conditionality Guidelines and the key principles underlying the design of conditionality in Fund-supported programs, see IMF (2014a).

[19] The performance criterion on Greece's general government primary cash balance was met for end-2010 but the criterion did not take account of the accumulation of arrears. Arrears were monitored via an indicative target that was breached by €3 billion, equivalent to a little more than 1 percent of GDP. The definition of the performance criterion was subsequently modified to incorporate domestic arrears.

Figure 7.9. Composition and Phasing of Fiscal Adjustment

Change in Revenue, Expenditure, and Cyclically Adjusted Primary Balance, 2009–13
Selected Advanced and Emerging Economies
(In percent of GDP)

Change in Cyclically Adjusted Primary Balance, 2009–11, 2013–11, and 2015–13.
Selected Advanced and Emerging Economies
(In percent of potential GDP)



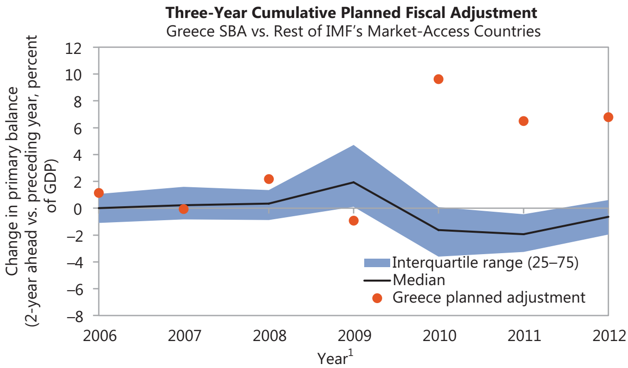
Note: Estimates do not exclude the effect of asset/commodity prices or one-off measures such as financial sector support on revenue and expenditure.
Source: IMF, *Fiscal Monitor*, October 2012.
[1] Changes in revenue are estimated in percentage points of GDP, which implicitly assumes an elasticity of revenue to GDP of one.
[2] Changes in expenditure are estimated in percentage points of potential GDP, which implicitly assumes an elasticity of expenditure to GDP of zero.

Note: Fiscal adjustment in 2010–11 refers to the change in the cyclically adjusted primary balance (CAPB) in 2011 compared to 2009; 2012–13 refers to the change in the CAPB in 2013 compared to 2011; and 2014–15 refers to the change in the CAPB in 2015 compared to 2013.
Source: IMF, *Fiscal Monitor*, October 2012.

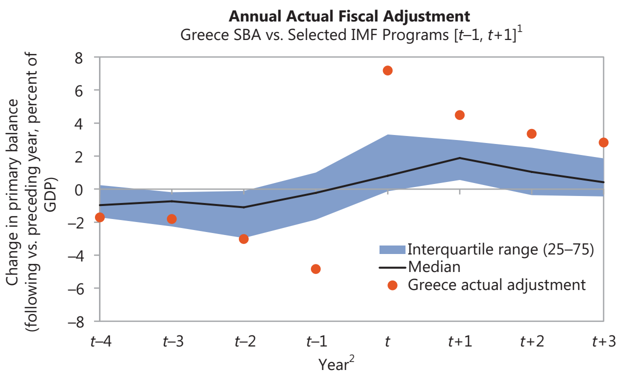
declining path from 2013, given that upfront debt relief had been ruled out and that additional financing—either by the IMF or by the euro partners—would have been politically infeasible.

The extent of the fiscal adjustment envisaged was exceptional by international and historical standards (Figures 7.9 and 7.10). Just as exceptional is the fact that Greece broadly achieved the planned fiscal adjustment in the face of worse-than-expected economic conditions. Its overall public deficit came down from above 15 percent of GDP in 2009 to around 3 percent at the end of 2013. While part of this improvement can be explained by the large drop in interest payments that resulted from improvements to the terms of lending by the EFSF/ESM and from the private debt restructuring agreement

Figure 7.10. Greece: Planned and Actual Fiscal Adjustment in International Perspective



Source: IMF, *WEO*.
[1] For rest of market access countries, projections refer to the spring *WEO* vintage in each year.



Sources: IMF, *WEO* and MONA database.
[1] Selected IMF programs denote the same sample of IMF programs featuring in Figure 7.1.
[2] *t* indicates the year of the program request.

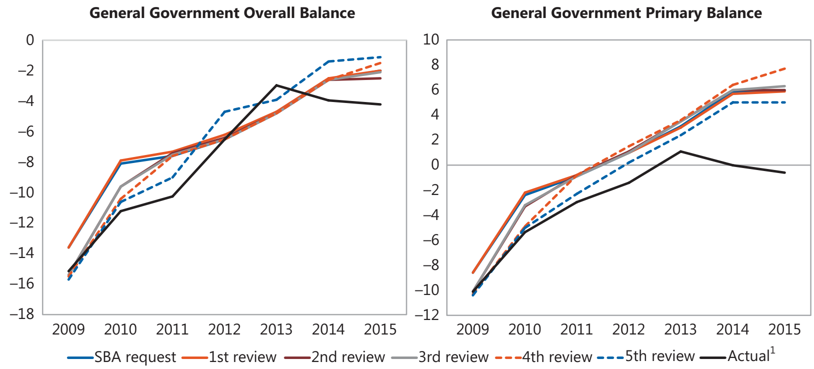
of February 2012, the actual improvement in the primary balance was also remarkable.

The improvement in the primary balance turned out to be almost as strong as initially envisaged, despite the dramatic deterioration that took place in growth vis-à-vis expectations and despite the starting point being worse than it was thought to be when the 2010 Stability Program was drawn up (Figure 7.11).[20] Even though the revenue base clearly shrank much more

[20] In April 2010, the estimated fiscal deficit for 2009 was revised to 13½ percent of GDP from the 12½ percent of GDP estimate that prevailed when the 2010 Stability Program was

Figure 7.11. Greece: Headline and Primary Fiscal Balance, Projections over the Stand-By Arrangement

(*In percent of GDP*)



Sources: IMF Country Reports and IMF, *WEO*.
[1] Refers to IMF, *WEO* (Spring 2016).

significantly than originally foreseen, the change in the primary deficit during 2010–11 was 8 percentage points of GDP—slightly above target despite the deep recession and revised-down budget numbers for 2009. However, starting from the second review it became clear that the ambitious primary balance cash targets were being met by running arrears and by unsustainable postponement of social security and defense spending. As a result, a tightening of conditionality was required and a new performance criterion for arrears introduced. To support this additional performance criterion, more ambitious structural benchmarks on commitment controls were also introduced (see the section "Structural Conditionality" below).

The automatic stabilizers were not allowed to operate and adjustments to the fiscal targets were not made until end-2011. When GDP contracted more than originally anticipated, the nominal deficit ceiling was routinely tightened in order to achieve the original targets (which were set in relation to GDP) and maintain the official financing envelope (Kopits, 2017). This tightening was tantamount to disallowing the operation of automatic stabilizers, thus aggravating the pro-cyclicality of the fiscal policy, which exacerbated the contraction. An explicit relaxation of the fiscal targets against a background of worse-than-expected economic conditions was made only at the time of the fifth review of the program, in December 2011. Once again, while an earlier adjustment of the targets could have been beneficial by tempering

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formulated. The estimated 2009 fiscal deficit was revised again in December 2010, from 13½ percent to 15½ percent of GDP.

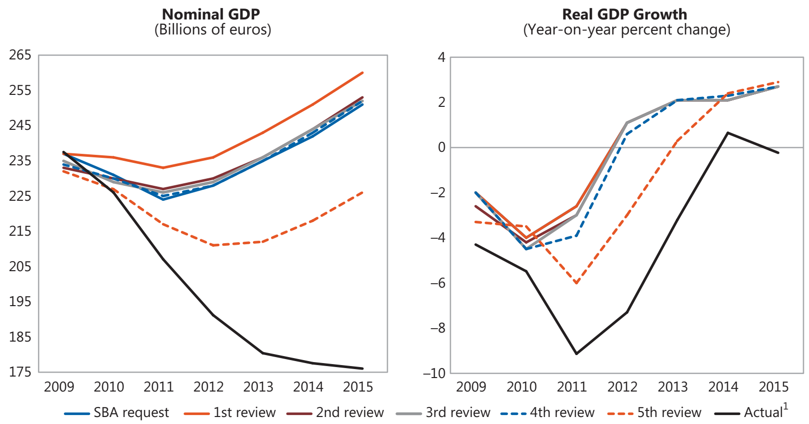
the contraction, the program would have ultimately required additional financing—a politically unpalatable option.

The drop in revenues thus had to be offset by further cuts in public spending.[21] About half of the adjustment in the primary deficit reflected lower spending. The expenditure measures focused on reducing public sector wages and social benefits, but with safeguards intended to protect the most vulnerable. Measures that were implemented in 2010–11 included cuts in public sector salaries, bonuses, and allowances, and steps to reduce health care spending on drugs. Other measures included cuts in capital spending and a reorganization of subnational governments (*kalikrates*). Revenue measures, including increases in VAT rates, had already been taken in May 2010 under the 2010 Stability Program. Additional tax policy measures that were implemented during the SBA-supported program comprised increases in indirect tax rates, including further VAT rate hikes; a new property tax; and somewhat higher income taxes. Efforts were also made to strengthen tax administration and raise tax collection rates.

Growth Forecasts and Fiscal Multipliers

Greece's economic slowdown proved much more severe than the program had anticipated (Figure 7.12). Data revisions complicate the comparison,

Figure 7.12. Greece: Nominal GDP and Real Growth, Projections over the SBA



Sources: IMF Country Reports and IMF, *WEO*.
[1] Refers to IMF, *WEO* (Spring 2016).

[21] The authorities introduced additional measures in 2011 (Medium-Term Fiscal Strategy, amounting to 10½ percent of GDP during 2011–14) once it became clear that the initial set of fiscal measures was insufficient to deliver the consolidation target.

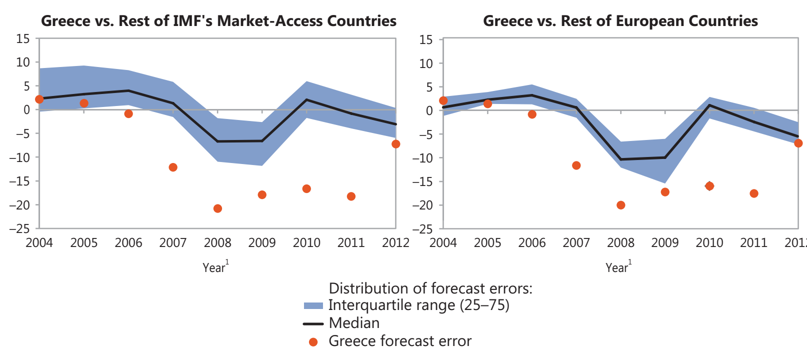
but real GDP in 2012 was 17 percent lower than in 2009, compared to the 5½ percent decline that was projected in the SBA-supported program. Over the same period, nominal GDP was almost one-fifth lower, compared to the 2 percent decline initially forecasted. The original growth projections were largely maintained until the fifth review (December 2011) but were then marked down, with the expected recovery delayed until 2014. Projections for unemployment were raised in line with the severity of the contraction. The unemployment rate in 2012 was 25 percent, compared to the original program projection of 15 percent.

It is not unusual for IMF programs to disappoint in comparison to initial forecasts, but orders of magnitude are usually much smaller than those in the SBA for Greece. On the basis of an assessment of 159 programs, an earlier IEO evaluation found that growth disappointed in about 60 percent of programs, and that over a two-year period the average output shortfall was 1.5 percent, and was 6.4 percent in cases of capital account crises (IEO, 2003). An output shortfall as large as Greece's is thus exceptional even by IMF program standards. Also, in comparison with IMF forecasts made for other market access countries over the same crisis years (2010–12), the magnitude of Greece's growth forecast errors looks extraordinary (Figure 7.13).

The reasons behind these exceptional forecast errors were manifold. A first important reason why the Greek economy contracted more than expected was that the program over-relied on the confidence effects, restoration of market access, and improvements in the investment climate that its designers hoped would result from program implementation and completed structural reforms. In the event, confidence was badly affected by domestic social and political turmoil as well as by European policymakers' talks of a Greek exit from the euro (Meghir and others, 2016). Some of the adverse political developments were endogenous and followed from limited ownership of the program (see the section "Limited Ownership" below). The result was a sharp fall in private

Figure 7.13. Greece: Growth Forecast Errors in International Perspective

(Three-year cumulated growth forecast error (actual projection, in percent))



Source: IMF, *WEO*.

[1] For comparator countries, projections refer to the Spring *WEO* vintage of each year.

investment, as noted below (see the section "Weakening Program Performance" below). This outcome was in stark contrast to what was optimistically assumed in the program, where positive confidence effects were expected to lead to higher private sector growth, ultimately offsetting the contractionary effects of the fiscal retrenchment. To be sure, even if structural reforms had been transformative, a quick supply response was unlikely (IMF, 2015c).

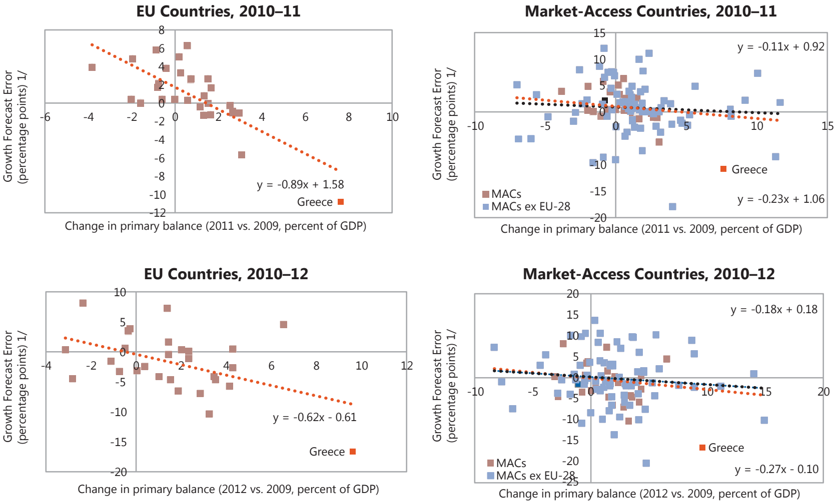
Second, the assumed fiscal multipliers were too low, implying a fiscal consolidation less costly than it actually turned out to be. The program initially assumed a multiplier of only 0.5 despite the staff's recognition that Greece's relatively closed economy and lack of an exchange rate tool would magnify the fiscal shock. Recent iterations of the Greek program have assumed a multiplier twice this size. Blanchard and Leigh (2013) admit that the IMF generally underestimated the contractionary impact of the fiscal stabilizations under its watch over the period 2010–12, particularly in the case of European countries.[22] They show that multipliers tend to be higher when households are short of liquidity and when monetary policy cannot provide an offset—influences that appear not to have been fully appreciated when the SBA-supported program for Greece was designed. Arguably, the contractionary impact of the simultaneous deficit stabilization programs that were conducted as part of the EC's efforts to implement the Stability and Growth Pact might have been also underestimated (Figure 7.14).

A third reason for the larger-than-expected contraction was that the peculiarities of the Greek export structure were not well taken into account when judging the program's ability to foster external adjustment. As noted by Gros and Alcidi (2010), the Greek economy is a rare case of a small closed economy: only a small part of Greek exports could be expected to depend on competitiveness; a more substantial part (food, commodities, and maritime services) could not be expected to respond to lower unit labor costs. Awareness of the peculiar structure of exports should have lowered the expectation of the potential contribution that exports could make to growth.

Finally, the size of potential GDP may have been overestimated. That is to say, actual growth before the crisis may have significantly outpaced potential growth as conventionally estimated. Part of the contraction after 2009 could be thus seen as a return to a potential growth path which was significantly lower than assumed in the program. If so, this implies that the fiscal policy (and export) multiplier may not have been as underestimated as it may appear. Regardless, it remains legitimate to ask why the IMF was so optimistic about the underlying growth potential of the economy and waited so long before revising downward its growth forecasts and adjusting the fiscal targets accordingly.

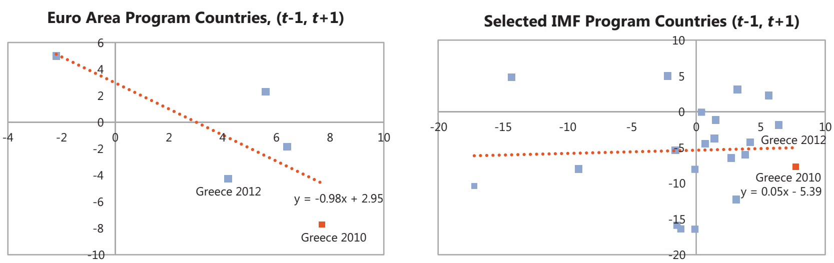
[22] For previous studies and commentaries identifying larger multipliers, see for example Fatas and Mihov (2001); Blanchard and Perotti (2002); Auerbach and Gorodnichenko (2010); Corsetti (2010); Ilzetzki, Mendoza, and Vegh (2013).

Figure 7.14. Growth Forecast Errors and Fiscal Consolidation Plans: International Comparison



Source: IMF, *WEO*.

[1] Vertical axis displays forecast error for real GDP growth in year 2010 and 2011 made in April 2010 *WEO* (top panel) and corresponding forecast error in year 2010, 2011 and 2012 made in spring 2010 *WEO* (bottom panel). Horizontal axis displays forecast of change in primary balance to GDP ratio between 2011 and 2009 made in April *WEO* 2010 (top panel) and forecast of change in primary balance to GDP ratio between 2012 and 2009 made in April 2010 (bottom panel).



Note: *t* denotes year of program request.
Source: IMF, MONA database.

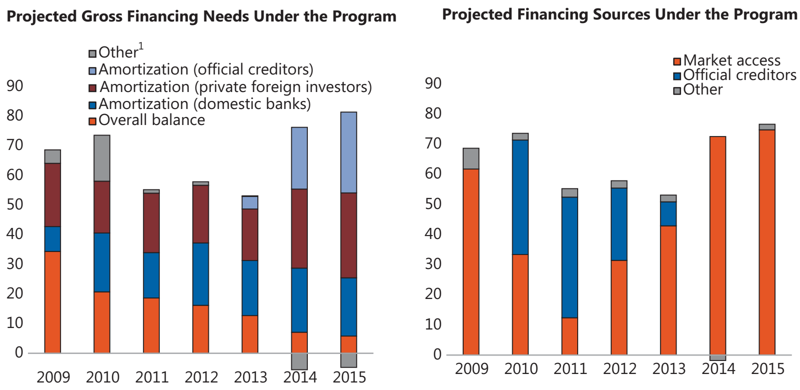
[1] Vertical axis displays forecast error for real GDP growth in year *t* and *t*+1. Horizontal axis displays forecast of change in primary balance to GDP ratio in year *t* and *t*+1.

Other Program Financing Assumptions

The financing strategy assumed that Greece would have regained market access from 2012. However, markets were concerned about the problem of large repayment obligations in 2014 and 2015 after the program expired (Figure 7.15). In addition, the prospects of an eventual private sector involvement (PSI)—and thereby of a migration of private debt into official

Figure 7.15. Greece: Projected Gross Financing Needs and Sources Under the Stand-By Arrangement

(*In billions of euros*)



Source: IMF Country Report No. 10/110.
[1] Includes bank assistance and stock-flow adjustments.

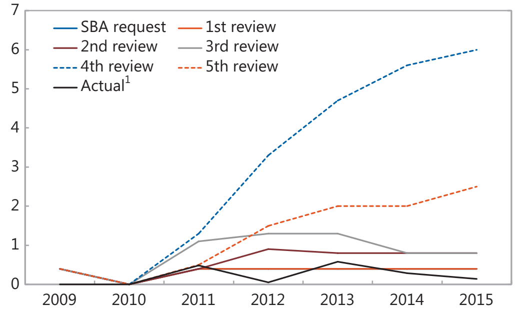
hands—might have deterred private lenders, given the seniority of official lenders. Subsequent research also suggests that the implicit assumptions about market access—assessed in terms of rollover rates—were overly sanguine compared to past experience in emerging markets facing exogenous shocks (see IMF, 2015c).

The three-year financing period of the SBA seemed relatively short. Given that the Greek program had so large a structural component, the question arises as to whether the Extended Fund Facility (EFF) should not have been utilized from the outset. Beyond the initial reservations of the Executive Board about using a facility that was originally intended for low-income countries for exceptional access by an advanced economy, there was the more crucial issue of whether the European partners were prepared to provide longer-term financing comparable to EFF terms (as the IMF would not want to be the last creditor standing). Tellingly, the conversion of the SBA into an Extended Arrangement that took place in 2012 was internally considered as early as a few months into the program, but the discussion was deferred pending consensus with the euro partners on a similar lengthening of their lending terms and agreement on PSI.

Despite the limited progress made in implementing the government's privatization plans, the fourth program review (July 2011) made highly optimistic assumptions about the privatization receipts compared to the original SBA request: the estimate was raised from €12.5 billion to €50 billion over the period 2010–15 (Figure 7.16). The optimism about privatization revenues signaled a virtual admission that the program was underfinanced, at a time when worse-than-expected economic conditions caused the underlying

Figure 7.16. Greece: Privatization Receipts, Projections over the Stand-By Arrangement

(*In percent of GDP*)



Sources: IMF Country Reports and IMF, *World Economic Outlook*.
[1] Refers to IMF, *WEO* (Spring 2016).

debt dynamics to start overshooting program projections by a large margin (Pisani-Ferry, Sapir, and Wolff, 2013; IMF, 2013c). The assumptions about privatization receipts were subsequently reversed and marked down substantially in the fifth review, in December 2011, once a deal over private sector involvement had been reached and more favorable official financing terms had been agreed with the European partners.

Structural Conditionality

Structural conditionality in the Greek SBA extended to three areas: (i) fiscal reforms; (ii) financial sector reforms; and (iii) competitiveness reforms. The detailed list of structural benchmarks (SBs) and prior actions (PAs) is summarized in Annex 7.3. For each measure, the annex also reports the date on which the structural benchmark or prior action was set, the corresponding target date, and the final status (e.g., "met," "not met," "partially met").

Fiscal reforms

The program focused heavily on structural fiscal reforms. These included: pension reform; tax administration reform; overhaul of the public financial management and the fiscal framework; reform of the debt management framework; strengthening of public sector reporting mechanisms, including statistical aspects. Supported by extensive IMF technical assistance, these reforms were meant to boost fiscal sustainability by helping strengthen control over revenues and expenditures.

Strengthening fiscal institutions was inevitably a complex and time-consuming task. Greece entered the crisis with a dysfunctional revenue administration, as repeatedly acknowledged by earlier IMF Article IV consultations and technical assistance reports. Problems plagued all stages of the collection process. The VAT gap and the size of the informal economy as a proportion of the total economy were the highest in the EU, while the collection of tax debt and verifications of tax payers were among the lowest in the OECD. In 2010, the Greek authorities started to implement a medium-term plan for revenue administration, but long delays prevented the launch of basic operational functions such as collection enforcement. Greece also had a very weak public financial management system, as reflected in domestic arrears that amounted to 2½ percent of GDP at end-2009. Problems marred all stages of the spending process, including budgeting, spending control, and reporting. To address these, the SBA program supported a new budget framework law, enhanced spending control, and fiscal reporting mechanisms. By the end of the SBA, commitment-based controls had started to become operational, but arrears and lack of detailed data for general government entities remained an issue.

Financial sector reforms

The establishment of a Financial Stability Fund (FSF) was intended to cope with solvency pressures in Greece's financial sector. As the banking system was expected to undergo a period of disinflation—with likely negative repercussions on profits and balance sheets—the program envisaged the creation of a fully independent FSF that the government would fund out of the resources made available under the program (a structural benchmark for end-June 2010). FSF funding initially amounted to €10 billion, to accommodate expected losses under a stress-test scenario. The FSF was expected to have governance arrangements in place to ensure the safeguarding of international financial resources. To mitigate potential liquidity pressures, the government's support facilities for banking liquidity were extended. The ECB's suspension of the application of the minimum credit rating threshold in the collateral eligibility requirements on debt instruments issued by the Greek government was also intended to serve as a useful liquidity backstop.

The FSF was designed to provide capital support to the banks through the purchase of preference shares. To help limit the FSF's participation in the shareholder base of the banks, the preference shares were convertible into ordinary shares, with the benefit of strengthening the banks' core capital base. By providing investors with a stronger equity base, the FSF was expected to facilitate banks' re-access to capital markets and thus to limit their recourse to Eurosystem facilities. Should banks have been unable to expeditiously raise additional capital on their own and repay the FSF, a restructuring process was expected to take place, in line with EU requirements on competition and state aid. The authorities were also expected to maintain close coordination with home and host country authorities within the EU framework of cross-border banking supervision.

As the recession intensified and liquidity tightened, the Greek financial sector became increasingly vulnerable. Financial sector distress was a result of the protracted recession combined with sovereign debt problems. By 2011, deleveraging in the financial sector and restructuring of state-owned banks were perceived to be necessary. ATE, the largest state-owned bank and the only Greek bank to fail the Europe-wide stress tests in mid-2010, had to be recapitalized. Sizable deposit outflows began in mid-2011, fanned by fears of a Greek euro exit.

The banks' capital needs dwarfed the FSF provision. As of the fourth review of the SBA-supported program, the purpose of the FSF changed: from topping up the capital of banks that had failed to raise private capital, to providing a substantial injection of public funds for banks that had been severely affected by the deep recession and prospects of PSI. In the context of the EFF-supported program, the amount needed for the FSF was estimated at €50 billion, up from the initial €10 billion estimated at the time of the SBA request. One reason for this large increase was that a sizable proportion of the government debt instruments that were disposed of by foreign banks and investors had ended up on the balance sheets of Greek banks. This migration of debt was the predictable consequence of the two-year delay in PSI, and served to wipe off the whole core capital of the banks (see the section "Bail Ins and Bail Outs" below).

Competitiveness reforms

The structural policies supported by the SBA were intended to boost competitiveness by enhancing the flexibility and the productive capacity of the economy. Lacking an external devaluation option, the program sought to ensure that wage and price developments would restore and then sustain international competitiveness, and progressively alter the structure of the economy towards a more investment- and export-led growth model. To this aim, the program envisaged a comprehensive structural reform agenda aimed at reducing rigidities in the labor market, liberalizing services, and improving the business environment.

Competitiveness-related structural conditions became more numerous as the review process progressed. The SBA request contained only one structural benchmark (SB) related to competitiveness: the preparation of a privatization plan. The second review set an SB on reforming the collective bargaining system and the third review set one on repealing closed professions. The fourth and fifth reviews contained numerous competiveness-related structural conditions. In this context, the Greek government was expected to work closely with the European Commission and the ECB to pursue reforms as specified in the memorandum of understanding attached to the IMF's Memorandum of Economic and Financial Policies, particularly in the following areas: modernizing public administration; strengthening labor markets and income policies; improving the business environment and bolstering competitive markets; managing and divesting state enterprises; and improving the absorption of EU structural and cohesion funds.

After a good start, the bold structural reform program fell into uneven implementation. Despite good initial steps such as labor market reforms that addressed high entry/exit costs, implementation weakened due to capacity constraints, lack of a management structure overseeing the reform process, and resistance from vested interests.

In spite of strong commitments to privatization plans, outcomes were disappointing. In mid-2011, Greece launched a very ambitious privatization program to help support growth and debt reduction, with parliamentary approval of a privatization and real estate development strategy. The preparation of the assets, however, revealed that they were often encumbered by multiple problems that would take time to resolve, including unclear titles and ownership, debts, complicated contractual obligations, state-aid issues, and resistance by incumbents or related parties to bring the assets to market or restructure them. In addition, the recession generally reduced the value of all Greek assets, eroding sale proceeds. The IMF should have accounted appropriately for these risks, by reflecting them in more conservative projections about the expected timing and receipts from asset disposal.

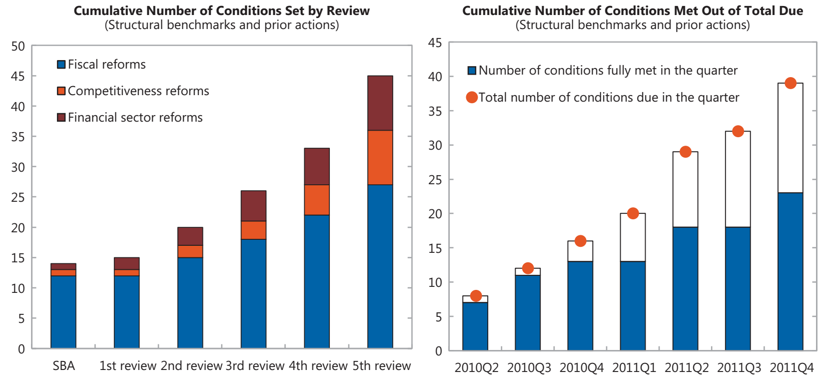
Program Follow-Up

Limited Ownership

According to program reviews, inadequate program implementation was a problem throughout 2011 and even until the fall of 2012. In fact, some measures that were adopted by the Parliament were not implemented by the administration, because the government was either unable or unwilling to act. As a result, structural conditionality eventually became much more detailed and less parsimonious, with further negative implications for the ownership of the program (Figure 7.17).

Little progress was made with politically difficult measures such as privatization, product and labor market reforms. As explicitly acknowledged by the staff in internal documents, the IMF recognized that vested interests had fiercely opposed structural reforms in Greece in the past, but at the beginning of the program it drew comfort from a number of factors: (i) the program was backed at the highest political levels in Greece and Europe; (ii) the most difficult actions had been taken as prior actions; and (iii) IMF technical assistance would support Greece's adjustment efforts. As it turned out, none of these factors proved compelling and the ownership of the program in Greece fell short of what was initially assumed.

Figure 7.17. Greece: Structural Conditionality Under the Stand-By Arrangement



Source: IMF Country Reports.

The IMF had concerns that implementation capacity might be weak based on its history of providing fiscal technical assistance to Greece. However, the extent to which administrative capacity was lacking in the public sector seems to have come as a surprise. In hindsight, it is debatable whether the program ever met the Fund's fourth criterion for exceptional access (i.e., a reasonably strong prospect of the program's success, taking into account institutional and political capacity to deliver adjustment).

As noted, structural conditionality became detailed as the program progressed. The IMF in general has, in recent years, moved toward focus on macro-critical structural reforms in programs and become more parsimonious in setting conditionality. Bucking these trends, the number of structural conditions set under the SBA-supported program for Greece was relatively large, and grew larger as the program progressed. By the fifth review, one of the fiscal structural prior actions had nine sub-prior actions. This proliferation of conditions partly reflected the IMF's recognition of the weaknesses in administrative capacity. The Fund's unprecedented TA programs in Greece, especially on revenue administration, may have gone beyond providing technical advice and taken on an institution-building dimension (Annex 7.4). The detailed conditionality was considered macro-critical and essential given the dire need to strengthen Greek fiscal institutions.

The burden of adjustment was not sufficiently spread across different strata of the society. Reform efforts in Greece under the program might have been more enduring had more visible progress been made in getting people on high incomes to pay their taxes. The risks to public support for the program from not reducing tax evasion were continually flagged by the Fund, but the lack of political will to make clear progress with improving tax compliance was a considerable obstacle to the program's success. As evidenced in several internal documents, the program also made an attempt to reflect distributional concerns by shielding people on low incomes from cuts in state pensions and by calling on protected sectors (like closed professions and product markets) to play their role.

Weakening Program Performance

In October 2010, the debt crisis in Europe reached a watershed at the Summit in Deauville, where a permanent European crisis-resolution mechanism "comprising the necessary arrangements for an adequate participation of the private sector" was called for. Although the Deauville statement referred not to the handling of the ongoing European crisis but to a European crisis-resolution framework that was intended to replace the EFSF in 2013, the statement was widely interpreted as an official signal that sovereign debt restructuring would henceforth be acceptable in European Union countries. The result was a sharp widening of the bond spreads of peripheral European countries. In this setting, Greece's prospects of a quick return to international capital markets by early 2012—as envisaged in the May 2010 SBA program—looked increasingly unlikely.

The program remained roughly on track until the third review in March 2011. Then a sharp deterioration took place between spring 2011 and spring 2012. Instead of stabilizing, as had been expected in March 2011, the decline in domestic demand accelerated sharply in 2011 and continued in 2012. In 2011, fixed investment declined by close to 20 percent. The tumbling in domestic demand was not offset by an expansion in foreign trade. The astounding collapse in demand largely mirrored the extreme uncertainty surrounding the prospects of the Greek economy as exit fear spiked.

In spite of growing evidence of their lack of realism, the underlying assumptions of the program were left largely unrevised until the fifth review in December 2011. Thanks only to more favorable official financing terms (through the EFSF as agreed at the July 21, 2011 Summit) and to the PSI deal reached at the October 26, 2011 Summit, it became possible to recalibrate the whole macro-framework on the basis of more realistic assumptions, without conceding that the debt was no longer sustainable. Thus in the fifth review, the debt sustainability analysis was cast with more conservative assumptions. At the same time, the projections for privatization receipts were dramatically lowered, possibly reflecting the fact that these receipts had become less important for debt sustainability once PSI was in prospect—and that equity prices had, by that stage, come down sharply. After three months, in March 2012, the SBA was converted into an Extended Arrangement.

Overall, the need to reach agreement with other creditors on macro-critical issues in order to receive their financing assurances limited flexibility. The Fund's scope to modify key macroeconomic assumptions and targets, flag concerns about the financing assurances, and adhere to the parsimony principle on structural reforms during the first four program reviews was very limited, and significantly smaller than what had normally been the case in exceptional access programs. Program reviews are typically the vehicle to recalibrate IMF's program assumptions and targets incorporating all the information available since the approval of the program. And they are particularly useful, and widely used, in exceptional access arrangements. However, the need to reach agreement with other troika partners on macro-critical issues in order to receive their financing assurances virtually eliminated this option, as any change had to be mutually agreed by all the institutions.

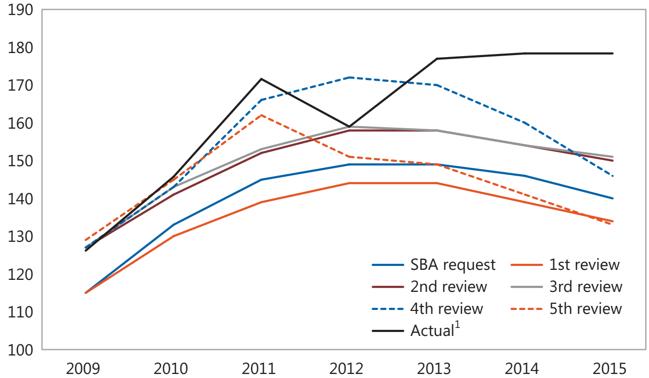
Debt Dynamics

While for the first year or so the IMF staff concluded that the Greek debt was sustainable, "on balance," the IMF gave up such a view by October 2011. Then, the Fund's DSA noted a more severe drop in output than expected, a slower expected recovery, continued exclusion from capital markets, and lower privatization proceeds. Under the revised macro-policy assumptions—but without accounting for the PSI—Greece's public debt could not be considered sustainable any longer, failing to decline or stabilizing at very high levels for even small deviations from the macro and program targets.

Despite the steep consolidation carried out, debt-to-GDP levels expanded much more significantly than forecast in the debt sustainability analysis (Figure 7.18). The most important factor explaining the more unfavorable debt dynamics was the effect of lower GDP. The worse-than-expected growth

Figure 7.18. Greece: Gross Public Sector Debt, Projections over the Stand-By Arrangement

(*In percent of GDP*)



Sources: IMF Country Reports and IMF, *WEO*.
[1] Refers to IMF, *WEO*, Spring 2016.

outlook did not just make deficit reduction harder, but it also made it impossible to translate this successful reduction into lower debt-to-GDP ratios. Contingent liabilities associated with banking recapitalization also increased as the recession deepened, as noted earlier.[23]

In the fifth review, the IMF explicitly admitted that "experience to date under the program suggests that Greece may not be able to set a new precedent by realizing at the same time and from very weak initial conditions a large internal devaluation, fiscal adjustment and privatization program." A fundamental problem of the program was the inconsistency between attempting to regain price competitiveness and simultaneously trying to reduce the debt-to-nominal GDP ratio. If the assessment that Greece needed a price-competitiveness adjustment of 20–30 percent was right, debt sustainability had to prove testing; ceteris paribus, a downward adjustment in prices implies a worsening of conditions for debt sustainability. Indeed, despite higher inflation, nominal GDP was significantly short of the rebound that was expected at the outset of the program. By the end of the program, it was more than 25 percent lower than the expected level (as shown earlier in Figure 7.12).

More favorable official financing conditions and debt restructuring only partially offset these adverse debt dynamics. Thus, by the end of the SBA, the reduction in the Greek debt-to-GDP ratio with respect to the initial forecast was quite limited, in spite of the substantial reductions that had taken place in interest payments and gross financing needs.

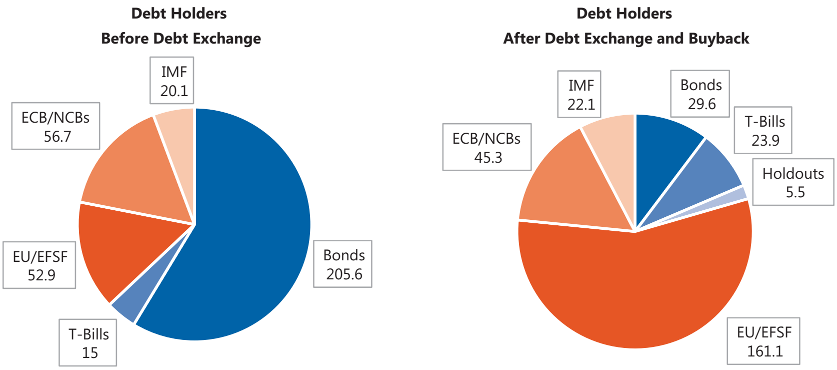
Bail Ins and Bail Outs

The possibility of restructuring private claims on the Greek sovereign—initially rejected as an option—was eventually reconsidered in the fall of 2011. By then, the deepening recession in Greece and the difficulties of the EU and IMF in agreeing on a credible package of structural reforms with the Greek government had lowered expectations of the growth path that Greece might realistically achieve and had exacerbated worries about the country's debt-servicing capacity. This view was corroborated by a new debt sustainability analysis that the IMF prepared for the October 26, 2011 Euro Summit. That analysis concluded that Greece's debt was no longer sustainable except "with much stronger PSI." This recognition set the stage for a new round of PSI negotiations, which finally resulted in a major debt exchange in spring 2012.

By late April 2012, Greece had successfully completed the exchange of approximately €200 billion in debt held by the private sector for 10- to 30-year exchange bonds, with a face value of 31.5 percent of the original bonds and paying 2 to 4.3 percent interest plus an up-front payment of 15 percent of their original face value over two years (Zettelmeyer, Trebesch, and Gulati, 2013). This achieved a €107 billion direct reduction in gross debt

[23] An additional important factor was the higher-than-expected initial debt level, which was in fact corrected after the start of the program by more than 14 percent of GDP.

Figure 7.19. Greece: Restructuring of Sovereign Debt, 2012



Note: The figure shows Greek government and government-guaranteed debt owed to private creditors (blue) and official creditors (orange) in billions of euros. "ECB/NCBs" debt refers to ECB SMP holdings as well as holdings by national central banks in the euro area. "EU/EFSF" loans include the GLF loans as well as the EFSF loans. "T-bills" are privately held short-term debt instruments. "Bonds" include also guaranteed debt issued by banks.
Source: Zettelmeyer, Trebesch, and Gulati (2013).

(€200 billion less €137 billion forgiven, plus a €30 billion up-front "sweetener"), representing a 53.5 percent cut in the nominal value of Greek debt held by private investors and exchanged (and 51.9 percent of the total eligible privately held debt) (Figure 7.19).

However, the €200 billion in debt exchanged accounted for only 56.2 percent of Greece's total debt at end-2011. Almost all of the rest was exempt—including, importantly, about €21 billion held by the IMF; €53 billion held by euro area governments in the Greek Loan Facility; and €57 billion held by the ECB from its Securities Markets Program purchases as well as by national central banks. In addition, losses by Greek banks on their holdings as a result of the debt exchange required recapitalization, necessitating new official borrowing to cover these needs (IMF, 2013b).[24]

The net debt reduction was thus €85 billion—or 23.9 percent of Greece's total public debt at end-2011—and as such it was insufficient to reestablish solvency decisively. Nonetheless, it had dramatically affected Greece's creditor structure. In less than a year, the structure of Greek government debt had been turned upside down, with privately held debt (bonds and T-bills) now accounting for only about 20 percent of the total. Most strikingly, privately-held sovereign bonds had been virtually eliminated. In mid-February 2012, banks and other investors still held almost €206 billion of Greek bonds. But after the April exchange and the subsequent buyback this figure had shrunk to a mere €35 billion (€29.5 billion in the form of new bonds and €5.5 billion of old Greek

[24] The banks' recapitalization needs following the 2012 debt restructuring amounted to €40.5 billion. The bulk of it—€37.7 billion—were direct losses from the PSI on banks holding of the restructured debt.

government bonds held by holdouts). At the same time, holdings of official loans by other euro area governments increased from €58 billion in early 2012 to more than €160 billion in late 2012, with a further €35 billion committed for 2013. In this respect, the 2012 Greek PSI can be labeled as the most dramatic credit migration from private into official hands in the history of sovereign debt.

Was the restructuring successful? On the one hand, the exchange succeeded in meeting the conditions imposed by the troika—that is, reaching the ambitious nominal debt-reduction target set in October 2011, excluding the holdings of the ECB, and avoiding financial collapse in Greece and beyond. On the other hand, its timing, execution, and design delivered too little from the perspective of Greece, created a large risk for European taxpayers, and set precedents that are likely to make future debt restructuring in Europe more difficult. The experience clearly calls for a more systematic approach to future debt restructuring.

Conclusion and Lessons

The need to innovate often arises in an emergency and nimbleness is an essential element of effective crisis management. While the IMF must thus retain flexibility to respond to a crisis, management and staff must ensure that any crisis response should be grounded in in-depth analyses and follow a transparent decision-making process. To be sure, responding to a crisis in the euro area posed new challenges to the IMF. Even so, the prospect of financing a potentially very large program in an advanced, financially developed and financially open economy should not have come as a surprise. Neither should the prospect of working with a regional partner have been unthinkable, given the proliferation of regional financing arrangements in various parts of the world. As it turned out, however, both the revision of the exceptional access framework to account for the risk posed by "systemic spillovers" and the modality of engagement with euro area institutions were decided with little preparation and inadequate analysis:

(a) The decision-making process that ultimately led to the revision of the exceptional access policy clearly lacked transparency. The need for a policy change was not disclosed to the Board until the staff report had been circulated. The policy change was embedded in the report requesting the Greek SBA and, therefore, was to be implicitly approved along with the formal and explicit request for Fund resources. Neither management nor staff drew the attention of the Board to the proposed decision itself or to the fact that the exceptional access criteria would effectively be modified by approving the SBA. A transparent and informed internal decision-making process, though it may not have led to a different outcome, certainly would have enhanced the legitimacy of the decision itself and weakened the perception that the IMF yielded to political pressures.

(b) Before 2013, the Fund never seriously considered how best to engage a regional partner in joint conditional lending operations (IMF, 2013a). An ad hoc collaboration approach—such as the one adopted for Greece—risks reducing the predictability of financial assistance and delaying assistance when it is needed. Discrepancies across institutions can lead to situations where one institution may be in a position to lend when the other is not, especially when their objectives differ. At the same time, too much flexibility on the part of the IMF may give rise to a perception of lack of evenhandedness and differentiated treatment among its members. In this perspective, a set of mutually agreed cooperation principles with regional financing arrangements should be established, ensuring a consistent approach to coordinating conditional lending between such arrangements and the Fund (Kincaid, 2017).

Departures of outcomes from predictions are often unavoidable in crisis situations. Program design must factor in uncertainty regarding both data and economic knowledge, including models used for forecasts and policy analysis. In the case of Greece, departures of outcomes from baseline predictions were unusually large. Irrespective of any particular methodological approach used by the Fund, it must always be borne in mind that mean forecasts are necessarily subject to considerable uncertainty. This is particularly the case in a crisis situation, where unexpected external developments are bound to happen and where the economic and social costs associated with worse-than-expected outcomes can be potentially large. In this context, staff should be encouraged to produce policy analyses based on a range of alternative assumptions or "fan charts" of the kind used by major central banks. Policy decisions, in turn, should weigh the worst case scenario in line with the Fund's risk aversion and set aside contingency plans if risks materialize.[25] This could help bolster the robustness of the Fund's decision-making process to adverse shocks and dispel the suspicion of politically-motivated optimism.

Burden-sharing (domestic, regional, and global) must be an integral part of program design and crisis resolution. This will help ensure broad political support for needed adjustment measures and—in the end—a greater chance of their success. In Greece, inadequate concern about domestic burden-sharing undermined efforts at improving tax compliance and led to limited efforts at liberalizing the product markets. At the global level, considerations of burden sharing and moral hazard would have weighed the obligation of borrowers to service debt and the recognition that lenders should be penalized for unwise decisions. If preventing international contagion was an essential concern, as argued at the time, the cost of its prevention should have been borne—at least in part—by the international community as the prime beneficiary (Mody, 2015; Sandri, 2015). In this context, the Greek experience is a reminder that the global cost of a sovereign debt crisis can be lessened by a well-designed mechanism for sovereign debt resolution (Gelpern, 2015). Such reforms should be part of the IMF's broader and continuous effort to reduce the cost of crisis resolution through a market-based solution (Hagan, 2014).[26]

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[25] There is a wide body of literature on decision-making that develops the theory of avoiding worst-case scenarios (see, for example, Hansen and Sarget, 2007).

[26] On this point, see also the 2014 reform of the Fund's lending framework in the context of sovereign debt vulnerabilities and the 2016 modification of the exceptional access criteria (IMF, 2014b; IMF, 2016a; IMF, 2016b; and Box 7.3).

Annex 7.1. The European Lending Framework: An Overview

Arrangement	Establishment/ Origin	Objectives	Type	Resource Size and Funding Structure	Size Relative to GDP/IMF Quota (2011, Percent)	Lending Instruments/ Conditionality	Fund Engagement	Institutional Frameworks
1. Balance of Payments Assistance Facility	Established in 2002 to provide medium-term financial assistance for non-euro area EU member states in financial difficulties.Originally the medium-term financial assistance set up in 1971 to avert balance of payments crises in the context of European integration.	To achieve orderly exchange rate conditions, encourage applicable member states to adopt economic policy measures likely to prevent the occurrence of an acute balance of payments crisis and to support its efforts towards convergence.	Lending facility financed by market borrowing by the EU.	Maximum lending capacity is €50 billion. Financed through capital markets using the creditworthiness of the EU, and lent under the same conditions under which it was borrowed (back to back loans).	1.5/212.3	Loans and appropriate financing facility. Can be used for precautionary financing. Amount, duration, and other terms are decided by the Council. Program and conditionality are presented in an MOU and loan agreement.	No formal link to Fund-supported program but organized jointly in recent cases; members obliged to consult EU before approaching IMF	Council Regulation No. 332/2002. Decisions are made by qualified majority of the Council acting on a proposal from the Commission made after consulting with the Economic and Financial Committee.

(*Continued*)

Annex 7.1. The European Lending Framework: An Overview *(concluded)*

Arrangement	Establishment/ Origin	Objectives	Type	Resource Size and Funding Structure	Size Relative to GDP/IMF Quota (2011, Percent)	Lending Instruments/ Conditionality	Fund Engagement	Institutional Frameworks
2. European Financial Stabilization Mechanism (EFSM)	Established in 2010, essentially reproducing EU balance of payments assistance facility for all EU member states.	As above, but available to all EU member states.	Lending facility financed by market borrowing by the EU.	Maximum lending capacity is €60 billion. Financed through capital markets using the creditworthiness of the EU.	0.5/69.6	Loans and appropriate financing facility. Can be used for precautionary financing. Amount, duration, and other terms are decided by the Council. Program and conditionality are presented in an MOU and loan agreement.	The EFSM Regulation states that its activation will be in the context of a joint EU/IMF support.	Council Regulation No. 407/2010. Decisions are made by qualified majority of the Council acting on a proposal from the Commission made after consulting with the Economic and Financial Committee.
3. European Financial Stability Facility (EFSF)	Established in May 2010 as a temporary mechanism to support euro area member states until June 2013.	Preserve the financial stability of the Economic and Monetary Union by providing temporary stability support to euro area member states.	Lending and other financing facility financed by market borrowing.	Maximum lending capacity was €440 billion when first set up. Borrowings are backed by guarantees of euro area member states in accordance with their share in paid-up capital of the ECB.	4.7/702.4	(i) Loans to member states in financial difficulties; (ii) intervention in debt primary and secondary markets; (iii) precautionary assistance; (iv) loans to governments for bank recapitalization.	The Framework Agreement envisages that financial support shall be provided in conjunction with the IMF.	Private company set up under Luxembourg law.

Arrangement	Establishment/Origin	Objectives	Type	Resource Size and Funding Structure	Size Relative to GDP/IMF Quota (2011, Percent)	Lending Instruments/Conditionality	Fund Engagement	Institutional Frameworks
4. European Stability Mechanism (ESM)	Inaugurated in October 2012 as a permanent crisis resolution mechanism designed to safeguard financial stability in the euro area.	To provide financial assistance to euro area member states experiencing or threatened by financing difficulties	Loan and other financing facility drawn from pooled member resources (via capital contributions), supplemented by market borrowing.	Maximum lending capacity is €500 billion (combined lending capacity of EFSF/ESM is €700 billion) against capital contribution of €700 billion. €80 billion is paid-in capital, provided in 5 equal installments. In addition, €620 billion callable capital from 17 euro area member states.	5.6/798.1	(i) Loans to member states in financial difficulties; (ii) Intervention in debt primary and secondary markets; (iii) precautionary assistance; (iv) Loans to governments for bank recapitalization.	A euro area member state requesting financial assistance from ESM is expected to address, wherever possible, a similar request to the IMF.	Intergovernmental institution under international law. Board of Governors are the finance ministers of euro area member states. Most important decisions require unanimity. Emergency voting procedure allows approval of financial assistance by a qualified majority of 85% of the votes cast.

Source: IMF (2013a).

Annex 7.2. Greece: Quantitative Performance Criteria, 2010–13

(In billions of euros)

	2010							2011									2012		2013
	Jun		Sep		Dec			Mar		Jun		Jul		Sep		Dec	Mar	Dec	Dec
	Target	Actual	Target	Actual	Target	Adj. Target	Actual	Target	Actual	Target	Actual	Target	Actual	Target	Actual	Target	Target	Target[1]	Target[1]
I. Quantitative performance criteria																			
Floor on the modified general government primary cash balance	–5.0	–3.9	–4.0	–3.5	–5.7	–5.7	–5.5	–2.0	–0.9	–4.3	–4.9	–5.1	–4.9	–5.0	–5.3	–5.1	–0.4	1.3	7.4
Ceiling on state budget primary spending	34.0	28.4	50.0	42.4	67.0	67.0	61.3	14.7	13.4	30.0	28.4	34.7	33.5	44.5	42.0	60.8	13.7	58.7	69.0
Ceiling on the overall stock of central government debt	342.0	316.7	342.0	327.5	342.0	366.0	340.0	394.0	365.9	394.0	364.5	394.0	377.3	394.0	371.1	394.0	408.9	408.9	…
Ceiling on the new guarantees granted by the central government	2.0	0.3	2.0	1.2	2.0	2.0	1.3	1.0	0.1	1.0	0.3	1.0	0.3	1.0	0.6	1.0	0.0	0.0	0.0
Floor on privatization receipts	…	…	…	…	…	…	…	…	…	…	…	0.4	0.4	1.7	0.4	1.7	5.0	11.0	20.0
II. Continuous performance criteria																			
Ceiling on the accumulation of new external payments arrears on external debt contracted or guaranteed by general government	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
III. Indicative targets																			
Ceiling on the accumulation of new domestic arrears by the general government	0.0	1.0	0.0	0.8	0.0	0.0	3.0	0.0	4.3	0.0	4.0	0.0	3.9	0.0	3.8	0.0	0.0	0.0	0.0

Source: IMF Country Reports.
[1] Indicative.

Annex 7.3. Greece: Structural Conditionality

Measures	Date		
Prior actions (PAs) and structural benchmarks	**Set**	**Target**	**Status**
Fiscal sector			
Reduce public wage bill by cutting bonuses/allowances; and pension bonuses (except minimum pensions).	Request	PA	Met
Increase standard VAT rate from 21 to 23 percent and reduced rate from 10 to 11 percent and excise tax rates on alcohol, tobacco, and fuel with a yield of at least €1.25 billion in the remainder of 2010.	Request	PA	Met
Appoint staff team and leader in General Accounting Office responsible for general government in-year cash reporting.	Request	PA	Met
Adopt and start to implement a reorganization of sub-central government with the aim to reduce the number of local administrations and elected/appointed officials (*kalikrates*).	Request	Jun-10	Met
Submit to Parliament amendments to Law 2362/1995 to (i) require the Ministry of Finance to present a three-year fiscal and budget strategy, (ii) introduce topdown budgeting with expenditure ceilings for the State budget and multi-year contingency margins, (iv) require a supplementary budget for any overspending above the contingency, (v) and introduce commitment controls. The amended law should be immediately effective, including in the context of the 2011 budget.	Request	Jun-10	Met
The National Actuarial Authority to produce a report to assess whether the parameters of the new system significantly strengthen long-term actuarial balance.	Request	Jun-10	Met with delay
Adopt a comprehensive pension reform that reduces the projected increase in public spending on pensions over the period 2010-60 to 2½ percent of GDP.	Request	Sep-10	Met
Establish a commitment register in all line ministries and public law entities. Begin publishing monthly data on general government in-year fiscal developments (including arrears).	Request	Sep-10	Met
Publish 2009 financial statements of the ten largest loss-making public enterprises, audited by chartered accountants, on the official website of the Ministry of Finance.	Request	Sep-10	Met
Put in place an effective project management arrangement (including tight MOF oversight and five specialist taskforces) to implement the anti-evasion plan to restore tax discipline through: strengthened collection funds—of the largest debtors; a reorganized large taxpayer unit focused on the compliance of the largest revenue contributors; a strong audit enforcement and recovery of tax arrears—coordinated with the social security program to defeat pervasive evasion by high-wealth individuals and high-income self-employed, including prosecution of the worst offenders; and a strengthened filing and payment control program.	Request	Sep-10	Met

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Measures		Date	
Prior actions (PAs) and structural benchmarks	**Set**	**Target**	**Status**
Publish a detailed report by the ministry of finance in cooperation with the single payment authority on the structure and levels of compensation and the volume and dynamics of employment in the general government.	Request	Dec-10	Met with delay
Adopt new Regulation of Statistical Obligations for the agencies participating in the Greek Statistical System.	Request	Dec-10	Met with delay
Pass legislation to: (i) streamline the administrative tax dispute and judicial appeal processes; (ii) remove impediments to the exercise of core tax administration functions (e.g. centralized filing enforcement and debt collection, indirect audit methods, and tax returns processing); and (iii) introduce a more flexible human resource management system (including the acceleration of procedures for dismissals and of prosecution of cases of breach of duty).	2nd review	Feb-11	Met with delay
Appointment of financial accounting officers in all line ministries and major general government entities (with the responsibility to ensure sound financial controls).	2nd review	Mar-11	Met with delay
Publish the medium-term budget strategy paper, laying out time-bound plans to address: (i) restructuring plans for large and/or lossmaking state enterprises; (ii) the closure of unnecessary public entities; (iii) tax reform; (iv) reforms ot public administration; (v) the public wage bill; and (vi) military spending.	2nd review	Apr-11	Met with delay
Articulate a strategic plan of medium-term revenue administration reforms to fight tax evasion.	3rd review	Jun-11	Met with delay
Publish three consecutive months of consistent arrears and consolidated general government fiscal reports (excluding small local governments).	3rd review	Jun-11	Met with delay
Adopt the necessary changes to enact the plan to reform the general government personnel system.	3rd review	Jun-11	Met with delay
Parliament to approve medium-term budget strategy (MTFS).	4th review	PA	Met
Government to legislate key fiscal-structural reforms in an MTFS Implementation Bill.	4th review	PA	Met
Government to enact legislation in the context of MTFS implementation (phase II) to: (i) introduce pension adjustment bill stipulating freezes through 2015, introducing individual social security numbers, caps, means testing, and rationalizing benefits of pension funds; (ii) introduce single public pay scale bill, temporarily freeze automatic progression, and halve productivity allowance; and (iii) close 40 small public entities, merge 25 more small entities, and close an additional 10 large entities under line ministries and in the social security sector.	4th review	Aug-11	Met with delay
Government to achieve quantitative targets set under its anti-tax evasion plan.	4th review	Dec-11	n.a.
Government to complete key actions to implement the various measures approved in the context of the first MTFS reform bill and anticipated in the second set of reforms bills, including the reform of the public sector wage grid and the closure and/or merger of extra- budgetary funds.	5th review	PA	Met

Measures	**Date**		
Prior actions (PAs) and structural benchmarks	**Set**	**Target**	**Status**
Government to enact spending reductions (including pensions and earmarked spending and advanced removal of the heating fuel subsidy) and revenue measures (including reducing PIT thresholds and reductions) as described in Memorandum of Economic and Financial Policies paragraph 6.	5th review	PA	Met
Parliament to approve a tax reform package, including (i) a simplification of the code of Books and Records, (ii) the elimination of several tax exemptions and preferential regimes under the corporate income tax and the VAT; (iii) simplification of the VAT and property tax rate structures; and (iv) a more uniform treatment of individual capital income.	5th review	Mar-12	n.a.
Government to undertake a thorough review of public expenditure programs to identify 3 percent of GDP in additional measures (including a 1 percent of GDP buffer of potential additional measures).	5th review	Jun-12	n.a.
Government to meet newly introduced and more ambitious targets for audits and debt collection and the resolution of administrative appeals.	5th review	Dec-12	n.a.
Competitiveness reforms			
Prepare a privatization plan for the divestment of state assets and enterprises with the aim to raise at least 1 billion euro a year during the period 2011-2013.	Request	Dec-10	Met
Table legislation to reform the system of collective bargaining, including to eliminate the automatic extension of sectoral agreements to those not represented in negotiations, and guarantee that firm level agreements take precedence over sectoral agreements without undue restrictions.	2nd review	Dec-10	Met
The Council of Ministers to adopt a comprehensive privatization plan through 2015.	3rd review	Jul-11	Met with delay
Parliament to approve privatization and real estate development strategy.	4th review	PA	Met
Government to legislatively establish a Privatization Agency (a private law vehicle into which privatizable assets will be transferred to be sold).	4th review	PA	Met
Government to (i) shift a second group of assets into the privatization fund covering transactions to be completed through end-2012; and (ii) appoint legal, technical, and financial advisors for 14 projects to be completed by end-2012.	5th review	PA	Met
Government to enact legislation to (i) allow worker representatives to negotiate both special and regular firm-level agreements; (ii) suspend the "favorability clause" in wage negotiations until at least 2015; and (iii) suspend until at least the end of 2014 the possibility to extend sectoral agreements to parties not represented in the negotiations.	5th review	PA	Met
Government to screen specific service sector legislation and repeal or modify unnecessary and outdated regulations to ensure full consistency with the new law liberalizing all professions and income-generating economic activities.	5th review	Mar-12	n.a.

(*Continued*)

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Measures		Date	
Prior actions (PAs) and structural benchmarks	**Set**	**Target**	**Status**
Government to enact legislation to (i) reduce the employers' share of social security contributions, including by rationalizing and consolidating small earmarked funds and broadening the base ; and (ii) improve the administration of security contribution collections, including by combining collection functions.	5th review	Jun-12	n.a.
Financial sector			
Establish the independent Hellenic Financial Stability Fund (HFSF) to preserve the financial sector's soundness and thus its capacity to support the Greek economy by providing equity support to banks as needed.	Request	Jun-10	Met
Enactment of €25 billion bond guarantee for bank liquidity.	1st review	PA	Met
Pass legislation to separate the core consignment activity from the commercial activities of the Hellenic Consignment and Loan Fund.	2nd review	Mar-11	Met with delay
Government to put forward for legislative adoption a new tranche of government guarantees for uncovered bank bonds.	3rd review	Mar-11	Met with delay
Commercial banks to submit medium-term funding plans to the ECB and the Bank of Greece.	3rd review	May-11	Met
Parliament to pass legislation revising the HFSF operating framework (to address conditions for recapitalization) and revising the bank resolution framework (in particular, the deposit guarantee scheme, and the early intervention and bank liquidation frameworks).	4th review	Sep-11	Met with delay
Government to enact legislation to address outstanding issues regarding the governance arrangements for financial oversight agencies, including (i) organizational arrangements for the Bank of Greece; (ii) the corporate governance arrangements for the HFSF; and (iii) the governance arrangements for the Hellenic Deposit and Investment Guarantee Fund.	5th review	Dec-11	n.a.
Bank of Greece and HFSF to complete a memorandum of understanding to further strengthen their cooperation (sharing of appropriate supervisory information).	5th review	PA	Met
Bank of Greece to complete bank capital needs assessment.	5th review	Feb-12	n.a.

Annex 7.4. IMF Technical Assistance in Greece, March 2010–March 2012

Department	Purpose	Date
MCM	Banking supervision	March 2010
FAD	Public financial management: initial analysis and priority reforms	April 2010
FAD	Revenue administration: initial analysis and reform priorities	April 2010
STA	Data quality and misreporting (K-1 Report)	April 2010
FAD	General tax policy	May 2010
MCM/FAD/LEG	Financial instruments	May 2010
FAD	Expenditure Policy	June 2010
FAD	Public financial management: follow-up on priority reforms	June 2010
LEG/MCM	Implementation of financial sector components of the SBA program	June 2010
FAD	Tax administration: design of the anti-evasion plan	July 2010
MCM	Implementation of financial sector components of the SBA program	September 2010
FAD	Tax administration: implementation of the anti-evasion plan	September 2010
FAD	Public financial management: implementation status of priority reforms	September 2010
STA	Monitoring of fiscal data for the program	September 2010
FAD	Tax administration: anti-evasion and structural reforms	October 2010
FAD	Health system analysis and proposals	October 2010
STA	Government finance statistics	December 2010
FAD	Tax administration: anti-evasion and structural reforms	February 2011
FAD	Role of accounting officers	February 2011
STA/FAD	Government finance statistics/fiscal reporting	March 2011
FAD	Tax administration: strategic planning	March 2011
FAD	Public financial management: follow-up on implementation of priority reforms	April 2011
FAD/LEG	Tax administration: anti-evasion and structural reforms	April 2011
LEG	Legal framework for privatization	April 2011
MCM/LEG	Review of the Legal and Operational Framework for Bank Resolution	June 2011
FAD	Tax administration: strategic planning and taxpayer audit	June 2011
FAD	Tax administration: tax collection and tax administration reform	July 2011
LEG	AML and anti-tax evasion: strengthening BoG's supervisory process	September 2011
LEG	AML and anti-tax evasion: review of cross-border financial flows	September 2011
FAD	Safeguarding revenue and encouraging growth	September 2011
FAD	Modernizing the General Accounting office	September 2011
FAD	Preparing the 2012 budgets	September 2011
STA	Fiscal Reporting	December 2011
FAD	Expenditure Policy: OECD Review of Social Programs	January 2012
FAD	Tax administration	January 2012
LEG	Reform of central bank governance for banking supervision and resolution	January 2012

(*Continued*)

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Department	Purpose	Date
LEG	AML and anti-tax evasion: strengthening BoG's supervisory process	January 2012
FAD	Public financial management: Accounting Officers and 2013 Budget Preparation	February 2012
FAD	Tax Administration: Collection and analyzing taxpayer compliance data	February 2012
STA	Fiscal Reporting	February 2012
FAD	Expenditure Policy: Spending Review Mission	March 2012
FAD	Tax administration: Follow up	March 2012
FAD	Revenue Administration: Social contribution complaisance	March 2012

Source: IMF Country Reports.

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CHAPTER 8

The IMF's Role in Ireland

DONAL DONOVAN

Introduction

On December 3, 2010 the Irish Government requested a three-year extended arrangement from the IMF in an amount of SDR 19.5 billion (about $30 billion), equivalent to 2,322 percent of Ireland's Fund quota. The loan, agreed within the troika framework established earlier for Greece, was part of a package totaling roughly $75 billion that included support from the European Financial Stabilization Mechanism (EFSM)/European Financial Stability Facility (EFSF) and bilateral partners.

The request by Ireland for emergency financial assistance followed two years of a deepening economic and financial crisis, one of the most severe endured by a post-WWII industrial country. It marked a dramatic reversal of fortune for Ireland. During the so-called "Celtic Tiger" years, from the mid-1990s onward the economy had enjoyed close to the fastest growth rates among OECD countries, an unprecedented boom in living standards, and the attainment of full employment. The budget had generally registered a surplus and the debt to GDP ratio reached an all-time low of 25 percent. This highly impressive macroeconomic record came to be widely admired within and beyond the shores of Ireland.

Beginning around 2002, however, the underlying nature of Ireland's economic performance success began to change significantly. Rather than relying on exports (up to then the main engine of growth), a property boom was reignited, fueled by fiscal incentives, which gradually metamorphosed into a full-scale bubble. The boom involved both residential housing and commercial property acquisition, including abroad (for example, in the London market). It was supported by a massive surge in bank lending for housing and construction which was in turn financed by large-scale recourse to low-cost external borrowing, mainly from the euro area and the United Kingdom. In parallel, soaring property-related revenues allowed the government to lower other taxes and boost spending very sharply (albeit in line with rapid GDP growth), while still maintaining the budget in balance or surplus. However, while Ireland continued to earn plaudits for continued high growth rates and apparent macrofinancial stability, beneath the surface the budget and the banking sector became deeply vulnerable.

Figure 8.1. Ireland: Selected Economic and Financial Indicators, 2000–15

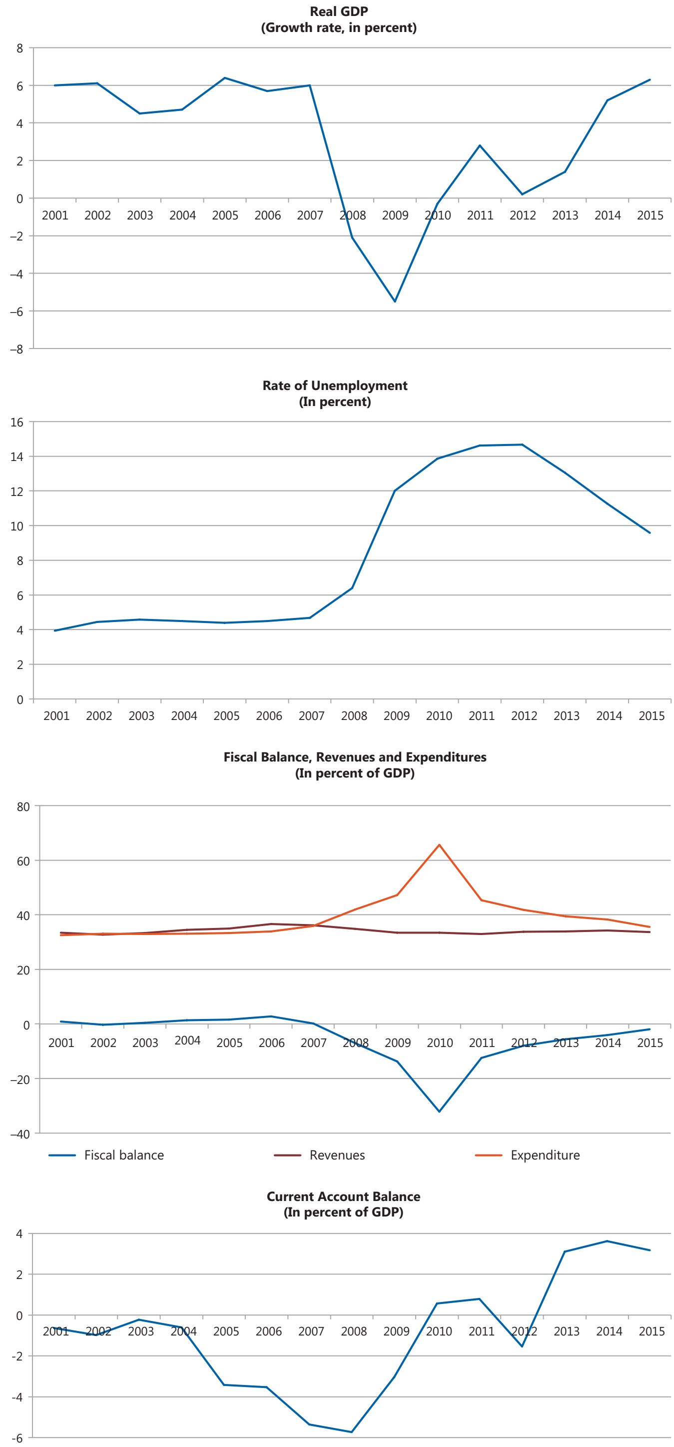
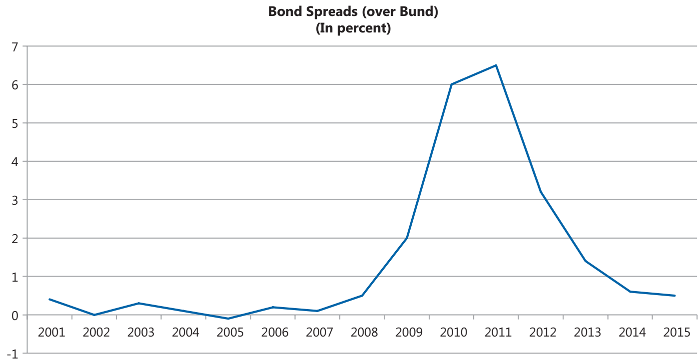


Figure 8.1. (Continued)



Sources: IMF, *WEO* (October 2015) and Ireland—Fourth Post—Program Monitoring Discussions (EBS/15/152).

From 2008 onwards, these vulnerabilities became starkly visible as the property bubble began to burst and financial fragilities worldwide intensified (see Figure 8.1). In the wake of the collapse of Lehman Brothers, in September 2008, faced with severe liquidity pressures, the Irish Government introduced a blanket state guarantee covering nearly all the liabilities of the domestic banks. This action—which proved to be highly controversial—provided only temporary respite. During 2009–10, the extent of the insolvency of the banks began to emerge while property-sector-related revenues collapsed and a severe recession turned the budget balance into a yawning deficit. As 2010 progressed, Irish sovereign bond yields started to soar, leading the authorities to withdraw from the markets. From October onwards, external pressures mounted and several informal contacts took place between the authorities and troika members. These culminated in the end-November decision by the government to seek an emergency bailout from official partners.

This chapter assesses the role played by the IMF vis-à-vis Ireland during the decade and a half from 2000 onwards. It is a story of a relationship involving two distinctly different phases. The first section of the chapter critically evaluates the workings of Fund surveillance during the pre-crisis years. The Fund—together with nearly all other external and domestic observers—did not adequately identify the underlying vulnerabilities that led to the massive economic and financial crisis that hit Ireland from 2008 onwards. Key elements of Fund staff analysis and policy advice contained in surveillance documentations (Article IV and Financial Sector Assessment Program reports) are assessed. Some broader "environmental" factors that appear to have influenced the effectiveness of surveillance in the case of Ireland—and probably of some other peripheral euro area countries—are also discussed.

The second section takes up the story from 2009 onwards, when contacts with the Fund began to deepen, culminating in agreement on a program in late 2010. Pre-program preparations, ownership and communication, the design of the program and the attainment of program objectives are evaluated. This section also considers a number of key program-related issues including the role of external support, aspects of fiscal policy and financial sector reform, the treatment of risks, and the effectiveness of the troika framework. The final section contains conclusions relating to both the surveillance and program phases of the Fund's involvement with Ireland.

IMF Surveillance—The Irish Experience

This section critically examines the part played by IMF surveillance in Ireland between 2000 and 2008, a period during which economic and financial imbalances developed gradually but persistently before erupting into a full-blown crisis. Article IV consultations with Ireland took place annually, except for 2008 when, for reasons discussed below, the consultation scheduled for that year was postponed until 2009. The annual consultations were supplemented by a Financial System Stability Assessment (FSSA) report under the Financial Sector Assessment Program (FSAP) in 2000, followed, importantly, given its timing, by an FSAP Update in 2006.

For most of this period, that is, including up to the 2007 consultation and some way beyond, Ireland's overall economic performance and prospects continued to be regarded by the large majority of observers, including the Fund, in a very favorable light. The scale of the global financial crisis was unanticipated by all. However, there was no indication given of the extent of possible major "homegrown" problems facing the Irish economy. The assessment that follows tries to pinpoint the reasons for what amounted to major shortcomings in the surveillance process. First, the substantive content of the staff's analysis is evaluated, followed by consideration of some broader background elements—involving the perspectives of both the Fund and the Irish authorities—that played a significant role. These aspects were reflected in the decision not to hold a consultation in 2008 and, more generally, in the absence of substantive interaction between the staff and the authorities during a critical period between mid-2007 and early 2009.

The Analysis by the Staff

This assessment of the analysis and policy content of the surveillance process focuses on four areas that are key to understanding the causes of the eventual crisis: property price developments; fiscal policy; the state of the financial sector; and overall vulnerabilities associated with domestic macroeconomic interlinkages.

By way of prelude, Ireland joined the euro area in 1999 as one of the 11 original members. As the adoption of the euro drew near, Fund staff did not provide a comprehensive analysis of the requirements and constraints imposed by euro area membership (this appears not to have been unique to Ireland's case). However, in 1999, reference was made to the asynchronized cycles of the Irish and other European Economic and Monetary Union (EMU) economies and the burden placed on fiscal policy due to the absence of monetary policy instruments (IMF, 1999). Also, in later reports, the assessment of external competitiveness indicators took into account the likelihood that Ireland entered the euro area at a somewhat undervalued exchange rate (see below).

Developments in the property sector

In view of what ultimately transpired, it is important to note that Article IV consultations did devote considerable attention to Irish residential property market developments. The dialogue with the authorities on the issue of house prices was persistent throughout the decade of the 2000s. From the mid-1990s onwards, residential house prices in Ireland began to increase very rapidly. Between 1995 and 2000, prices rose by almost 150 percent; over the 10 years ending in 2006 they more than quadrupled. Article IV staff reports from 2000 onwards (including Selected Issues Papers (SIPs)) contained quite comprehensive empirical analysis to support the prevailing staff theme that Irish house prices were very likely overvalued. The dialogue with the authorities on this topic covered: (i) whether "fundamental" factors were or were not driving the market; (ii) analysis of property boom and bust cycles elsewhere; and (iii) the impact of fiscal incentives.

Even by 2000, there were already significant fears that Irish residential property prices were overvalued. A common strand of much of the "give and take" between the staff and the authorities throughout was how to interpret the surge in house prices. Staff noted that the standard approach to this question was to distinguish between "fundamental" factors driving prices and that "beyond the influence of fundamental factors . . . sustained rapid price increases over several years may lead to self-fulfilling expectations-driven demand followed by price overshooting" (IMF, 2000a, p. 16). The authorities, on the other hand, tended to stress that changing "fundamentals" such as continued rapid growth in personal incomes (given Ireland's high growth rate and prospects), inward migration that boosted housing demand, prospective low and stable euro area interest rates, and the prevailing modest level of household indebtedness justified most, if not quite all, of the price surges that had occurred. While recognizing such factors, staff argued that these would not necessarily prevent a speculative element emerging. For instance, it was suggested that prospective purchasers would undertake their purchases earlier, a tendency that could be magnified by the low level of household debt and the high propensity to favor home ownership; this implied that for many households, the operative decision was not whether but when to buy (IMF, 2000b). More generally, in 2003, the staff observed that "while the potential for fundamentals to justify the sustained rise in house prices [was] easy to recognize *qualitatively* . . . it [was] difficult to assess *quantitatively* the degree to which these factors explain Ireland's housing boom" (IMF, 2003, p. 28).

In support of the probable house price overvaluation hypothesis, staff cited examples of several industrial countries during the 1980s. While recognizing there were some exceptions, in 2000, staff argued that ". . . in fact no industrial country in the last 20 years has experienced price increases on the scale of Ireland without suffering a subsequent fall" (IMF, 2000a, p.16). The accompanying Selected Issues Paper concluded more precisely: "excluding Finland, episodes [among the almost 40 studied] characterized by real house price inflation of 14 percent per annum or more suffered on average a loss in the next four years of 40 percent of the cumulative price increase during the boom" (IMF, 2000b, p. 19). While accepting that "soft landings" were possible, staff suggested that the experiences of Hong Kong SAR and Singapore (a trebling of house prices over a decade) were more relevant and argued forcefully that "if property prices were to level off without a significant fall, it would be an event unprecedented in the last 20 years" (IMF, 2000b, p. 23).[1,2]

Staff analysis also presented evidence from various supplementary indicators. While the ratio of house prices to rents had reached record levels by 2003, based on a model incorporating changes in fundamentals such as demographics, income, and real interest rates, an overvaluation of 16.5 percent was suggested. However, if the calculation was restricted to the 1976–97 period, i.e., excluding the subsequent "boom" years, the overvaluation was estimated at over 50 percent (IMF, 2003). In 2004, staff observed that rents had dropped over the previous two years, while prices had continued to rise; the price-earnings ratio (house prices divided by annual rental income) was estimated to be over 100 percent above its historical average (IMF, 2004). By 2005, this ratio had jumped to one-and-a-half times its 2002 level. Staff also noted that the fall in rents was accompanied by an acceleration in construction that had exceeded for some time the generally agreed sustainable rate. Some 40 percent of new houses were second homes and/or investment properties. It warned that some of this activity likely

[1] The staff's analysis found that Dublin house prices were above those of Paris and Berlin, albeit lower than in London. The ratio of house prices to disposable income in Ireland had reached its highest level since the 1970s and was substantially higher than in the United Kingdom, both then and during the earlier U.K. property boom.

[2] The OECD's 2006 *Economic Survey of Ireland*, in an exercise reminiscent of the earlier Fund staff analysis, concluded that "if a soft landing is defined as something that is both mild and gradual, there has not been a single case out of the 49 residential boom-bust cycles [examined for 23 countries between 1960 and 2004]" (OECD, 2006, p. 128).

involved the acquisition of property based on unrealistic expectations of future price increases.

Staff frequently criticized the key role that changing combinations of fiscal incentives were playing in fueling the property boom. Various tax measures had been introduced in 1998 in an attempt to deflate what appeared then to be an incipient housing bubble. A leveling off followed by a slight fall in prices occurred during 2001. As a result, and partly in fear of a looming domestic recession, the 2002 budget largely reversed these measures. This led to a sharp rebound in house prices and, indeed, helped set the stage for the bubble years thereafter. Staff expressed concerns that frequent policy reversals in the fiscal regime applicable to property would cause instability and distort the house buying decision-making process (IMF, 2003).

Unfortunately, the consultation reports did not contain any systematic analysis of the commercial property sector. In the wake of the crash it became apparent that the expansion in lending against commercial property development—much of which was eventually defaulted upon—had been even larger than that to the residential property sector and was a critical factor triggering the meltdown of the banking sector (see below).[3] Although there were some qualitative references, especially in the earlier part of the decade, to potential vulnerabilities, staff reports did not evaluate price trends or related indicators (such as price/earnings ratios) within this sector.[4] The Central Bank of Ireland (CBI) Financial Stability Reports did not refer to the commercial property issue until 2007 (and then only to a limited extent). According to staff observations subsequently, this omission was partly due to data limitations. However, at the time staff did not express concerns regarding data inadequacies or press the authorities to undertake any needed remedial steps.

From 2004 onwards, there was some move towards convergence of views as to the unsustainability of residential price increases that far exceeded real economic growth. The 2006 Article IV report stated that while the Fund staff had concluded that a significant overvaluation was present, the CBI considered prices to be somewhat overvalued, while Department of Finance officials viewed them to be in line with fundamentals (IMF, 2006a). Staff in 2007 indicated agreement—without reservations—with the authorities' (CBI) view that the most likely scenario would be a "soft landing" (generally understood to mean a price fall of around 15 percent, a decline that was thought to be manageable for the banks) (IMF, 2007).

Throughout the decade staff provided some policy recommendations to dampen the boom/possible bubble. Apart from urging a modest tightening of fiscal policy to counter general overheating (see below), staff consistently

[3] See Donovan and Murphy (2013).

[4] The 2003 Article IV Consultation report drew attention to the "concentration of large exposure to commercial property loans among a few institutions" (IMF, 2003, p. 26).

called for a phasing out of property-based tax incentives and subsidies, including via the introduction of a residential property tax and a reduction in mortgage interest tax relief. The 2004 consultation report recorded candid exchanges during which "the authorities noted the political, likely insurmountable difficulties of removing interest-deductibility of mortgages or introducing taxation on property given the electorate's long history of attachment to, and preference for owning property" (IMF, 2004, p. 20).[5] In 2006, staff reported that "the authorities acknowledged the economic desirability of broadening the tax base, but pointed to popular opposition to increasing property-related taxes" (IMF, 2006a, p. 13). The staff did not address whether tighter financial regulatory policies would have been appropriate to help curtail the boom.

Should the risks of a looming property market crash have been recognized and highlighted sooner? Staff's broad assessment that house prices were somewhat overvalued was expressed more forthrightly at the beginning of the decade. However, the reports spanning 2001–03 were somewhat guarded in tone; partly reflecting the general absence of reliable methodologies to identify asset bubbles in general ex ante, the staff appeared more hesitant to suggest the existence of a possible "property bubble" and refrained from speculating as to the size or timing of a likely fall in prices. From 2004 onwards, there was some movement towards a convergence of view as to the unsustainability of continued price increases. However, the authorities' view at the time of the 2007 consultation—which was endorsed by the Fund staff—that a "soft landing" was the most likely outcome was later described by the official Honohan enquiry as a "triumph of hope over reality" (Honohan, 2010, p. 10).

Subsequent discussions with the staff suggest a number of reasons that help explain their relatively cautious stance. Difficulties in credibly challenging prevailing views as to the role of fundamentals were a factor inhibiting more clear-cut judgments, as were more general analytical problems in predicting the timing and extent of likely asset price busts. Also, a fear of being seen to "cry wolf" too often was present to some extent, especially after earlier predictions around the start of the decade of an extended fall in prices did not materialize.[6] In addition, concerns of adverse market

[5] The OECD also took issue with the fiscal regime favoring home ownership and the frequent policy reversals that had taken place. In 2006, it cited, among other things, the large (and, in the OECD's view inadequately taxed) capital gains accruing to some landowners as well as the underpricing of infrastructure in the property sector. It advised the government "to phase out the strong bias towards housing that is embedded in the tax system and to introduce a property tax" (OECD, 2006, p. 31). The European Commission (EC) published a number of short reports on Ireland during this period. However, these did not contain specific analysis of property price developments. Staff did not report any specific substantive contact between the Fund and European Commission staffs on this topic.

[6] However, in retrospect the rebound in prices from 2002 onwards was due to a considerable extent to the reinstitution of fiscal incentives in the 2002 budget.

reactions may have played a role. Staff agreed that more should have been done to highlight the potentially crucial importance of lending against commercial property development. To the extent that informational/data shortcomings were a factor constraining analysis, the staff could have drawn the authorities' attention to these elements and highlighted them in consultation reports.

Financial sector surveillance

With property market developments as background, Article IV reports devoted significant attention to financial sector issues. The 2006 Article IV report, together with the 2006 FSAP Update,[7] contained an extensive review of the outlook for the financial sector; this aspect was returned to in the 2007 report. These assessments are a crucial—perhaps the most crucial—element in Fund surveillance of the Irish economy prior to the crisis.

The overall staff message conveyed throughout was one of reassurance as regards the state of the financial sector. There was no indication of any significant disagreement between the authorities and the Fund staff nor did divergences of view emerge among Executive Board members on key issues. Staff did express concerns regarding house price developments (see above) and drew attention to some financial sector vulnerabilities. However, they did not provide any hint of the existence of major problems, let alone of the possibility of the crisis that was soon to befall the banking system. In what was fairly representative language, the 2005 Article IV report noted that "continued efforts are needed to *maintain* [italics added] financial stability" and that "banking system profitability and capitalization are strong" (IMF, 2005, p. 3). The 2006 FSAP Update concluded that "the outlook for the financial sector is positive" (IMF, 2006b, p. 1), while the parallel 2006 Article IV report stated that the "financial system continues to perform well" (IMF, 2006a, p. 3). A year later, the 2007 Article IV report reiterated that the "banking system is well-capitalized, profitable and liquid and that "stress

[7] An earlier FSSA/FSAP report was issued in 2000. This exercise took place following a suggestion by the staff in the 1999 Article IV Consultation report that the authorities undertake a peer review as a means of strengthening supervision. The Financial System Stability Assessment concluded that "Ireland's highly developed financial system had remained stable, even in times of international financial turmoil. . . and that the regulatory framework showed a high degree of observance of international codes and standards" (IMF, 2000c). It noted a number of policy challenges, including sustained rapid growth in credit and real estate and house prices, increased competition from abroad, and some supervisory issues relating to the International Financial Services Centre (IFSC), particularly as regards the reinsurance industry. Interestingly, the accompanying 2000 Article IV consultation report stated that "the sustained rapid growth in private sector lending calls for extreme vigilance, and supervisors should use all the tools at their disposal to ensure that the financial system remains sound" (IMF, 2000a, p. 36). This language was more forceful than that of subsequent consultation reports.

tests suggest that [banks' financial cushions] are adequate to cover a range of shocks" (IMF, 2007, p. 20).[8]

The 2006 Article IV Report and the 2006 FSAP Update both drew attention to the increased reliance by banks on external wholesale funding. The surge in lending by the banks had far exceeded deposit growth; according to ECB data, as of end-2004 Irish banks had the lowest deposits-to-assets ratio of all western European Union (EU) countries.[9] Staff observed that such funding was more sensitive to confidence than were deposits and was generally more expensive. As against that, it was noted that wholesale funding had become increasingly diversified, that Irish banks' funding needs were small relative to the size of the liquid euro market and that the maturity mismatch of funding and loans had not changed over the last few years.[10] Moreover, based on liquidity stress tests, a 30 percent reduction in private sector deposits would exhaust only 15 percent of liquid assets, while a 10 percent haircut on sales of securities and bonds would still leave bank capital at more than adequate levels. Staff concluded overall that the banks "appear to have generally appropriate contingent liquidity arrangements to address tightening of access to wholesale markets" (IMF, 2006b, p. 21).[11]

Staff did not consider the possibility of substantially greater reductions in the availability of liquidity. This might occur, for example, via a widespread reluctance to roll over large wholesale deposits and/or a liquidation of bonds as their maturities fell due.[12] While mentioned in the 2007 Article IV report, the specific risks associated with the shortening of funding maturities that took place from 2005 onwards were not highlighted. However, the benefits of funding diversification proved to be of little solace when the external systemic crisis took place. The continued high reliance on U.K. funding sources ended up being particularly damaging when U.K. banks' financial positions began to weaken sharply.

The analysis of increased riskiness of banks' lending activities was grounded upon the assessment of the housing market outlook. A key element underlying the 2006 FSAP Update—consistent with the view of the accompanying Article IV report—was the conclusion that "the central expectation is for an orderly slowing of the housing market . . . a sharp correction cannot be ruled out, however" (IMF, 2006b, p. 13). As noted above,

[8] The precise range of shocks considered was not entirely clear from the report.

[9] The ratio reported even as of August 2005 (prior to the peak of the boom) was 1.7, significantly above the euro area median of 1.3. Irish banks' exposure at the time to capital market funding, at 30 percent of assets, was among the highest in the EU.

[10] However, the fact that 40 percent of funding came from the U.K. was not mentioned.

[11] The growth of complex financial products, including mortgage-backed securities, was a very minor feature of Ireland's banking crisis. As elsewhere, staff noted the emergence of these products with a mixture of approval and concern that the risks were not fully understood.

[12] According to staff, data distinguishing different categories of deposits were not available at the time of the 2006 FSAP mission.

the expectation of a "soft landing" was also the view of the CBI in 2006 and was reiterated in 2007.

The 2006 FSAP Update concluded reassuringly that "the banking sector has enough profit and capital buffers to withstand severe shocks on combinations of house price declines and default rates" (IMF, 2006b, p. 20). The precise meaning of "severe" was not spelled out explicitly. Nevertheless, staff stated that "the current value of provisions set aside for mortgage lending would cover a scenario of 25 percent fall in house prices" while "even if the mortgage NPL [non-performing loan] ratio was to increase from the currently low 0.45 percent to 5 percent after a 40 percent fall in house prices, the banks' existing capital buffer would adequately absorb the resulting loss" (IMF, 2006b, p. 20).[13] In the event, however, NPLs (relating to both residential and commercial property) peaked post-crisis at almost 25 percent of total bank lending, a fifty-five-fold increase from the 2006 level.

These positive overall messages stemmed from a variety of stress tests. Stress tests referred to by the Fund staff (which were undertaken by the financial institutions themselves in consultation with the staff who requested, but did not receive, detailed supervisory data) appear to have gone some way beyond the "top down" versions undertaken by the CBI. However, the tests did not analyze the possible cumulative effect on likely loan losses (and hence banks' capital adequacy) of "worst case" possibilities, such as: first, a considerably greater fall in house prices (prices eventually fell by some 51 percent from peak to trough, while the drop in commercial property prices was even greater); and/or NPL ratios much greater than the assumed 5 percent that might result from the macroeconomic effects of a possible "hard landing." While "bottom up" tests were conducted by the banks themselves—the results of which were similarly reassuring—the FSAP team did not have the opportunity to discuss their findings directly with the banks while in Dublin.

The staff's favorable conclusions did not take into account major risks associated with commercial property lending (see earlier discussion). During the crash, the commercial market collapsed completely, leading to the insolvency of many developers. Large-scale lending to this sector played an even greater role than household mortgage borrowing in causing the financial demise of the banks. It emerged from later official inquiries[14] that much of the lending in question—especially towards the end of the bubble—lacked adequate supporting financial documentation, including accurate information on borrowers' financial positions and the soundness of their personal guarantees, and also reflected weak internal control procedures by some banks.

These subsequent enquiries concluded that the supervisory authorities had exercised an unduly "arm's length" approach. The Financial Regulator, it later

[13] It was clarified subsequently by the staff that the analysis did not imply that a 40 percent fall in prices would lead to only a 5 percent NPL ratio; the 40 percent number was referred to for illustrative purposes.
[14] See Honohan (2010) and Nyberg (2011).

transpired, had been reluctant to delve into the specific lending practices of the banks. Also, it had been hesitant to take effective decisive action whenever any specific problems came to light. However, the 2006 Article IV report and FSAP Update did not query or comment upon any of the underlying practices or procedures of the Regulator.[15]

Why were such positive reassurances conveyed as to the state of the banking system? The weak points underlying the favorable staff evaluation are evident. The sudden unprecedented collapse in liquidity worldwide in 2007–08 could only have been foreseen with the benefit of hindsight. On the other hand, the benign view of the banks' capital strength was driven by too ready an acceptance of the central scenario of a "soft landing" for the residential housing market. While staff stress tests went some way beyond those of the CBI, their scope fell far short of what actually transpired, nor did they take into account commercial property lending. Staff had an insufficient appreciation of the limitations associated with the interaction of the Financial Regulator with the banks that stemmed from the "principles based" approach to regulation. The staff did not call for any significant tightening of regulatory practices and its favorable assessment of the Regulator's performance in 2006 FSAP was echoed in market commentary at the time.

In subsequent interviews, staff involved acknowledged many of the above shortcomings. Not focusing on the commercial property market was a key omission, partly explained by data limitations; similar constraints had inhibited a more thorough in-depth assessment of the quality and robustness of the banks' "bottom up" stress tests. Fund staff constraints may also have militated against a meaningful appreciation of the operational problems associated with the Financial Regulator's approach that were later uncovered. Finally, staff felt that they should have expressed their view that the CBI and the Regulator were both significantly under-resourced as regards financial supervision and macro prudential oversight, respectively.

Undoubtedly, some key aspects of financial sector surveillance could and should have been done differently. Nevertheless, the Irish experience suggests that there were some inherent limitations to the FSAP process at that time, given resources and time constraints, including the extent of in-depth information available to outside experts (or even to the authorities themselves). Both the 2000 FSAP and the FSAP Update were "pilot exercises." That being said, as a minimum, the FSAP Update report for Ireland could have been more cautious and should have contained a "health warning" to accompany its positive assessment. The subsequent official inquiry into the banking

[15] In 2006, the Regulator, after extended internal discussions spanning over a year approved an increase in the risk weighting assigned (for capital adequacy purposes) to certain kinds of non-residential mortgage lending. This measure, which became fully effective only in 2007, was described subsequently as a "belated and relatively modest . . . warning signal" (Honohan, 2010, p.12). While Fund staff welcomed this policy action after it had been taken, earlier staff reports do not refer to it having been raised beforehand in the staff dialogue with the authorities.

collapse observed that "in hindsight such an unwarrantedly favorable report by an authoritative international body was clearly unhelpful" (Honohan, 2010, p. 10). This impression was shared more recently by several Irish officials who recalled the comforting impact of the FSAP Update report's overall conclusions at the time.[16,17]

Fiscal policy

The extent and rapidity of Ireland's fiscal deterioration in the latter part of the 2000s was virtually unprecedented among post war industrial country experiences. After running overall budgetary surpluses in every year but one in the previous ten years, the small surplus recorded in 2007 turned into a massive deficit of 14.3 percent of GDP in 2009 (the even larger deficit of over 30 percent of GDP recorded in 2010—see Figure 8.1—is accounted for by the major one-off injection of state funds to recapitalize the banking system). Over the same two-year period, the debt to GDP ratio soared from 24 percent to 64 percent. The reasons for this dramatic reversal of fortunes are well known: the collapse of the property boom (and of construction) from 2007 onwards and the knock on effects on overall economic activity caused budgetary receipts to plummet. At the same time, the surge in spending, especially current spending, that had taken place in the preceding years could not be halted (let alone reversed), at least in the short term. Nevertheless, the Fund had characterized Ireland's fiscal policies throughout virtually all of the pre-crisis years as "prudent." As late as 2007, reference was made to what was described as Ireland's "strong underlying fiscal position" (IMF, 2007, p. 20).

What lay behind the Fund's relatively benign analysis of Ireland's pre-crisis fiscal situation? Article IV reports during 2001–07 did voice concerns about the pro-cyclical fiscal stance followed by the authorities and generally urged aiming for a somewhat larger overall surplus.[18] The debate usually centered on the desirability of taking additional fiscal measures in the order of one to one-and-a-half percent of GDP. However, this discussion masked a key aspect—of a far more damaging order of magnitude—unrecognized at the time. In reality, contrary to the picture depicted by the staff at the time, Ireland was actually running a very large—and growing—underlying structural fiscal deficit. A failure to identify this explains the Fund's mischaracterization of the state of Ireland's fiscal health throughout the pre-crisis years.

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[16] See, for example, the recent evidence by Liam O'Reilly, former Chairman of the Regulatory Authority, to the Irish Parliamentary Inquiry into the banking crisis (*Irish Times,* June 11, 2015).

[17] It is only fair to acknowledge that since the crisis there has been a sea change in thinking as to what constitutes good financial supervision.

[18] This recommendation was usually, but not always, shared by all of the Board. The 2007 Executive Board assessment stated "*Many* [italics added] Directors, however, saw the planned reduction in the fiscal surplus as an undesirable pro-cyclical fiscal stimulus, while acknowledging Ireland's pressing need to increase infrastructure and social spending" (IMF, 2007).

This major weakness in surveillance stemmed from the analysis of the cyclically adjusted fiscal balance (CAB). Until the time of the 2009 Article IV discussions, the staff—and the authorities—had consistently estimated the CAB to be in *small surplus* in each of the preceding years. However, in 2009 the Article IV report concluded that in fact the CAB had registered *large (and rising) deficits*. For example, the original estimate for the 2007 CAB contained in the 2007 staff report was a surplus of 0.7 percent of GDP. However, the 2009 report re-estimated the 2007 CAB as a deficit of 8.7 percent of GDP—a difference of almost 10 percentage points of GDP for the same year.[19,20] The authorities during 2008 had themselves come to a very similar conclusion. The portrayal of Ireland's underlying fiscal stance in the pre-crash years underwent a dramatic negative revision.

What led to such a radical reassessment? In the 2007 and earlier reports staff had noted that estimates of the structural balance were fraught with considerable methodological difficulties. In a technical sense, the earlier (pre-2009) calculations were based largely on the assumption that actual output was close to potential output. Estimates of the latter were derived using (broadly speaking) the methodology followed by the Irish authorities; this was based on an aggregate production function approach used throughout the EU and mandated by the EC. In Ireland's case, the approach implicitly assumed that the changes in the sectoral composition of output arising from the marked shift towards the construction sector and associated changes in asset prices were structural in nature. However, once this assumption was relaxed and account was also taken of the sensitivity of revenues to movements in asset prices, an entirely different picture of the CAB emerged. Already by 2008, this reality had become obvious and by 2009 a more appropriate methodology was employed.

In the pre-crisis years, the composition of overall budgetary revenues changed markedly and led to major fiscal vulnerabilities. A key feature was the shift in the burden of taxation away from income-taxes (via discretionary cuts in tax rates and upward adjustments in thresholds and tax credits) towards property-related revenue, i.e., capital taxes and stamp duties (a real estate transactions tax). During 2001–07, personal income taxes as a share of total revenue fell by over 6 percentage points while, according to Eurostat estimates, between 2000 and 2006 the share of revenue associated with the property sector rose from 8 percent to 18 percent. When the property market collapsed, the latter plummeted and total revenues fell precipitously.[21] In the

[19] The estimate for 2007 in the 2007 Article IV report was partly a projection as it was prepared early in that year, based on the 2007 budget. However, for the previous year (2006), the difference was equally striking—a surplus of 2.7 percent of GDP (original) versus a deficit of 5.7 percent (revised).

[20] As noted above, the Article IV consultation originally scheduled to take place in 2008 was postponed until 2009.

[21] See Donovan and Murphy (2013).

meantime, expenditure—which, especially in the case of current expenditure, could not be easily cut back—had soared.

Staff commentaries mentioned, but did not highlight these vulnerabilities. Both Article IV reports and Executive Board assessments supported explicitly the thrust of the authorities' policies aimed at lowering the income-tax burden. Although on several occasions staff urged a widening of the overall tax base, the reduction in the base associated with changes in income-tax provisions was not called into question. Instead, the main staff recommendation—repeated in virtually every report—was to introduce a residential property tax and curtail and/or phase out property-related tax incentives. However, as indicated above, the authorities on several occasions explained that such measures were not likely to be politically feasible.[22]

Staff reports were continuously mindful of the need to restrain current expenditure. Particular attention was paid to the major increases in public sector pay stemming from the benchmarking of pay against private sector comparators and broader public-private partnership political agreements. However, while urging that various mechanisms be put in place to limit outlays, the staff refrained from offering any direct judgments as to the possible sustainability of the growth in spending that was occurring. Thus, the link between the artificial—and unsustainable—rise in revenue and the seemingly more permanent boost in expenditure was largely missed.

Other recurrent fiscal policy recommendations by the staff included the introduction of a medium-term approach to budgetary planning. This recommendation was partly implemented in 2004, via the introduction of multi-year ceilings for capital spending. Staff also suggested the establishment of an external body to assess fiscal policies (such as a fiscal council) to help improve the quality of public debate on fiscal matters. The authorities disagreed strongly and some divergence of views emerged among Board members as to the merits of the proposal (IMF, 2005).[23]

Could the misreading of Ireland's underlying fiscal position have been avoided? The pre-2007 staff calculations showing CAB surpluses had been based to a large extent on the "common EU approach" used by the Irish authorities. However, while the authorities may have felt constrained by this framework, the Fund staff were free to employ whatever country-specific methodology they felt to be appropriate for Ireland. As a minimum, the pre-2009 estimates should have spelled out the key assumptions underlying the staff's approach (in particular as regards the sensitivity of the overall budget to the revenue structure) and critically evaluated the suitability of their application to Ireland.[24]

[22] Measures of this type were introduced later as part of the troika-supported program.

[23] As part of the troika-supported program, an independent Fiscal Advisory Council was established in mid-2011.

[24] An earlier paper by Fund staff (Jaeger and Schuknecht, 2004) had assessed the implications for fiscal policy of boom-bust phases and applied their analysis to 16 previous cycles (including

Overall macro vulnerabilities

Staff reports frequently discussed indicators of external competitiveness. Throughout most of the decade, reflecting wage (both public and private) and service cost pressures, inflation in Ireland was consistently 1 percentage point to 2 percentage points higher than in EU trading partners. Staff did not generally see this as a source of concern, citing the likelihood that Ireland had entered EMU at an undervalued exchange rate and the presence of Balassa-Samuelson "catch up" effects on non-tradable goods prices. The 2007 Article IV report concluded that the exchange rate was "close to, but perhaps slightly above, its equilibrium value" (IMF, 2007, p. 20). The 2009 Article IV report was more critical, arguing that the serious deterioration in competitiveness that had occurred in previous years had contributed to a marked erosion in Ireland's export shares and suggesting a possible overvaluation relative to the equilibrium real exchange rate of about 15 percent. In common with general European Department practice vis-à-vis the euro area, staff reports during most of the period devoted relatively limited attention to analysis of the balance of payments.

Staff reports, especially in the two to three years prior to the outbreak of the crisis, did not tease out adequately the potentially self-reinforcing linkages between specific sectoral vulnerabilities. An overall scenario similar to that which unfolded eventually, namely, a plummeting in property prices associated with the collapse of construction, a deep recession, an associated dramatic drop in budgetary receipts that led to major fiscal cutbacks and further depressed demand, and last, but by no means least, an unraveling of the banks' financial position that could (and did) soon accelerate the downward economic and financial spiral, was not alluded to as a possibility. In 2007, staff observed that the long period of strong economic performance limited the ability to quantify other than first round effects associated with banks' stress tests (IMF, 2007).

Should the analysis have attempted to address, at least to some extent, such possible scenarios? While precise quantification of the overall impact undoubtedly would have been challenging, some key elements could have been explored, at least qualitatively. For instance, using approaches developed in the earlier work by Fund staff, the budgetary implications of a sharp downturn in property and construction should have been spelled out via sensitivity analysis and some likely knock-on effects considered. To the extent that such an exercise, if made public, would have been viewed as alarmist and highly market sensitive, it could have been discussed confidentially with

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Ireland). A later paper published by the European Commission (Martinez-Mongay, Maza Lasierra, and Yaniz Igal, 2007) estimated that some 50 percent to 75 percent of the increase in Spain between 1995 and 2006 might be of a transitory nature and disappear with the asset boom. The methodology used by the Fund staff to calculate the CAB in 2009, while not outlined in the 2009 Article IV staff report for Ireland, was described in Kanda (2010).

the authorities. However, scenarios along these lines were not pursued by the staff. The consensus, perhaps reinforced by elements of "group think," was to stay with the "soft landing" hypothesis and its attendant comforting implications, albeit with some mild notes of caution. In subsequent reflections, some staff involved at the time remarked that it was "difficult to imagine" that a euro area member such as Ireland, whose economic performance had been so lavishly praised over many years, could undergo a disaster on the scale that eventually befell it. That being said, staff acknowledged that they should have taken a closer look at the experiences of some other industrial countries (for example, the Nordics) that had undergone financial crises in the not so distant past. For whatever reasons, what is often referred to as a major asset of the Fund, namely, its lengthy experience with different countries over long periods, did not feature in the staff analysis of Ireland's case.[25]

The Surveillance Environment

The failure of the IMF surveillance process in Ireland to identify the deep-rooted nature and extent of the emerging weaknesses in the Irish economy partly reflected broader factors. As described above, staff did not undertake sufficiently comprehensive and rigorous analysis that could have recognized in advance the degree to which the Irish economy had become exposed. Consequently, the Fund's policy advice fell far short of what would have been needed to help avert the looming problems. However, there were also significant "environmental elements" that help explain these shortcomings, namely, the changing approach to surveillance of some euro area members and the prevailing climate within Ireland in which the dialogue with the authorities was occurring.

Following the establishment of the euro area, there appears to have been some—perhaps subtle, but nonetheless significant—change in the approach to IMF surveillance to individual euro area members. Some staff interviewed subsequently reported a sense that potential criticism of member countries' performance—especially in the macroeconomic and macro-financial areas—should be tempered by the view that the euro area authorities, rather than the Fund, were better placed on the front line to address some issues.[26] Later in the decade, in early 2008, the Fund embarked on a major downsizing of staff. This affected all departments, including the European Department, which underwent major restructuring and also involved extensive changes in senior staffing. Many countries (although not Ireland) were moved to a

[25] An exception, as noted above, was the comparative analysis of house price booms and busts in several countries at the start of the decade, which was not, however, repeated in following years.

[26] The review paper by Pisani-Ferry, Sapir, and Wolff (2011) prepared for the IMF's 2011 Triennial Surveillance Review concluded, in a somewhat similar vein, that "the IMF fell victim to a 'Europe is different'" mindset and that "eagerness to play a role in the complex European policy process . . . and close relationships between the Fund and the authorities . . . reduced the IMF's effectiveness as an independent and critical observer of the euro area."

24-month consultation cycle. Some consultations were conducted under "simplified procedures" (i.e., involving a significant shortening in the duration of the visit of the staff team and a sharp reduction in the size and coverage of topics), as occurred in the case of the 2007 consultation with Ireland. Some staff recalled Fund management at one stage wondering whether in fact consultations were needed in smaller euro area countries.

Some of these elements came into play in Ireland's case and, in particular, help explain the postponement of the 2008 Article IV consultation. Although Ireland continued to be on the 12-month cycle, no consultation took place in 2008. In December 2008, the Executive Board was informed that due to staffing constraints (as a result of staff downsizing and the restructuring of the European Department) and the authorities' preferences regarding timing, the consultation mission, which would normally have taken place around mid-2008 (the previous consultation had taken place in June 2007), had been delayed until April 2009. The staffing constraints referred to partly reflected the fact that a new mission chief for Ireland, after being appointed in the fall of 2007, was almost immediately thereafter reassigned to work full time on the United Kingdom. In the event, between mid-2007 and early 2009, there was no substantive contact between the Fund and the Irish authorities as regards the nature, extent, and policy implications of the economic and financial crisis that was starting to emerge. In the absence of a mission chief, staff work on Ireland was essentially limited to monitoring of developments by the desk officer.

As the major events of 2008 began to unfold, the Fund absented itself from the Irish stage. In the fall of 2008, the authorities implemented the second in a series of major fiscal adjustment packages to cope with a massive budgetary shortfall. In late September 2008, in the wake of worldwide financial turbulence and severe liquidity pressures, they provided a comprehensive state guarantee in respect of nearly all the financial liabilities of the six domestic banks. This decision—often described as the single most important policy measure taken by an Irish government—had far-reaching implications and was to prove, and to remain, highly controversial. Fund staff did not have any contact with the Irish authorities (nor was contact sought by the latter) in the period either before or after the guarantee decision.[27] A visit by senior European Department staff to several countries around that time to discuss unfolding developments did not include Ireland. It is evident that as the crisis began to emerge and intensify from late 2007 onwards, staff resources were prioritized towards what were considered to be "systemically important"

[27] A memo from the Monetary and Capital Markets Department (MCM) to management shortly after the granting of the guarantee described its main features and noted some of the associated uncertainties and risks. It did not suggest any proactive engagement with the Irish authorities by staff or management.

countries, some of which (such as the United Kingdom) were beginning to experience significant financial stress.[28]

Finally, the prevailing climate in Ireland at the time does not appear to have been conducive to a more intensive surveillance dialogue. Both staff involved and the authorities have acknowledged that the Irish side would not have readily countenanced consideration of significantly more adverse scenarios than the "soft landing" hypothesis. This was consistent with the general political view—echoed by the markets and the media—that any hint of a major shock to come would have been unfounded and irresponsible. As late as 2009, the authorities firmly believed that, given their prior impressive track record, they could handle any problems that might arise. It is striking that at no stage during the tumultuous events surrounding the bank guarantee decision of September 2008 did the authorities think of seeking Fund advice. Overall, for whatever reasons, the Fund's role as a potential "trusted advisor," especially in times of difficulty, did not seem to have featured in the case of Ireland.[29] Together with a certain perception of reticence on the part of senior European Department staff to be too interventionist, this played a (perhaps unconscious) role in how far the staff might have been willing to go in querying the prevailing wisdom in Dublin.

The Program Phase, 2009 Onwards

Beginning in 2009 the IMF's role in Ireland started to enter a new phase. The June 2009 Article IV consultation mission (which followed an earlier short staff visit) highlighted the major economic and financial problems facing the government. The 2010 consultation took place against the background of a sharply deteriorating external and domestic environment. By mid-November 2010, the authorities had come to the conclusion that it was necessary to seek external financial assistance within the troika framework that had been established a few months earlier in the context of the Greek crisis.

On December 3, 2010, the Irish government requested a three-year extended arrangement under the IMF's Extended Fund Facility (EFF) in an

[28] Somewhat paradoxically, although Ireland was not considered a "systemically important" economy in 2008, in 2010, the provision of exceptional access to Ireland by the Fund was justified by the invocation of the "systemic exemption" provision because of a threat of spillover due primarily to the interlinkages of European banks and their exposure to sovereign debt. Moreover, during the program, whether or not the Irish authorities should impose haircuts on senior unguaranteed bondholders was thought to involve major systemically significant issues (see the section "Some Issues" below for further discussion of these aspects).

[29] The authorities appear to have been quite sensitive at times to whatever the conclusions of the staff consultation might be. Ireland was the only European member country that did not consent to the publication of the staff team's concluding statement until 2009. Staff also recall one occasion when the authorities contacted senior European Department officials directly to express concerns about the approach of the consultation mission.

amount of SDR 19.5 billion (2,322 percent of quota), or about $30 billion, which was approved on December 16, 2010. The remainder of the total financing package of €85 billion (about $113 billion) was provided jointly by the EU Financial Stabilization Mechanism/European Financial Stability Facility and bilateral partners (totaling about $60 billion) and the government's own resources (€17.5 billion).[30]

This section assesses the IMF's role from 2009 onwards under several broad headings: (i) pre-program preparations; (ii) ownership and outreach; (iii) overall program objectives and outcomes; and (iv) some key topics, namely, the role of external support within the European context, issues in fiscal policy and financial sector restructuring, the treatment of risks and the effectiveness of the troika framework.[31]

Pre-Program Preparations

Contacts between the staff and the authorities deepened from 2009 onwards. As early as a staff visit in early 2009, the possibility was raised with the authorities of Ireland requesting a precautionary credit line in the form of a Flexible Credit Line (FCL). It was suggested that such an arrangement—which might be made available on the basis of the authorities' track record and their policy plans—could help insulate Ireland from emerging market turbulence. The authorities took the view that any hint of Fund involvement could have a sharply negative effect on market sentiment and did not wish to pursue the matter further. In mid-2010, the possibility of a precautionary arrangement—which would likely at that stage to have involved some conditionality—was again raised; however, the authorities indicated that any discussion of a role for the Fund was premature. Neither the staff reports for the 2009 nor 2010 Article IV consultations made any reference to the possible need for external financial support. Nevertheless, the deepening policy dialogue from 2009 onwards which included, apart from the formal consultation process, many informal contacts, was to prove highly useful. The authorities observed that establishing a relationship of mutual trust—which can take some time—had been an important element facilitating successful program negotiations at a later stage.

As the summer of 2010 came to an end a series of events—the ongoing Greek crisis, the Deauville declaration espousing the principle of burden-sharing by private sector creditors, the announcement that yet more capital injections were needed for the Irish banks and the "funding cliff" associated with the pending expiration of the 2008 State banking guarantee—led

[30] Beginning in 2015, Ireland made early repayments to the Fund. As of March 31, 2016, outstanding Fund credit to Ireland amounted to SDR 3.8 billion, or 109 percent of quota.

[31] Detailed information on all aspects of the program is contained in IMF (2010a); IMF (2011a, 2011b, and 2011c); IMF (2012a, 2012b, 2012c, and 2012d); and IMF (2013a, 2013b, 2013c, and 2013d).

to heightened market nervousness and major pressures on Irish bond spreads. On September 30, the Irish authorities indicated their intention to withdraw from borrowing on international markets. Around the same time, the Irish banks were facing a mounting crisis of confidence, necessitating large-scale emergency liquidity financing from the European Central Bank (ECB). The ECB, in a series of confidential communications to the Irish authorities (later made public) expressed major concerns about the state of the Irish banks; this culminated in a letter from then ECB President Trichet in mid-November indicating that emergency ECB funding could not be sustained in the absence of a program supported by external assistance.[32]

Unknown to the general public a team from the troika had been present already in Dublin for some weeks beforehand. This followed unpublicized meetings with the troika in Brussels in October and again in mid-November 2010. The authorities observed later that these contacts—which had taken place discreetly and with due regard for the sensitivities involved—had helped significantly to resolve many key program-related issues that arose subsequently. By the weekend of November 13–14 pressures from various quarters had mounted to such an extent that external intervention appeared inevitable. On November 18, the authorities announced the arrival of a large troika team in Dublin and a few days later announced their intention to negotiate a comprehensive program that would form the basis for the authorities' request for financial assistance.

Program Ownership and Outreach

A high degree of ownership characterized the program from the outset. The broad elements of the program had already been announced prior to the negotiations. In particular, the government, as part of the National Recovery Plan issued in early November, had made a firm public commitment to reach the budget deficit target of 3 percent of GDP stipulated under the EU's Excessive Deficit Procedure (EDP) by 2014. During program negotiations, in line with the IMF staff's own views, agreement was reached between the troika and the authorities on extending the deadline for reaching this target from 2014 to 2015 and on the associated quantum of fiscal measures to be undertaken in 2011 and in subsequent years.

The authorities stressed throughout their strong adherence to this agreed deficit reduction path. Importantly, in the run up to the general election in early 2011, the main opposition parties—with whom the Fund staff had consulted at the time the program was agreed the previous November—also announced their commitment to the deficit reduction trajectory; the new government, after taking office, did not seek to alter this stance. The Fund staff team noted publicly—particularly in the earlier stages of the

[32] It is not entirely clear as to whether the Fund staff may have been aware of or seen this letter at the time.

program—that provided the annual fiscal packages were credible and reasonably "growth friendly," the particular choice of specific measures was a matter for the authorities. Some representatives of the then opposition parties have observed, however, that the Fund staff should have been more vocal in disagreeing with occasional official pronouncements to the effect that particular unpopular measures had been "insisted upon" by the IMF/troika. That being said, there was general agreement that the authorities took full ownership of the overall "austerity" strategy embodied in the program's fiscal consolidation.

The strategy for restructuring and rehabilitating the banking sector also had broad support. Although the approach to dealing with the banking crisis had received less public attention, the broad elements were already committed to by the authorities. The main contribution of the program was to delineate a detailed strategy and time bound plan for implementation. Staff from the Fund's Monetary and Capital Markets Department (MCM) played a key role, especially as regards the use of an outside third party to conduct asset quality reviews and the need to ensure that the stress test process applied to banks involved a high degree of transparency. While the degree of domestic ownership of the financial reform program thus was high, as discussed below, progress on some elements ended up being delayed by domestic factors or constrained by considerations associated with external partner support.

Public outreach was a key element. Early on it was decided, with the authorities' support, that the Fund team would engage in extensive outreach activities vis-à-vis the media and other stakeholders, including the opposition parties, trade unions and non-governmental organizations (NGOs). Joint press conferences (with the EC and ECB teams) were held at the end of both the negotiating mission and the first five review missions. Following a subsequent decision by the EC not to continue with this joint format, a conference call was held by the staff with the media at the end of each mission; the Fund mission chief also conducted a teleconference from headquarters with the Irish media when staff reports were published. On an ongoing basis, the Fund Resident Representative—at his own initiative and in response to many requests—met with various interested stakeholders. The authorities felt that these outreach activities had contributed to a better understanding of the program's content as well as the nature of the Fund's supporting role. They also remarked that while the broad domestic consensus underlying the program's overall strategy helped, the communications style of key members of the Fund mission teams had also been important.[33]

[33] However, some senior Irish officials have indicated that some highly publicized (and interpreted as critical by the media) subsequent comments by a former IMF senior staff member who had been closely involved in program discussions had not been helpful.

Program Objectives and Broad Outcomes

The program focused on addressing the key problems that had caused Ireland's economic and financial crisis. The design of the program supported by the extended arrangement—and associated conditionality—highlighted the two critical elements: first, restoration of the banking system to health; and second, further major fiscal consolidation to promote debt sustainability and facilitate a return to market access.[34] Given the balance sheet nature of Ireland's deep recession, the impact of further fiscal drag and the far from bright external outlook (although the full effect of the crisis on the euro area was not yet evident), the prospects for a rapid return to growth were at best uncertain.[35] Although not subject to specific conditionality (Ireland's economy was relatively distortion-free), the program also addressed some perceived impediments to growth, including regulatory issues and labor market activation policies designed to encourage the take-up of jobs by the unemployed or those not participating in the labor force.[36]

Despite the strong domestic and external headwinds, the overall macroeconomic outcome under the program was modestly positive. By 2012 real GDP had ceased to fall and signs of recovery appeared during 2013.[37]

[34] Prior to the negotiations, there was discussion within the Fund as to whether a three-year Stand-By Arrangement (SBA), as opposed to an extended arrangement under the Extended Fund Facility (EFF), was appropriate (Ireland's was the first case involving exceptional access under an EFF). The large structural content of the program relating to the banking sector, as well as the uncertain prospects for debt sustainability argued for the more favorable maturity terms of an extended arrangement.

[35] Discussion of the architecture of the program did not address explicitly the question of the interaction between fiscal and Irish monetary conditions (i.e., developments in interest rates and credit). The 2012 Article IV consultation Selected Issues Paper contained a comprehensive analysis of whether the decline in credit extended by the banks—to small- and medium-sized enterprises, as well as to households—was driven primarily by demand or supply factors. Staff also frequently referred to the funding costs faced by Irish banks. While monetary policy for the euro area as a whole was determined by the ECB, monetary conditions in individual countries (such as Ireland) were influenced by, among other things, perceived sovereign credit risk as well as the Securities Markets Program (SMP) undertaken by the ECB. A question can be raised, which is not unique to the Irish case, of how, in such circumstances, the appropriate mix of fiscal and monetary elements (including the role played by the ECB's SMP) could or should be incorporated into program design.

[36] In internal documents the staff noted that technical discussions on several of these structural aspects (specifically, those relating to competition law and the legal, health and pharmacy sectors) were to be handled by the EC team—the Fund mission would only address their possible macroeconomic impact as needed. However, this distinction may have been lost from the point of view of perceptions. In practice, so far as most public opinion in Ireland were concerned (including many officials), there was just "one program." Moreover, given that completion by the EC of a program review was a prerequisite for continued disbursements by the Fund (due to the need for financing assurances), it can be argued that some "indirect" structural conditionality was present (see the section "Some Issues" below).

[37] Excluding the fall in value added of the multinational sector (due essentially to special factors associated with the "patent cliff" faced by the pharmaceutical sector), real GDP rose by 3 percent in 2013.

Unemployment, after peaking at almost 15 percent in 2012, declined to 13 percent by end-2013, while net emigration, which had risen sharply during the recession, began to slow. The targets for fiscal consolidation were observed in each year with some margin. The external current account began to register a significant surplus from 2010 onwards. Most striking, Irish bond yields, which continued to increase until mid-2011, declined steadily thereafter, reflecting the confidence boosting impact of sustained program implementation and important euro-wide policy initiatives. As of end-2013, spreads on sovereign 10-year bonds had fallen to just over 1 percent, compared to a peak of 6.5 percent in mid-2011, while from mid-2012 onwards Ireland was able to gradually re-enter the market. The authorities opted not to seek a follow up arrangement of a precautionary nature.[38]

The measures to restore the banking sector to health achieved considerable success. The major up-front recapitalization of the two largest pillar banks, based on comprehensive in depth stress tests undertaken in early 2011, finally began to restore confidence. The extensive deleveraging exercise, involving phased asset disposals of non-core assets, often outside Ireland, and which were subject to safeguards against fire sales, helped downsize the banking sector towards a more sustainable level.[39] These measures were supported by comprehensive reforms of the financial supervision regime and an associated restructuring of the central bank. Less positively, as discussed below, tackling the problem of mortgage arrears and the associated reform of the personal insolvency regime proceeded more slowly than desirable. By end-2013, the two major banks had not been restored to profitability while the third, smaller, bank continued to face an uncertain financial future.[40]

The envisaged fiscal consolidation was achieved. The EDP budget deficit targets and the performance criteria relating to the (adjusted) primary structural deficit and the debt stock were both met as were, in essence, all structural benchmarks.[41] However, mainly reflecting lower growth, the debt/

[38] From early 2013 onwards the question of a subsequent arrangement was discussed extensively. Issues explored included the possible conditionality content of a program and monitoring modalities (these aspects would also have involved the EC). In the end the authorities opted for a "clean exit;" factors such as the improvement in bond spreads and uncertainties as to the extent of partner support for a further arrangement played a role in their decision.

[39] The Fund staff were not involved in earlier exercises (in 2009, March 2010, and September 2010) aimed at determining the true capital needs of the banks. While some observers have pointed to the costs associated with possible "overcapitalization," the general view of the authorities was that, given the limitations associated with the previous estimation exercises, regaining market credibility required, if anything, erring on the high side as regards possible capitalization requirements.

[40] However, the two banks were breaking even on an operational basis, i.e., excluding bad loan provisions.

[41] One structural benchmark (further recapitalization of the banks) was observed with a slight delay owing to the change in government in early 2011, while the initial timing associated with a few other benchmarks was subject to ex ante modification as circumstances evolved.

GDP ratio remained high before starting to fall in 2013.[42] Supporting structural fiscal measures, including the specification of medium-term expenditure ceilings and the establishment of an independent fiscal advisory council, were also implemented.

There was further major progress on all these fronts during the post-program monitoring period. Under Fund policies governing exceptional access, post-program monitoring (PPM), involving twice yearly visits by the Fund staff (together with other troika members) and the issuance of associated staff reports, continued while outstanding Fund credit to Ireland remained above 200 percent of quota.[43] During 2014–15, while PPM has been in effect, the positive macroeconomic trends observed in 2013 continued and strengthened, while additional progress was made on some "unfinished business." Growth rebounded very sharply to average around over 5½ percent annually, while unemployment had dropped to 9.6 percent as of end-2015. The budget deficit, after falling to 4 percent of GDP in 2014, declined further in the following year to under 2 percent of GDP, comfortably below the specified 3 percent EDP limit for 2015. Both mortgage arrears and non-performing loans (NPLs) finally started to decline from 2014 onwards. The two pillar banks returned to profitability in 2014 and their financial position strengthened further in 2015.[44]

Some Issues

Although the program achieved considerable success overall, several important issues arose at various stages. Some of these can be viewed as having broader implications for the design of programs in the context of a currency union and the associated role of the Fund vis-à-vis the troika.

The role of external support in a European context

The extent of external support was a major and at times quite controversial element throughout much of the program period. The banking guarantee of September 2008, which had been introduced to forestall a possible bank run on one or more of the domestic banks, involved the assumption by the state of most of the liabilities of the domestic banking system, including all deposits and senior and junior bonds. This decision seriously complicated subsequent efforts under the program both to restructure the Irish banking system and attain a sustainable debt position for the sovereign. The guarantee, which transferred to the sovereign much of the losses that were later borne by

[42] However, the debt outcome was lower than the original program projections, largely because the actual bank recapitalization cost ended up below that initially allowed for.

[43] Because early repayments to the Fund by Ireland in 2015 were in respect of the initial purchases under the arrangement, the envisaged time period covered by post-program monitoring was not affected.

[44] The government has commenced preparations aimed at beginning divestiture of the state's 99 percent shareholding in the second largest pillar bank.

the banks was a major factor underlying the need for the state to inject some €64 billion (about 40 percent of GDP) into the banking system. It remains a matter of intense debate.

Many felt—and continue to feel—that Irish taxpayers had ended up unfairly bearing most of the costs of imprudent creditor behavior. This view emphasized that the state banking guarantee had been introduced in late 2008 not only had safeguarded Irish banks but also had contributed to sustaining financial confidence within the euro area (and perhaps, by extension beyond). From this perspective, considerations of burden sharing and avoidance of moral hazard (lenders should be penalized for unwise decisions), as well as concerns about debt sustainability and regaining market access for Ireland, called for strong supportive actions by Ireland's external partners. These should have included, in addition to steps to address directly the burden on the Irish sovereign, a comprehensive European-wide plan to address sovereign banking debt linkage issues and help promote confidence and a sustained recovery. The importance—not only for Ireland but for the euro area as a whole—that the program turns out to be a demonstrable success was emphasized.

At the same time, the fact that the ECB had already extended unprecedentedly large financial assistance to the Irish banks by late 2010, as well as the possible systemic implications for the euro area and elsewhere of certain possible alternative courses of action to help lessen the Irish debt burden, was recognized. Addressing—at both Irish and European levels—the complex issues involved in the interaction between these various elements was a central part of the debate surrounding the Irish program, especially after a long period of continued "austerity" (including prior to the program commencing) began to take a domestic political toll.

Dealing with one aspect of the issue, namely, the burden associated with subordinated/junior debt owed by the banks proved to be relatively manageable. Although the original two-year banking guarantee of 2008 covered (dated) subordinated debt, its replacement (at end-September 2010) did not. Hence, under the program the authorities continued to implement a write down of subordinated debt of the two banks that were in resolution (Anglo and Nationwide). They also undertook "liability management exercises" aimed at ensuring a similar outcome for subordinated debt owed by the other pillar banks. These operations achieved considerable savings, of the order of 10 percent of GDP.[45]

The treatment of senior unsecured unguaranteed bondholders raised considerably more difficult issues. The possibility of implementing a write down/private sector involvement (PSI) on this category of debt was explored in discussions between Fund staff and the authorities during October–November

[45] However, subsequent rulings by the U.K. court authorities suggest that payments to some of the bondholders involved could end up being somewhat higher than anticipated originally.

2010. Although the size of the potential savings remained unclear (as did the possible legal and operational mechanisms to be employed, especially in the case of the pillar banks), the authorities came to the view that such an exercise should form part of the program.[46] It was felt that, as a minimum, a write down of the debt owed by the banks in resolution should occur. However, in late November, midway through program negotiations, the authorities were informed by the ECB and EC troika teams that bailing in senior bondholders was no longer an option, at least for the time being, in order for there to be agreement on a program; the Fund team conveyed the same message to the authorities. According to reports published later, this position followed a teleconference (in which the Irish authorities did not participate) that included G-7 Finance Ministers, the IMF Managing Director, and the President of the ECB.[47] The quantitative design of the program was finalized on the assumption of no senior bondholder PSI.

A more limited PSI proposal was again rejected by the ECB in early 2011. Following the change of government, in March 2011, the authorities, who had concluded meanwhile that involving pillar ("going concern") bank bondholders could harm future relationships with counterparts, proposed addressing only bondholders of the two "gone concern" banks. By this stage the amounts involved were relatively small—around €3 billion. However, from the Irish perspective there were important principles at stake that could impinge on the sustainability of the political consensus underpinning the program; by coincidence, the amount of fiscal consolidation planned for the 2012 budget was also €3 billion. This alternative option was again opposed strongly by the ECB on contagion grounds (the ECB also raised issues about the implications for the banks being able to retain their banking license—even the gone concern banks required a banking license in order to continue to receive Eurosystem funding). The ECB indicated that their public support for the latest CBI recapitalization plans for the banks was conditional on there being no mention of senior bondholder involvement. In their letter of intent for the third program review (in May 2011), the Irish authorities stated that they would proceed with any such initiative only in consultation with European partners. The issue does not appear to have been raised subsequently (the final payments to the bondholders concerned were made not long thereafter).

The central issue under debate—both within the Fund and elsewhere—was the possible contagion impact of PSI and its implications. On the one hand, it has been argued (for example, by the IMF's ex post evaluation of the Irish program) that since the senior bonds in question were trading at a substantial discount, markets had already priced in a likely bail in; the

[46] The judgment was that possible legal obstacles (including as regards differentiated treatment of depositors and senior bondholders) were not insurmountable.
[47] See the published accounts in Honohan (2014) and Cardiff (2016) from the Irish side and, from a G-7 perspective, Geithner (2014).

knock on contagion effects in other markets where such discounts were absent would thus be small (IMF, 2015). Furthermore, "firewall" arrangements could and should have been put in place elsewhere in the euro area, including via lender of last resort support, to contain possible adverse contagion fears.[48]

Opinions continue to differ on this issue. As a counter argument to the above, ex ante market discounts prevailing beforehand may not be a reliable guide as to market reactions ex post following the actual occurrence of PSI.[49] Given the uncertainties following such a "regime change," the extent of possible contagion cannot be predicted with confidence; looking back, many among the Irish authorities indicated subsequently that they had not excluded the possibility of some contagion, especially in the case of the pillar banks. The ECB had voiced strong concerns on this score throughout. It was also noted that in spring 2011, euro area financial fragility was at a very high level (sovereign bond spreads were escalating rapidly) and even a limited haircut operation on senior debt could have had, in the ECB's view, unknown and potentially far-reaching consequences. While ideally adequate protective firewall arrangements should or could have been in existence, in reality at the time they were not viewed necessarily as sufficiently robust.[50] Nevertheless, while views continue to differ as regards the appropriateness of the decisions taken, there was general agreement that had the EU Bank Recovery and Resolution Directive (BRRD) agreed in late 2013 been in place at the time, the outcome in Ireland's case would most likely have been different.

A second linked issue was the replacement of the promissory note. In early 2009, the Irish government issued a promissory note (in an amount of €31 billion—about 18 percent of GDP). The promissory note was used to inject capital into the "gone concern" banks (Anglo and Nationwide) and was the means by which the state enabled banks to meet their financial obligations despite their losses. Payments due under the promissory note—which in effect represented the counterpart of the assumption by the state of the banks' obligations—was a particularly sensitive political issue, especially following the failure of the PSI initiative. Throughout 2012, the authorities worked closely with the ECB to explore possible solutions that would be compatible with the ECB's prohibition on the extension of monetary financing to

[48] A range of views on these matters continues to be held by current and former Fund staff involved.

[49] As an analogy, the probabilities assigned by financial market participants to possible losses in other institutions were undoubtedly considerably higher following the Lehman's collapse compared to before the event occurred.

[50] Judging market reactions in advance is a hazardous exercise. As an example, it appears that at the time there was some tendency to downplay the positive market impact of the Promissory Note deal in early 2013 (see below), as it did not have an effect on the outstanding value of the debt in question. However, it was soon recognized that in fact markets had placed considerable weight on the implied improved time profile of Ireland's financing needs and accordingly had reacted very favorably.

governments.[51] The IMF staff highlighted in program review documents the importance of a satisfactory resolution of the issue while the matter was raised by Fund management with high-level European partners on several occasions. In the end, the solution reached in early 2013 vis-à-vis the ECB did not alter the nominal size of the debt in question. However, the market financing needs of the government in coming years were reduced while there were some modest interest savings for the general government budget; the budget could benefit further substantially in outer years. Markets reacted favorably to the agreement, also taking into account the parallel extension of maturities of financing provided by the EFSF.[52]

Other ways of addressing Ireland's debt sustainability came into play at various stages of the program. Subsequent decisions taken in the context of the program with Greece to lower interest rates on EFSF debt (in 2011) and to extend the associated maturities (in 2012—both of which were applied to Ireland) had a significant favorable impact on the debt profile. However, staff, management, and the Executive Board consistently emphasized that enhanced and broader European support was key to achieving more fundamental and lasting success. The need to clarify Ireland's eligibility for the ECB's Outright Monetary Transactions (OMT) program and to put into practice EU leaders' commitment of July 2012 to improve "the sustainability of Ireland's well performing adjustment program" (including possible direct retroactive recapitalization by the European Stability Mechanism (ESM) of Irish banks) were highlighted from mid-2012 onwards (IMF, 2012c, p. 29). Staff reports also analyzed possible arrangements involving external institutions to deal with banks' legacy assets (including the loss making "tracker" mortgages) and improve banks' profitability. The recommendations relating to the specifics of the Irish program met with limited success. However, on a broader level, public statements by Fund management and senior staff frequently highlighted the urgent need for a more comprehensive euro-wide approach to the banking-sovereign debt problem.

Could the Fund have done more to address some of the debt-related obstacles to achieving debt sustainability? The Fund—the Executive Board, management and staff—did not hesitate to identify clearly what was needed by way of greater European support for the Irish program. And in the end, Ireland did succeed, via a combination of steadfast program implementation and the effect of (albeit delayed and partial) European initiatives in regaining market access. Nevertheless, for much of the program period, the prospects for achieving such an outcome were in doubt. Should the Fund have sought to insist on more progress earlier so as to better safeguard the program's

[51] A temporary solution was found with respect to the first payment due in early 2012 which, however, was not possible to replicate.

[52] The agreement was subsequent to the June 29, 2012 announcement by EU leaders to strengthen their commitment to safeguard the euro area and was seen by some as delivering (in Ireland's case) on that commitment.

objectives? The possibility of, for example, requiring agreement on PSI for some senior bondholders or a satisfactory outcome of the promissory note discussions, before completing a program review was discussed internally. However, in the end such an option was not pursued. A confrontation with partners ultimately might not have proved helpful or effective. The general view among the authorities was that the Fund used its influence to a broadly appropriate extent; in any case, they felt strongly that a collapse of the program due to disagreements among troika partners had to be avoided at all costs.

The options available under the program were constrained by Ireland's euro area membership. The constraints on program design arising from the need to seek external support could be viewed as in principle no different from those present in any case of financing assurances. External partners usually face some institutional and legal limitations on their ability to provide the degree of commitment desired. However, membership of the euro area involved particular constraining features. These included: the Irish banks' heavy dependence on euro system financing; perceptions of contagion effects (inevitably involving major judgmental elements as well as differing risk appetites); the fact that some financial sector restructuring measures require close consultation with European partners; and finally, the need for a political consensus at a European level before key systemic actions can be taken. These features impeded—as in most cases where constraints of one sort or another are present—applying what might otherwise have been considered, from a Fund perspective, "first-best" solutions. However, the Fund presumably knew—or should have known—such constraints and taken them into account at the time the arrangement for Ireland was approved. Thus, even as some of the limitations in question began to emerge more visibly, considering a possible interruption of the program on these grounds would likely have been viewed as an unreasonable change in "the rules of the game." Nevertheless, the question of whether the Fund sacrificed an undue amount of its independence in these particular circumstances can be legitimately raised.

Fiscal policy

Overall fiscal consolidation exceeded program targets. The targets for reducing the overall fiscal deficit were surpassed in each of the three program years and the annual quantum of fiscal measures specified at the program's outset was implemented more or less as planned.[53] The fiscal performance criterion (the primary balance adjusted for lower than anticipated revenue that largely reflected weaker growth) was observed throughout. Other favorable

[53] Additional measures of about €0.4 billion were added in the 2012 budget while there was a shortfall of €0.4 billion in the 2013 budget relative to the originally specified amount. Both these adjustments had been agreed with the staff.

developments, in particular net interest savings, led to a somewhat larger than programmed fall in the overall budget deficit.

Should the program's fiscal stance have been tighter? This question was debated at various stages among the staff and vis-à-vis the authorities and troika partners. According to one view (which the EC and ECB—as well as some Fund staff—tended to advocate at times), given the ongoing risks to debt sustainability a faster pace of consolidation than that implied by the EDP targets would have been desirable.[54] This could have been achieved by, for example, placing a cap on the adjustor for revenue shortfalls or increasing the quantum of fiscal measures to ensure that some part of the unanticipated interest savings be used for debt reduction.[55] Counter arguments appealed to the fact that additional consolidation could be difficult to sustain politically, especially since the EDP adjustment path was widely understood and had gained broad public acceptance. Additional fiscal contraction could have been self-defeating, given the weak outlook for growth,[56] while applying interest savings (perceived by many as partial recompense for the absence of burden sharing on senior debt) to debt reduction would also have posed political difficulties. Account also needed to be taken of the major fiscal adjustment prior to the program and the frontloading of measures already envisaged. Irish officials stressed that the authorities' credibility had been significantly enhanced by their ability to deliver on their commitments to sustained fiscal adjustment. In the event, the original deficit reduction path in 2011–13 was retained unaltered. Although by the end of the program the debt ratio did not fall to the extent anticipated, this largely reflected weaker growth and the buildup of a "war chest" of liquid assets after the authorities' partial return to the markets.[57]

Divergent views on the fiscal multipliers underlay some of the debate about the speed of fiscal consolidation. Apart from sustainability aspects, views differed somewhat on the likely size of fiscal multipliers and hence, the negative growth impact of additional consolidation. The openness of the Irish economy suggested that the multiplier was on the low side but its behavior

[54] The Irish Fiscal Advisory Council (IFAC) urged that in view of uncertainties surrounding growth and the potentially high costs associated with any shortfall from the EDP deficit reduction path, the 2013 budget should include additional measures so as to provide a "buffer." In the end, such a buffer arose from the savings associated with the agreement on the promissory note.

[55] However, there were no significant revenue shortfalls under the program so a cap on the revenue adjustor would have had no practical effect.

[56] It should be noted that the discussion of this issue within the Fund was not always in one direction. Some thought was given at one stage to applying fiscal stimulus by reducing the quantum of additional measures relative to the originally programmed amount. However, this option was not pursued, partly because of financing considerations and likely difficulties in obtaining support from troika partners.

[57] Thus, net debt—which was not a variable explicitly targeted under the program—was lower than anticipated.

during the adjustment process was subject to some debate.[58] The publication of research on fiscal multipliers in the Fund's *World Economic Outlook (WEO)* in 2012 led some critics of the authorities' adjustment strategy to argue that the Fund had in general underestimated the adverse effects of fiscal retrenchment on euro area growth. In response, the Fund mission chief for Ireland stated publicly that the multiplier estimate used in designing the Irish program (about 0.5) remained appropriate, a conclusion supported by Irish officials subsequently.[59]

The use of different fiscal anchors could have complicated program implementation but in the case of Ireland in the end did not. Troika partners placed differing emphasis on alternative fiscal variables for monitoring purposes. The Fund staff approach was to concentrate on the Exchequer primary balance, a variable over which the authorities had most control and which was available on a monthly basis.[60] The EC (and, to some extent, the ECB), on the other hand, placed more emphasis on the general government balance expressed as a percent of GDP, the principal EDP-related variable and which was harmonized across the EU. However, the general government balance is on an annual basis and reported by Eurostat about four months after year-end so it could not be used for purposes of Fund conditionality; in addition, using this variable to determine the amount of annual fiscal adjustment required would have risked applying pro-cyclical measures if growth turned out to be weaker.[61] Given strong overall performance under the program, possible inconsistencies associated with alternative fiscal anchors did not arise. However, in other circumstances, these differing approaches to fiscal monitoring, which reflected the Fund's need for operational quarterly review purposes of a high frequency and timely fiscal indicator relative to European partners' emphasis on comprehensiveness and cross-country comparability, might well have given rise to confusion and led to complications.

The Fund staff consistently supported improved targeting of fiscal measures and emphasized the need to protect the most vulnerable. From the outset, the program aimed at better targeting, especially as regards the very large expenditures on social protection. Staff urged means testing of certain

[58] In discussing the composition of adjustment between 2014 and 2015 (the budget for 2014 was a structural benchmark under the program) it was suggested that some back loading might be appropriate as the multiplier would likely be lower at a later stage in the cycle; also the "base level" of adjustment measures would be lower.

[59] However, the staff documents relating to Ireland did not contain analytical material in support of this conclusion.

[60] The target level for this variable was derived using a base ("no policy change") projection, to which was applied the agreed quantum of measures to be taken.

[61] Deriving the general government balance/GDP measure from the Exchequer primary balance involved adjustments for net interest costs, deviations from anticipated costs associated with bank restructuring, several other transactions (including moving from a cash to an accrual basis), as well as the outcome for GDP. The EC was also concerned with the behavior of the structural budget balance which involved additional methodological complexities.

programs and tightening of access criteria for others, while emphasizing the avoidance of poverty and inactivity traps. The authorities indicated that highlighting these issues had proved helpful. It was recognized, however, that the final choice of measures would take into account a number of considerations, including the balance of views among the governing coalition parties and the need to ensure social cohesion and broad public support for the overall adjustment effort. Program review documents noted that the cumulative impact of fiscal measures during 2009–12 was assessed by external analysts as progressive rather than regressive, although equity issues were raised by some measures taken in 2011–12, for example, the introduction, on a temporary basis, of a flat household charge in lieu of a property tax related to value.[62] Overall, however, it appears that a sharp rise in poverty rates was avoided.

Restructuring of the financial sector

The program went a considerable way towards restoring the Irish banks to health. The program's financial sector measures were exceptionally comprehensive and detailed and very substantial progress was achieved. The threats to financial stability were removed as the two major pillar banks were fully capitalized and passed the 2014 European Banking Authority stress tests.[63] The oversized banking system was reduced significantly mainly via deleveraging, while banks' dependence on Eurosystem financing had fallen sharply by the end of the program. Major reforms in bank supervision were introduced, the Central Bank of Ireland was restructured and organized and progress (albeit delayed) was achieved in tackling NPLs and mortgage arrears. The authorities observed that the technical experience of specialized Fund staff in several areas had been a very useful contribution. Some noted that solutions that might work well elsewhere needed to be tailored to take into account some Irish-specific political/social and institutional features, especially as regards repossession and loan resolution procedures.

Despite progress overall the banks remained in a fragile state. As had been largely anticipated, NPLs continued to climb throughout the first two-and-a-half years of the program as did mortgage arrears. The two major banks remained loss making (prior to provisioning) until the second half of

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[62] Staff observed, however, that this analysis, undertaken regularly by the Economic and Social Research Institute (an Irish policy think tank) using a specific model, captured the impact of only a subset of measures.

[63] During 2013, there was considerable discussion as to how to help ensure that the banks were in relatively sound financial shape as the program neared its end. The previous comprehensive Prudential Capital Asset Requirements (PCAR) exercise in 2011 had not been updated in the meantime. The authorities were anxious to avoid possible inconsistencies that could arise between a repeat of the PCAR-type assessment and a similar exercise planned by the European Banking Authority in the second half of 2014. The solution arrived at was to undertake a "point in time" Asset Quality Review (AQR), the main results of which were made available to the Fund's Executive Board prior to the last review of the program. The AQR essentially anticipated the results of the ECB's subsequent AQR.

2013 while the smaller bank, Permanent TSB (PTSB), was not expected to be restored to profitability until 2017. Bank lending fell throughout the program period. However, these negative trends had already bottomed out by the end of the program and during 2014–15 the momentum turned in a significantly positive direction.

Could more have been done under the program to address some of these issues and hasten a recovery in the quality of bank balance sheets? Dealing with mortgage arrears (in particular household arrears) and the related issue of NPLs proved very difficult. For a variety of reasons (including clearly inadequate levels of trained personnel to deal with a problem of an unprecedented scale), the banks were unwilling and/or unable to face up to reality and try to work out solutions with affected clients until well into the program. In addition, some necessary key elements were not under the direct control of the authorities (specifically, passage of bankruptcy/personal insolvency legislation bill and addressing legal obstacles in the foreclosure process—a particularly sensitive subject in Ireland). It was essential that the legislative process, albeit time consuming, be fully respected, as unless laws are well designed and adapted to local practices they will not be effective. An unduly hasty approach, arguably, could have led to the conclusion of arrangements that might not have been in the best long term interest of the taxpayer. During 2013, progress began to be finally achieved via the setting of quantitative targets for the banks by the CBI. It was agreed by staff and the authorities that adoption of a more aggressive stance somewhat earlier may have been desirable. However, given the exceptional breadth and complexity of the financial sector program some prioritization was inevitable with the attendant risk of there being some substantial "unfinished business" at the end of the program.

As in other areas, the search for ideal solutions encountered constraints involving troika partners. Several avenues were explored for accelerating the process of rehabilitating the banks. Against the background of the need to reduce sharply financing from the Eurosystem, the speed of bank deleveraging, via the sale of foreign non-core assets, was a subject of debate and compromise. Various financial engineering schemes to address the "tracker mortgage" problem and improve bank profitability were explored but in the end did not command sufficient support, including at European level. In the case of PTSB, it was argued that in the absence of prospective medium-term viability, the appropriate solution was to move towards resolution. However, such an option, which would leave only two Irish banks in existence, was opposed by the EU Competition Directorate;[64] moreover, staff noted that speedy resolution would have entailed sizable fiscal costs. Nevertheless,

[64] On the other hand, Fund staff argued that the ability of foreign banks to enter the Irish market freely would provide contestability. Some other possible solutions for PTSB would have required additional funding from external sources that was not available at the time.

although various constraints prevented possibly "more optimal" solutions, taking into account the scale of the problem and continued substantial progress in the post-program period, the overall outcome can, in most respects, be regarded as very satisfactory.

Risks to the Fund and the involvement of the Executive Board

Risks to the program were spelled out consistently. Program documentation (both the initial request and review papers) highlighted the range of risks that could threaten the program's success. These included growth disappointments (arising both from weak domestic and global demand and delays in euro area policy initiatives), possible shortfalls in sustaining fiscal consolidation, the impact of the far-reaching financial sector restructuring, and difficulties in restoring market access. Political risks were also spelled out in the request for the arrangement. However, before program approval the main opposition parties provided assurances to Fund management that, if elected to government, they would adhere to the main program objectives, including the fiscal consolidation path. Concerns about the sustainability of domestic political support were also noted by staff in the context of the ongoing debate on debt burden sharing.

Exceptional access by Ireland involved particular financial risks for the Fund. The arrangement represented over 2,300 percent of quota. Availing of exceptional access to the Fund's resources required that four criteria be satisfied. While three of the four criteria did not raise major issues, one of them, the existence of a high probability that the member's public debt is sustainable in the medium term, in the staff's judgment was not met and hence the "systemic exemption" clause was invoked.[65] This clause justified Fund support for Ireland at the level proposed, given the high risk of international systemic spillover effects in the absence of a program.

Detailed justification for availing of the systemic exemption clause to justify exceptional access was provided only at the time of program approval. The staff paper in support of the request for the arrangement contained detailed analysis of potential spillover effects, citing country-specific conditional cross-correlations vis-à-vis Irish sovereign spreads, an increasing joint probability of distress in a set of nine large European banks, and a rising probability of distress in at least one other European bank given distress in the Irish banks. Under Fund policies, continued satisfaction of the criteria governing exceptional access is required throughout the period of an arrangement. However, this aspect was not referred to in the staff papers for the following six reviews. From the seventh review onwards staff reaffirmed explicitly the justification for using the systemic provision, although an updating of the analysis undertaken at the time of the request for the arrangement was not

[65] Some senior Irish officials noted subsequently that they were not fully aware at the time of the agreement on the program of this assessment by the staff.

provided. This issue was not discussed during subsequent Board reviews of the program.[66] From the eighth review onwards, staff stated that a major risk to the program related to the implementation of European-wide policy plans and that exceptional access continued to be justified on the basis of "systemic international spillover risks given euro area fragility" (IMF, 2012d, p. 24; IMF, 2013a, p. 28; IMF, 2013b, p. 25; IMF, 2013c, p. 26). The general use of the systemic exemption clause throughout the program period was subject to considerable debate subsequently and the policy was removed in January 2016, although some flexibility was retained.

The effectiveness of the troika framework

The troika was an efficient structure for interaction among the external partners and vis-à-vis the Irish authorities. The tripartite arrangement involving the IMF, the EC, and the ECB followed the precedent set with Greece in May 2010 (described in the later staff paper on Ireland as "established practice"). Prior to the late summer of 2010 there had been relatively little interaction among the three institutions on Ireland-related matters. The more structured troika framework within which pre-program discussions and subsequent negotiations took place was considered both at the time and in retrospect as an effective way to share information and policy thinking. Given the complexity and comprehensiveness of the program and the constraints on time and resources, this was felt by all parties to have been a major advantage.

However, the arrangement involved considerably more than practical and procedural aspects. The troika framework could also be viewed as an efficient structure to address the "financing assurances" needed to support the program. In more traditional situations, external partners/lenders whose support is required typically are not themselves involved in directly negotiating the program. However, a key feature of the troika was that all three financing partners were party to the negotiations. In particular, the content of each Memorandum of Policies attached to the authorities' letters of request sent to the Fund and the EC had to be agreed with both these institutions. Although no analogous request letter was sent to the ECB, it was generally understood that given the large-scale liquidity it was providing, continued ECB endorsement of the program was also needed. If either of the other two troika partners were not to find the proposed memorandum acceptable, the Fund would have faced difficulties in completing the review, assuming that financing assurances were still required. Thus, although the concept of cross-conditionality was not involved explicitly, endorsement by each member of the troika of the content of the authorities' program was in practice necessary.

Efforts to resolve differences among troika members met with varied results. As discussed above, members of the troika, not surprisingly perhaps, at

[66] However, at the time of the tenth review, one Executive Director noted, without comment, the staff's continued justification for invoking the systemic exemption clause.

times held somewhat different views on important program aspects, including the need for external support (both Ireland-specific and more comprehensive European-wide approaches); the need for and/or advisability of further fiscal consolidation; the speed of deleveraging; and the treatment of PTSB. In some of these areas, either compromises were arrived at (in the case of fiscal policy and deleveraging) or actions were eventually taken (e.g., EU-debt initiatives). All parties were aware of these divergences of view which in part reflected different mandates and institutional or legal constraints. Even in the absence of a troika structure these differences would have had to be resolved somehow.[67]

Nevertheless the troika framework may raise more fundamental issues of an architectural nature. The Irish authorities felt that having the three parties together "in the room" had greatly facilitated the process of reaching a joint agreement. They also considered that the Fund's presence may have promoted a more reasonable compromise outcome on some program aspects. That being said, a question can be raised as to whether the ECB, which, ultimately, is "Ireland's central bank" should not have formed part of the Irish side in the negotiations.[68] Relatedly, the situation whereby the ECB representatives from Frankfurt sat on one side of the table and the Governor of the Central Bank of Ireland, a member of the ECB's Governing Council, sat on the other, could be viewed as somewhat anomalous.[69]

Was the Fund a "junior partner" in the troika? Since it contributed only one-third of the total official financing excluding the ECB, in a financial sense, the Fund was a "junior partner." However, the support of all three troika institutions for the program was required throughout. Equally, if not more important, all parties (including the Irish authorities, other troika members and different stakeholders) were emphatically of the view that the IMF had not been a junior partner in helping design the program. According to senior Irish officials, the Fund team had brought to the table high-quality expertise and a wealth of experience from other countries, a thorough understanding of the economy and a pragmatic approach to searching for solutions appropriate to the particular Irish context. This contribution was considered highly important when differences of view emerged vis-à-vis other troika partners on some important policy matters. However, in the case of one key issue, namely,

[67] The (now retired) IMF staff member with lead responsibility for the IMF's work on Ireland during 2010–13, in recent testimony before the European Parliament criticized the ECB's views on some key issues. He has also observed that Ireland and other crisis countries could have had bailouts with "fewer constraints" if the ECB had not been involved in the troika (*Irish Times*, December 3, 2015).

[68] Consider a situation in a program country where the national central bank has extended major financing to the domestic banks. While addressing this issue would likely be part of any program supported by the Fund, the central bank would clearly sit only on the authorities' side of the table.

[69] It was indicated that under the ECB framework, a number of unspecified "other matters" are the responsibility of the national central bank. Representing the authorities in negotiating with external partners was deemed to fall under this category.

the decision not to seek a restructuring of senior unsecured bondholders, the views of the ECB and the EU prevailed over those of the Fund staff.

Conclusions

The IMF's role in Ireland over the last decade and a half is a drama in two acts. During the first phase (2000–07) the relationship between Ireland and the Fund was based on surveillance at a time when the economy was widely perceived as continuing to turn in a stellar performance. However, the surveillance process failed to identify sufficiently or highlight the deep-seated vulnerabilities underlying the continuing boom, including the emergence of a massive property bubble, the financial fragility of the banks, and a major underlying structural budget deficit. By 2008, as global financial pressures mounted, these weaknesses began to rapidly emerge and the authorities increasingly began to move towards crisis mode. However, the Fund was absent from mid-2007 onwards; the Article IV consultation scheduled for mid-2008 regrettably did not take place as originally planned.

The second phase of Fund involvement started in 2009 when the staff's dialogue with the authorities resumed and intensified. Faced with a steady worsening of domestic economic and financial conditions, in December 2010, the government requested an extended arrangement under the troika framework established earlier for Greece.

The failure of Fund surveillance (both annual Article IV staff reports and the FSAP process) prior to the crisis was due to several interrelated factors. In the first place, staff did not undertake sufficiently comprehensive and rigorous analysis that could have recognized in advance the looming Irish problem and provided policy advice commensurately. Although staff did raise concerns about property market developments and aspects of the banks' financial situation, the overall message, especially in 2006–07, was one of reassurance. Nor were the linkages between the underlying fragile budgetary position performance (in particular, the dependence on property-sector-related revenues) and the macroeconomic impact of a potential collapse in construction explored. Some staff involved at the time have remarked that it was "difficult to imagine" a euro area member such as Ireland, whose economic performance had been praised so lavishly experiencing a disaster on anything like the scale that eventually happened. It was also acknowledged that staff should have looked more closely at the experiences of some other industrial countries (for example, the Nordics) that had undergone financial crises in the not so distant past. What is often said to be an important feature of the Fund staff, namely, its extensive cross-country experience, seemingly was not brought to bear in this case.

"Environmental" factors also played a significant role. Following the establishment of the euro area there appears to have been a sense among at least some Fund staff that potential criticism of individual countries' macroeconomic or financial performance should be tempered by the view that the euro area authorities were regarded as being in the "front line" when it came to addressing some issues. Coupled with staff downsizing and restructuring of the European Department this view tended to imply that smaller countries were given a lower priority. Many consultations (although not with Ireland) were moved to a 24-month consultation cycle, while several took place under "streamlined" procedures. Some staff recalled Fund management wondering at one stage whether consultations were actually needed with some euro area members.

These shifts impacted significantly surveillance of Ireland. The postponement of the 2008 consultation with Ireland (by all accounts not at the initiative of the authorities) was regrettable. Staff originally assigned to Ireland were redeployed to work on systemically more important countries, some of which were experiencing financial stress. During a critical two-year period (mid-2007–early 2009) in Ireland's economic fortunes, the Fund was entirely absent; there was no substantive contact between the staff and the authorities.

Neither was the prevailing climate within Ireland conducive to a more robust dialogue. Both staff and the authorities acknowledge that the Irish side would not have willingly countenanced any explicit consideration of more adverse downside scenarios than the "soft landing" hypothesis. This was consonant with the general political, market, and media view in Ireland at the time that any hint at a risk of a widespread crash to come was unfounded and irresponsible. The authorities firmly believed, as late as 2009, that, in light of their impressive track record, they could handle any problems that might arise themselves. It is striking that at no stage during the tumultuous events surrounding the September 2008 granting of the state banking guarantee decision did the authorities seek Fund advice (nor were any contacts initiated by the staff). Thus, for whatever reasons, the Fund's role as a potential "trusted advisor" in times of difficulty did not feature in this case. Undoubtedly, this had a, perhaps subconscious, impact as to how far the Fund staff might have been willing to go in querying the prevailing wisdom in Dublin at the time.

Nevertheless, once the severity of Ireland's problems became apparent the nature and depth of the dialogue quickly shifted to a more proactive stance. From early 2009 onwards, the staff engagement stepped up. The 2009 and 2010 consultation reports contained a much more extensive analysis of the mounting difficulties and offered advice as to the most appropriate policy responses. The deepening dialogue served to build up relationships of trust and confidence that were to help significantly at the later negotiating stage. During this period, on two occasions the staff raised the possibility of Ireland requesting some form of precautionary arrangement to help provide some protection against increasing global financial turbulence. However, the authorities, fearful of the impact of any hint of Fund involvement on market and public sentiment and, quite possibly, cognizant of the broader costs of a perceived policy failure, chose not to pursue such an avenue. This reluctance highlights a general issue. Once market sentiment becomes a factor, the involvement of the Fund, even in a precautionary or supporting role, may be viewed as exacerbating, rather than alleviating, financial pressures.

The program eventually negotiated in late 2010 in the face of severe external pressures rightly focused on the root causes of the Irish crisis. Addressing the enormous problems facing banks was the centerpiece of the program, supported by continued fiscal consolidation. Fund conditionality was not applied to other structural aspects, which were not central to overall program objectives (although this may to some extent have been lost on the general public). The high degree of program ownership by the authorities throughout was key and extensive outreach to stakeholders also helped. The authorities subsequently gave high praise to the Fund staff involved for their technical expertise, their understanding of the Irish situation, including the political constraints present, and their readiness to seek pragmatic solutions to achieve overall program objectives. On the Fund's side the risks to the program at various stages were outlined clearly by the staff.

Judged by the yardstick of experiences elsewhere, the program achieved very considerable success. By the end of the program, the banking system was in a much healthier state and incipient threats to macro-financial stability had been removed, while fiscal consolidation targets were met or exceeded. These achievements, aided by an eventual improvement in the external environment in Europe and elsewhere as well as the underlying structural strengths of the Irish economy, helped restore confidence. Growth picked up significantly from 2013 onwards and unemployment declined steadily while bond yields fell sharply and Ireland was able to return to the market. This economic and financial turnaround occurred in the absence of major domestic social unrest, despite the extended period of harsh adjustments in living standards. After weighing up carefully various considerations, the Irish authorities concluded that a "clean exit" from the program at end-2013 was appropriate. As of March 2016, following renewed market borrowing by Ireland, all but the equivalent of 109 percent of quota of the amounts outstanding to the Fund had been repaid.

There was nevertheless continued debate as to the content and timeframe of some key measures. At various stages, a number of issues arose, including, within the staff, whether the speed of fiscal adjustment should be accelerated, the appropriate strategy and timetable for dealing with mortgage arrears and non-performing loans and the treatment of the third, smaller bank, PTSB. Staying with the degree of fiscal consolidation specified at the outset of the program was adjudged by both the authorities and the Fund to be the right course, given continued weak growth, the credibility that had been hard won by the authorities and the risk that calling for additional measures might undermine the political consensus underlying the overall strategy. The mortgage arrears issue could have been addressed more forcefully at a somewhat earlier stage. However, this required the prior passage of major new legislation and the buildup of sufficient skilled resources by the banks to deal with an unprecedentedly large problem; arguably an unduly hasty approach at a time when the economy remained very weak might have led to restructuring arrangements that were not in the best public interest. Finally, while there was a case for moving to resolve PTSB, the "wait and see" approach adopted in practice by the staff also had merit. Crucially, the approaches adopted in the above areas did not affect realization of the program's overall objectives. This suggests the importance of selectivity in deciding the key issues for program conditionality to focus upon. It is noteworthy that substantial progress on these outstanding matters continued to occur in 2014–15 on the basis of the framework established during the program.

The issue of whether or not private sector bondholders could or should have been bailed in continues to provoke major controversy. Although the possibility of applying PSI to senior bondholders had been explored actively with the authorities, in the end, faced with strong opposition by the ECB and the EC, the Fund concluded that such an initiative could not be included as part of the program. In March 2011, a more limited proposal, supported by the Fund staff, to apply only to the two "gone concern" banks, was again rejected by the ECB. Advocates of imposing haircuts cite moral hazard, burden sharing considerations, and the need to contain fiscal costs, while arguing that contagion effects would not occur as the bonds in question were already trading at a significant discount; moreover, to the extent there might be some contagion, it was the responsibility of the euro area as a whole, not Ireland, to put in place appropriate arrangements to limit the adverse impact. Those opposed emphasized that actual implementation of haircuts would represent a major regime change that could significantly affect default probabilities on other instruments and hence the broader market in bank funding. All euro area members, it has been argued, had a common responsibility to try to avoid such an outcome, especially since in reality adequate firewall arrangements were not perceived as having been in place at the time.

Reasonable people can differ as to the relative merits of the above arguments. Given the counterfactual and speculative nature of what might have happened in the wake of a bail in operation, it is difficult to be definitive as to what was the best course of action at the time. Risk appetites in a highly volatile situation may differ depending on institutions' responsibilities and perspectives. In the end, the Irish authorities concluded that given European partner views the possible costs of pursuing the PSI option would likely outweigh the benefits. There is general agreement, however, that if the European-wide Bank Recovery and Resolution Directive (BRRD) and related measures had been in place in November 2010, the outcome in Ireland's case could have been quite different.

The broader issue of the external support needed to help achieve debt sustainability and to regain market access by Ireland was a continuing concern. Apart from PSI, the treatment of the promissory note and related schemes for improving the quality of the Irish banks' balance sheets were studied intensively; Fund management engaged in high-level contacts with European partners on the promissory note issue. Fund management and staff also called continuously for broader European-wide initiatives to restore banking confidence. These initiatives bore considerable fruit in the end although for much of the period the prospects for Ireland attaining debt sustainability were in considerable doubt. Despite the uncertainties and associated fragilities, there was, rightly, little support for the Fund taking a more interventionist stance by, for example, requiring progress on some issues before completing a review. Arguably, the constraints surrounding European partner support should have been well recognized at the time the arrangement was approved. The Irish authorities were strongly of the view that any initiative that might have led to open dissent among the troika would have been counterproductive and seriously undermined their hard won gains.

The troika framework was effective in an operational sense but raised some important "architectural" issues. Given the prevailing circumstances there was general agreement that the troika structure was an effective framework to address issues of common concern. Good working and personal relationships prevailed among troika staff despite some significant differences of view at times. However, several issues deserve consideration. First, given the ECB's key role in providing financing to the Irish banks, it was essential for it to be closely involved in the process. That being said, the question of "which (if any) side of the table the ECB should sit on" can be raised, given that the ECB, ultimately, is Ireland's central bank. Second, was the Fund a "junior partner" among the troika? Although the Fund contributed less than one-third of official program financing, in practice agreement by all three troika members to continue to support the program was required. Moreover, there is general agreement that reflecting its background and expertise, the Fund staff took the leading role in helping design critical elements of the program. It was suggested that whatever new and different arrangements might conceivably replace the troika structure in the future this key contribution of the Fund in this area should not be lost.

Finally, did the Fund "compromise its independence" by engaging in the troika lending framework, particularly as regards the question of debt burden sharing? The Fund's lending decisions should be independent and, in the first instance, be based on what is in the best interests of the member. In the end, the Irish authorities concluded that they did not wish to engage in a confrontation with other external partners on the debt issue. However, a broader question is raised. According to Fund policies, Fund-supported programs should avoid recourse to "measures destructive of national or international prosperity." In a case such as that of Ireland, where fears of contagion were openly expressed, inconsistencies could well have arisen between what may have been in the best interest of the member and considerations of systemic financial stability.

In the end, the program with Ireland was largely successful, partly reflecting some features specific to Irish circumstances. Nevertheless, this might not have ended up being the case, given the fragilities and uncertainties present, including the particular constraints associated with Ireland's membership of the euro area. The Irish experience with the troika lending framework—and some of the issues it gave rise to—suggest that notwithstanding the favorable outcome, a comprehensive review of the legal, institutional and economic aspects associated with the Fund's lending to a common currency area such as the euro area is warranted.

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CHAPTER 9

The Portuguese Crisis and the IMF

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AND CARLOS DE RESENDE

Introduction

In May 2011, Portugal entered a three-year arrangement with the IMF under the Extended Fund Facility (EFF). The EFF-supported adjustment program was designed, implemented, and funded by the IMF, in close cooperation with the European Central Bank (ECB) and the European Commission (EC), with the European portion of the funding coming from the European Financial Stability Facility (EFSF) and the European Financial Stabilization Mechanism (EFSM). The IMF, the ECB, and the EC came to be collectively known as the troika.

This chapter evaluates the IMF's role in the program, including the surveillance of the Portuguese economy that preceded it. The chapter is structured as follows. The second section briefly describes the performance of the Portuguese economy prior to the program, and the third section assesses the IMF's pre-program surveillance. The fourth section describes the program's design and implementation, and the fifth section evaluates the Fund's contributions to the program. The sixth section discusses whether the troika structure posed a problem in program design and implementation. The final section concludes, summarizing the key lessons for IMF surveillance and program design.

Our analysis and conclusions are primarily based on publicly available data, including IMF staff reports. We also incorporate insights obtained from: (i) a survey of Portuguese economists conducted by the IEO; (ii) interviews with staff of the IMF, ECB, and EC, IMF Executive Directors, Portuguese authorities involved in the program, and Portuguese economists; and (iii) internal IMF documents, many of which are not available to the public.

Unless stated otherwise, we use the most recent version of the data available. Because the data have been subject to revisions, they may differ from what was available to IMF staff at the time of their analysis.

Background to the Crisis

How did the Portuguese economy perform in the years leading up to the 2011 program? We consider three time periods: 1995–2000, 2000–07, and

2007–11. The first of these coincided with the run-up to and immediate aftermath of the creation of the euro and was marked by fast growth; the second saw a sharp deterioration in Portugal's economic performance; and the third was characterized by the global financial crisis and the euro area sovereign-debt crisis.

1995–2000: The Run-Up to the Euro

During these five years Portugal enjoyed high real GDP growth, an investment boom, and a substantial decline in borrowing costs. At the same time, its trade and current account deficits were rapidly deteriorating. The domestic banking sector intermediated the required borrowing by seeking wholesale funding from foreign banks. Since the ratio of government debt to GDP was stable during this period, the increase in external deficits was fueled by the private rather than the public sector.

High real GDP growth

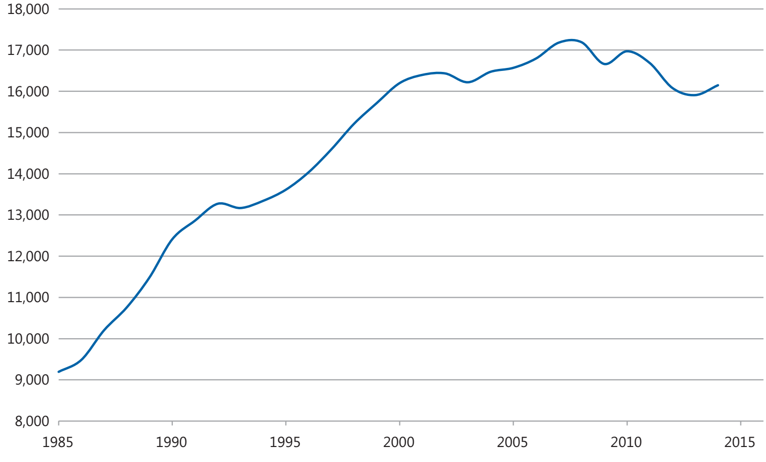
Portugal's per capita real GDP grew by nearly 3 percent in this period (Table 9.1, Figure 9.1), led by nontradable goods and services: utilities, transport, and wholesale and retail trade (Table 9.2).

Table 9.1. Portugal: Average Annual Growth Rate of Real Per Capita GDP
(In percent)

1974–86	1986–95	1995–2000	2000–07	2007–11	2011–15
1.8	3.7	2.9	0.7	–0.6	–0.4

Source: IMF, *WEO* (October 2015).

Figure 9.1. Portugal: Real Per Capita GDP
(In billions of euros)



Source: IMF, *WEO* (October 2015).

Table 9.2. Portugal: Average Annual Growth Rate of Real Sectoral Output
(In percent)

	Agriculture, Forestry, and Fishing	Industry	Energy, Water Supply and Sewage	Construction	Wholesale and Retail Trade, Repair of Motor Vehicles and Motorcycles, Accommodation and Food Service Activities	Transportation and Storage, Information and Communication	Financial Insurance and Real Estate Activities
1995–2000	−1.1	3.8	4.9	3.8	4.0	4.2	2.6
2000–07	−0.3	0.3	1.9	−1.8	0.5	3.4	2.7
2007–11	0.3	−1.4	0.2	−5.7	0.4	0.5	1.3
20011–14	1.2	−0.3	−2.9	−6.1	1.0	−1.3	−2.2

Source: Instituto Nacional de Estatística, National Income Accounts.

Table 9.3. Portugal: Average Annual Growth Rate of Real GDP and Expenditure Components
(In percent)

	GDP	Private Consumption	Private Durable Goods Consumption	Public Consumption	Residential Investment	Nonresidential Investment
1995–2000	3.4	3.4	7.0	3.3	5.5	7.2
2000–07	1.0	1.2	−1.5	1.7	−4.5	0.6
2007–11	−0.6	−0.5	−5.0	−0.4	−10.0	−3.3
2011–14	−1.1	−1.2	−2.5	−1.4	−7.8	−4.3

Source: Instituto Nacional de Estatística, National Income Accounts.

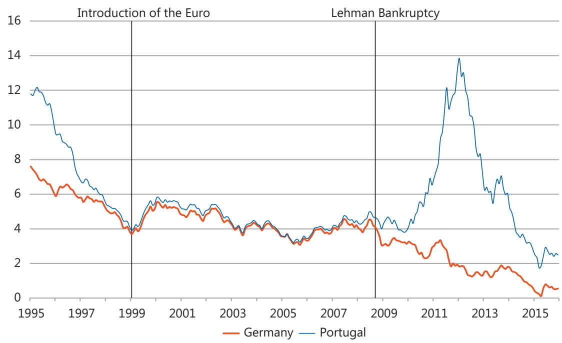
Private consumption and investment boom

Consumption of durable goods, and residential and non-residential investment, all grew faster than overall economic activity (Table 9.3). The first two types of spending did not add to Portugal's export capacity, a point to which we return below. Car ownership rose rapidly; the annual growth rate in an index of passenger vehicles (1995=100) exceeded 7 percent in much of the five-year period. The number of new homes built increased by 64 percent over the period. In sharp contrast to Spain and Ireland, there was no pronounced rise in Portuguese house prices.

Sharp reduction in borrowing costs

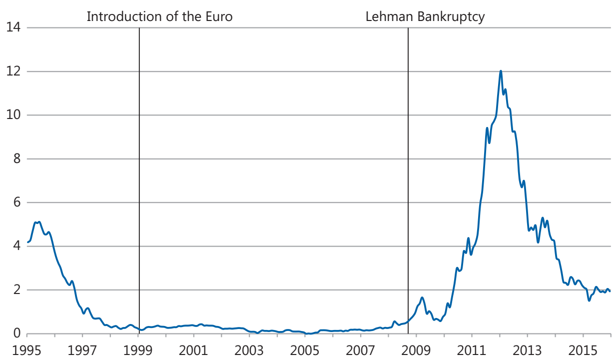
Both the private and the public sector experienced a steep reduction in borrowing costs, in line with the broader European trend during this period. Yields on ten-year government bonds fell from 11.5 percent in 1995 to 5.6 percent in 2000 (Figure 9.2), and the spread between the yields on Portuguese and German 10-year government bonds declined from a peak value of 5.1 percent in June 1995 to 0.3 percent in 2000 (Figure 9.3).

Figure 9.2. Yields on Ten-Year Portuguese and German Bonds
(In percent)



Source: Eurostat.

Figure 9.3. Spread Between Ten-Year Portuguese and German Government Bonds
(Basis points)



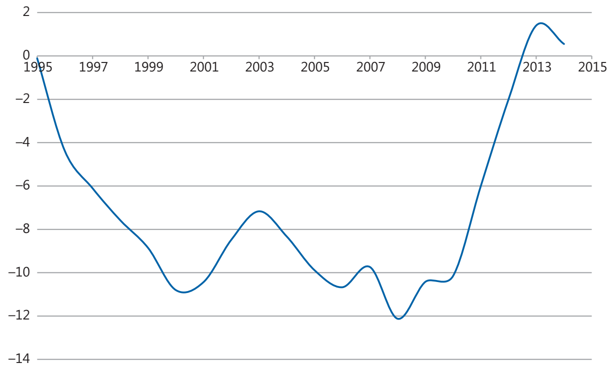
Source: Eurostat.

Rising trade and current account deficits

Portugal's current account deficit deteriorated sharply during the period, rising from roughly 0.1 percent of GDP in 1995 to 10.8 percent of GDP in 2000 (Figure 9.4). The trade deficit increased from 6.4 percent of GDP to 11 percent (Figure 9.5). The change in the trade deficit overwhelmingly reflected a large rise in imports, which rose as a percentage of GDP from 33.1 in 1995 to 39.2 in 2000. In contrast, exports were quite stable, remaining roughly at 27 percent of GDP over the period (Figure 9.6). Portuguese exports also remained stable as a percentage of the GDP of countries to which Portugal was exporting (Figure 9.7).

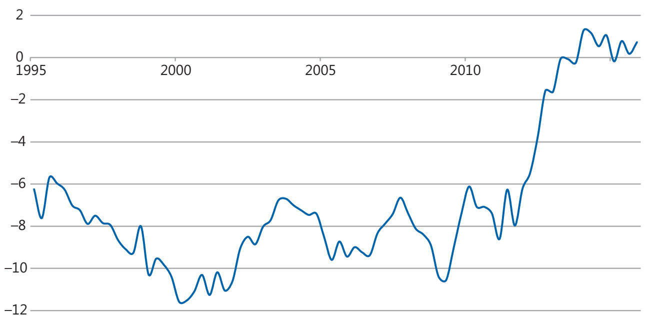
A different way to understand the deterioration in Portugal's trade deficit is to consider the savings gaps in different sectors of the economy. By savings gap we mean the difference between savings and investment expressed as a

Figure 9.4. Portugal: Current Account
(In percent of GDP)



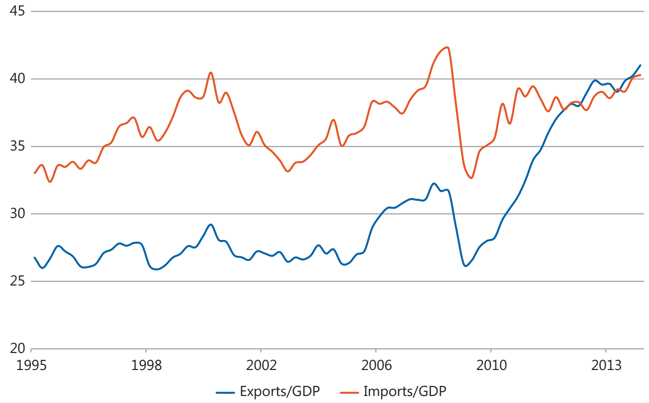
Source: IMF, *WEO* (October 2015).

Figure 9.5. Portugal: Trade Balance
(In percent of GDP)



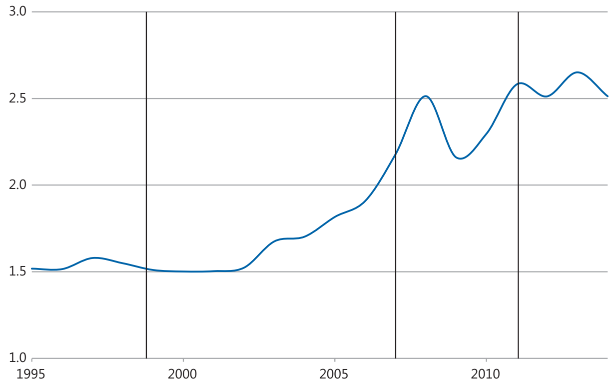
Source: IMF, *WEO* (October 2015).

Figure 9.6. Portugal: Imports and Exports
(In percent of GDP)



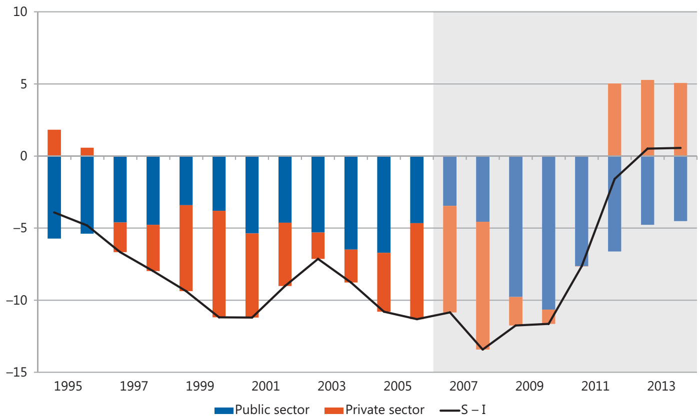
Source: Instituto Nacional de Estatfstica, National Income Accounts.

Figure 9.7. Portugal: Exports of Goods as Percent of GDP of Trade Partners



Source: Authors' calculations using data from UNCTAD.

Figure 9.8. Portugal: Public and Private Sector Savings Minus Investment
(In percent of GDP)

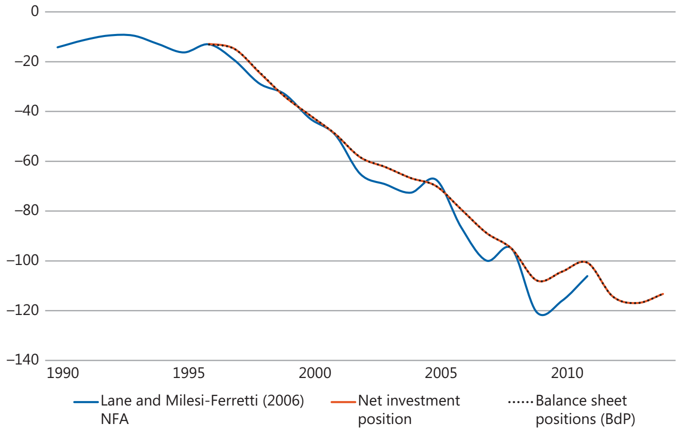


Source: IMF, *WEO* (October 2015).

percentage of GDP. In 1995, the trade deficit was entirely due to the savings gap in the public sector (Figure 9.8). But the sharp deterioration of the trade deficit that ensued was due entirely to a fall in private sector savings. The public sector savings gap actually improved during this period. We infer that Portugal's growing external imbalances were being driven by private rather than public sector behavior.

As a consequence of the deteriorating current account deficit, Portugal saw its net foreign assets decline from –16.3 percent of GDP in 1995 to roughly –43 percent in 2000 (Figure 9.9). A similar decline took place in Portugal's international investment position—that is, the consolidated (net) balance sheet positions of Portuguese households, corporations, and government vis-à-vis the foreign economy.

Figure 9.9. Portugal: Net Foreign Assets and International Investment Position
(In percent of GDP)



Sources: Updated version of Lane and Milesi-Ferretti's (2007) data set; Banco de Portugal; and IMF, *WEO* (October 2015).

Expansion of credit by domestic banks and reliance on wholesale funding

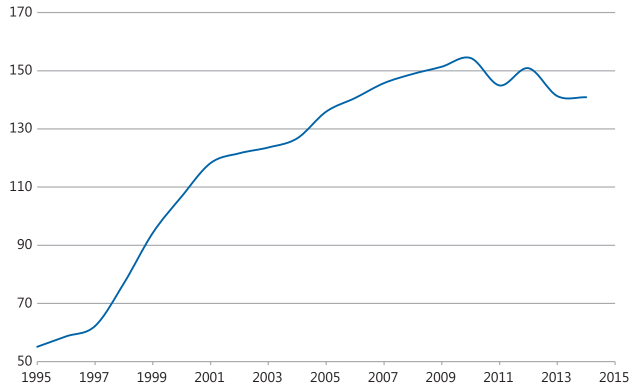
The widening of the private sector savings gap was financed by an explosion of borrowing. Household debt as a fraction of disposable income rose from 55 percent in 1995 to 107 percent in 2000 (Figure 9.10), and mostly took the form of mortgages. The rise in private debt was not confined to households: the consolidated debt of nonfinancial corporations rose from 59 percent of GDP in 1995 to 84 percent in the last quarter of 2000 (Figure 9.11).

In contrast to private sector debt, public sector debt did not increase substantially during the 1995–2000 period; indeed, the average overall government deficit declined from 6.8 percent of GDP in 1990–95 to 4 percent in 1995–2000. Granted, most of this decline reflected a fall in government bond yields rather than an improvement in the primary deficit. The latter actually deteriorated from an average surplus of 0.4 percent of GDP in 1990–95 to 1.3 percent in 1995–2000. Nevertheless, the combination of the lower government deficit and the relatively high growth rate of the economy reduced gross government debt from 56.5 percent of GDP in 1990 to 47.9 percent in 2000 (Figure 9.12).

The explosion of borrowing by the private sector was financed by domestic banks, which became increasingly dependent on external wholesale funding. The loan-to-deposit ratio rose from an average of 86 percent in 1997 to 105 percent in 2000 (Figure 9.13).[1]

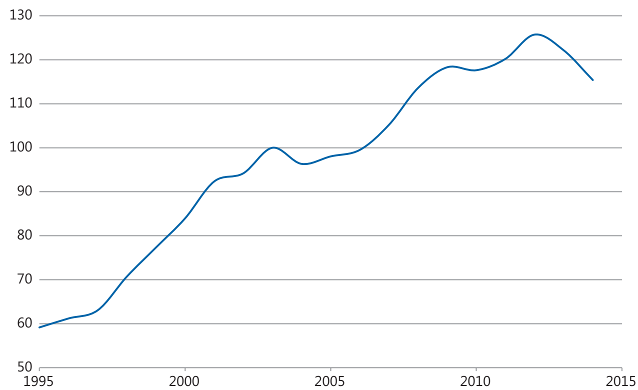
[1] Data for the loan-to-deposit ratio are not available before September 1997.

Figure 9.10. Portugal: Household Debt as Share of Disposable Income
(In percent)



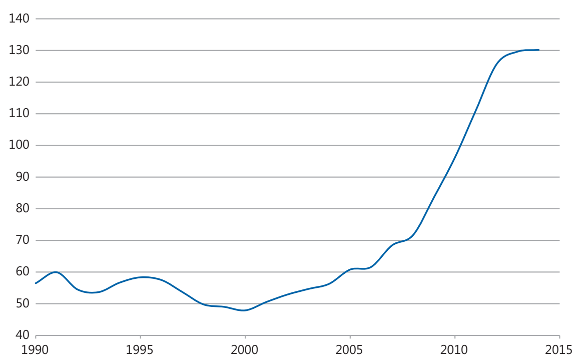
Source: OECD.

Figure 9.11. Portugal: Consolidated Debt of Nonfinancial Corporations
(In percent of GDP)



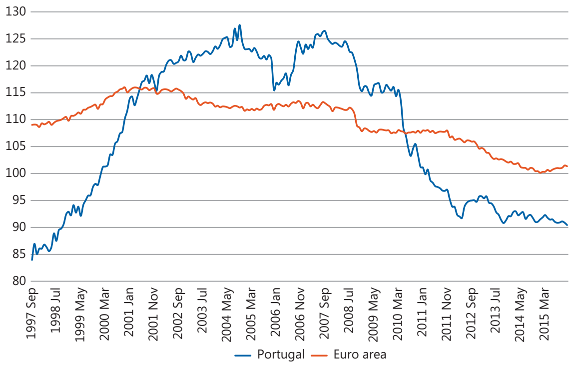
Sources: Bank of Portugal and IMF, *WEO* (October, 2015).

Figure 9.12. Portugal: Government Debt
(In percent of GDP)



Source: *IMF*, WEO (October 2015).

Figure 9.13. Portugal: Loan-to-Deposit Ratio



Source: ECB.

2000–07: The Great Slowdown

In this seven-year period Portugal's economic performance sharply deteriorated. The great slowdown was marked by six key features: low growth, a decline in investment, ongoing large trade and current account deficits, a rise in the government deficit, continued low interest rates, and continued reliance on wholesale funding by the banking sector.

Low growth

Though it was part of a general slowdown in the developed world, the decline in Portuguese growth was particularly large (Table 9.4).[2] The average growth rate of Portugal's real per capita GDP slowed to 0.7 percent in 2000–07 (Table 9.1). The slowdown was most marked in industry, particularly in the construction sector. The average annual growth rate of Portugal's industrial output declined from 3.8 percent in 1995–2000 to 0.3 percent in 2000–07, while construction output, which had grown at an average annual growth rate of 3.8 percent in 1995–2000, contracted at 1.8 percent in 2000–07.

Despite the slowdown in growth, both the private and the public sectors continued to borrow. The net results were large current account and government deficits. Household debt as a percentage of disposable income and corporate debt as a fraction of GDP rose between 2000 and 2007 (Figures 9.10 and 9.11). The former rose from 107 percent to 146 percent, and the latter from about 84 percent to 105 percent.

Weak investment

After its rapid growth in the preceding five years, residential investment declined in real terms at an average annual rate of 4.5 percent (Table 9.3).

[2] See Reis (2013) for an interesting analysis of this period.

Table 9.4. Selected Countries: Average Annual Growth Rate of Real Per Capita GDP
(In percent)

	1995–2000	2000–07	Difference
Austria	2.4	1.5	–0.9
Belgium	2.2	1.4	–0.9
Finland	4.0	2.5	–1.5
France	2.1	1.0	–1.1
Germany	1.5	1.2	–0.3
Greece	2.7	3.3	0.6
Ireland	7.4	2.9	–4.5
Italy	1.6	0.7	–0.9
Portugal	2.9	0.7	–2.2
Spain	3.0	1.6	–1.4
Sweden	2.9	2.2	–0.7
United Kingdom	2.3	2.1	–0.3
United States	2.6	1.3	–1.3

Source: IMF, WEO, October 2015.

While nonresidential investment grew at roughly the same rate as GDP, total investment as percentage of GDP fell from roughly 29 percent to about 23 percent (Figure 9.15).

Ongoing large trade and current account deficits

Despite the slowdown in overall growth, Portugal continued to run large trade deficits, averaging 8.7 percent of GDP (Figure 9.5). There are no marked trends in the ratio of exports and imports to GDP over the 2000–07 period (Figure 9.6). Still, there were interesting patterns in the behavior of both exports and imports. Imports as a percentage of GDP fell from 2000 to 2003. This decline reflects a sharp drop in the growth rate of real GDP during that time period. As the growth rate of real GDP recovered, the ratio of imports to real GDP returned to its 2000 level. The ratio of exports to GDP dropped from 29 percent in 2000 to a trough of 26 percent in 2005. Thereafter, the ratio began a strong recovery, reaching 31 percent by the end of 2007.[3]

Consistent with Portugal's large trade deficits during this period, the current account deficit averaged 9.4 percent of GDP between 2000 and 2007 (Figure 9.4). The ratio of net foreign liabilities to GDP increased from 43 percent in 2000 to about 100 percent of GDP in 2007 (see Figure 9.9).[4]

[3] An important driver of these dynamics was the product cycle at VW's Autoeuropa plant. The initial decline in the ratio of exports to GDP reflected the end of a product cycle at that plant. New investments and the introduction of a new product cycle led to a rise in production and exports that began in 2005. See *OECD Economic Surveys: Portugal* (2008).

[4] By comparison, according to Lane and Milesi-Ferretti (2007) the analogous 2007 numbers for Spain and Greece are 84 percent and 104 percent.

This extraordinary rise left Portugal vulnerable to a sudden stop in capital inflows.

Ongoing fiscal deficits

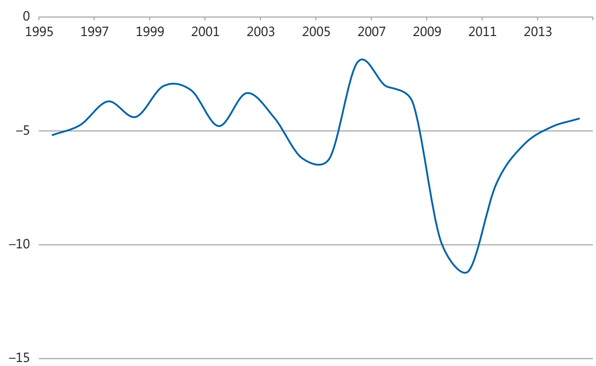
The government did not adapt fiscal policy to the new slow-growth environment, and general government gross debt as a percentage of GDP rose from 47.9 in 2000 to 68.4 in 2007 (Figure 9.12). To understand the source of this increase, note that the instantaneous change in the debt to GDP ratio is given by:

$$d(B/Y)/dt = D/Y + (B/Y)(R\text{-}g)$$

where *B, Y, D, R*, and *g* denote the nominal government debt, nominal GDP, the nominal government deficit, the nominal yield on government debt, and the growth rate of nominal GDP, respectively. This formula shows that a rise in the debt to GDP ratio can result from two forces. The first is the government deficit as a percentage of GDP, *D/Y*. The second is a nominal yield on government debt that exceeds the growth rate of nominal GDP, *(B/Y)(R-g)*.

In 2000–07, the primary driver of the increase in Portugal's debt to GDP ratio was an average annual deficit equal to 4.1 percent of GDP (Figure 9.14).[5] This ratio was roughly the same as in 1995–2000. The difference between the two periods is that *R-g* was higher in the later period. The rise of *R-g* occurred primarily because of a large drop in the growth rate of nominal GDP, from 7.7 to 4.9 percent. It is clear that the government did not adapt fiscal policy to the new slow growth environment.

Figure 9.14. Portugal: General Government Balance
(In percent of GDP)



Source: *IMF*, WEO (October 2015).

[5] In our view, the official government deficit figures understate the structural imbalances in public finances because the government used one-off measures to raise revenue. These measures included a tax amnesty in 2002, the transfer of the postal pension fund in 2003, the transfer of the state enterprises' pension funds in 2004, and sales of assets.

Continued public and private borrowing

Despite the increases in public and private debt, both the government and the private sector continued to be able to borrow at low interest rates. The average yield on a ten-year government bond in this period was 4.5 percent, down from 5.6 percent in 2000 (Figure 9.2). The average spread in 2000–07 between a Portuguese and German ten-year government bond was only 20 basis points (Figure 9.3).

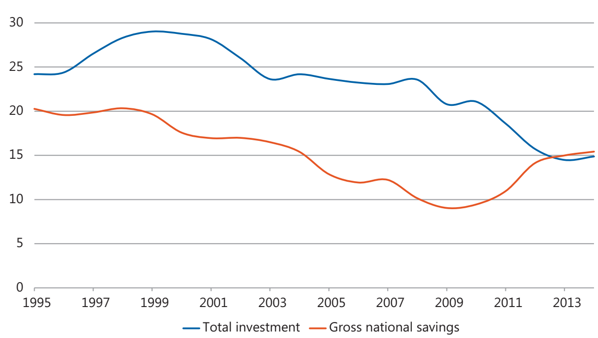
The low interest-rate spreads may have reflected lenders' optimism about growth prospects, a surplus of savings in the current account surplus countries of Europe, and/or optimism about the possibility of a bailout in the event of a Portuguese default. In evaluating the importance of these factors, it is useful to keep in mind the standard national income accounts identity:

$$\text{Current account} = \text{national savings} - \text{national investment.}$$

As noted above, Portugal's current account markedly deteriorated during the 2000–07 period relative to the 1995–2000 period. To interpret this deterioration, note that both investment and savings as a percentage of GDP were lower in 2000–07 than in 1995–2000 (Figure 9.15). But savings clearly fell by more than investment. Perhaps savings declined because the Portuguese were optimistic about the future. In this scenario we would expect interest rates on Portuguese debt to have increased, whereas they actually fell (Figure 9.2).

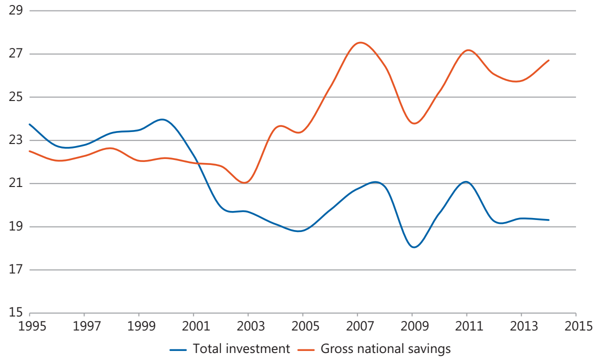
The fall in interest rates suggests that there was a rise in the supply of funds to Portugal. This hypothesis is consistent with the increase in savings and the decline in investment that occurred in Germany during this period (Figure 9.16). The net increase in the supply of German funds is likely to have affected all of the European periphery countries. Figure 9.17 displays Germany's current account surplus as a percentage of German GDP, along

Figure 9.15. Portugal: Savings and Investment
(In percent of GDP)



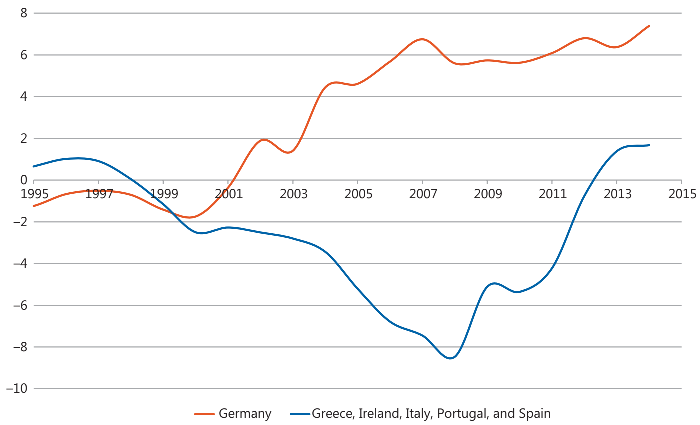
Source: *IMF*, WEO (October 2015).

Figure 9.16. Germany: Savings and Investment
(In percent of GDP)



Source: *IMF*, WEO (October 2015).

Figure 9.17. Selected Countries: Current Account
(In percent of Germany's GDP)



Source: *IMF*, WEO (October 2015).

with the combined current account deficits of Italy, Spain, Portugal, Greece, and Ireland as percentages of German GDP. Strikingly, the two lines mirror one another. This pattern lends credence to the view that the deterioration in Portugal's current account was fueled in part by an increase in German savings.

Continued reliance on wholesale funding

During the 2000–07 period, Portuguese banks continued to fund domestic loans by borrowing abroad. As a result, the loan-to-deposit ratio of Portuguese banks rose from 85.5 percent in the second half of 1997 to 124.8 percent in 2007 (Figure 9.13).

2007–11: The Global Financial Crisis and the Run-Up to the 2011 EFF-Supported Program

The global financial crisis began in the United States but quickly led to a global recession. The downturn had a powerful impact on the Portuguese economy: real GDP growth, which was 2.5 percent in 2007, fell to 0.2 percent in 2008 and to –3.0 percent in 2009, before recovering to 1.9 percent in 2010. The trade deficit widened from 7.6 percent of GDP in 2007 to 9.7 percent in 2008, before recovering to 7.6 percent in 2010 (Figure 9.5). The current account deficit widened from 9.7 percent of GDP in 2007 to 10.2 percent in 2010, after reaching 12.1 percent in 2008 (Figure 9.4). The result was an increase in net foreign liabilities to roughly 116 percent of GDP (Figure 9.9). The government deficit increased dramatically during this period, rising from 3.4 percent of GDP in 2007–08 to 10.5 percent in 2009–10 (Figure 9.15).[6]

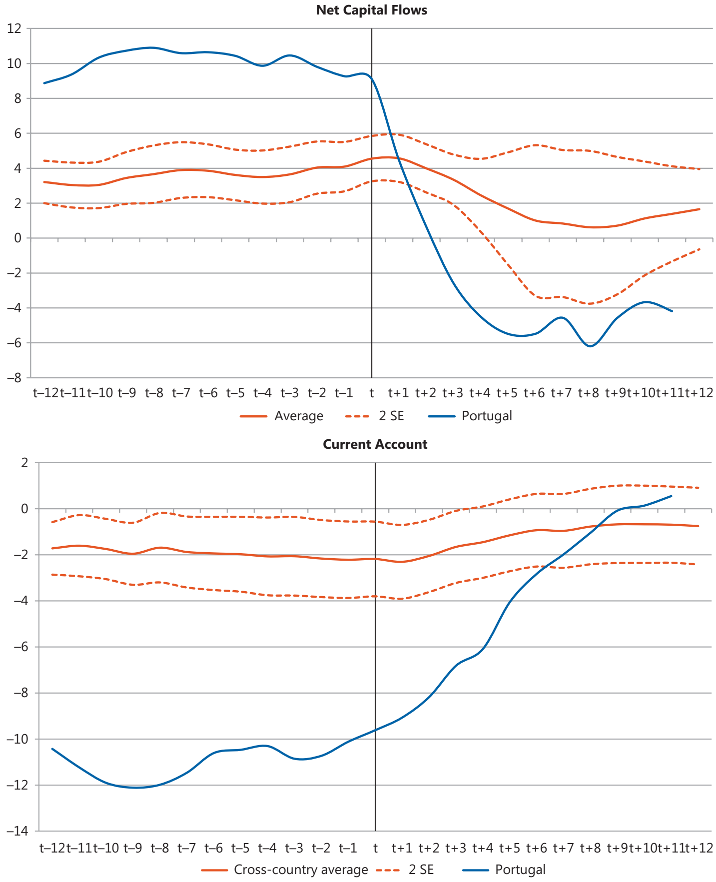
The era of low interest rates on Portuguese debt ended during this period (Figure 9.2). In reaction to the U.S. financial crisis, spreads on sovereign debt of European periphery countries and emerging markets rose, peaking in the first quarter of 2009. Consistent with this pattern, the spread between German and Portuguese ten-year government bonds rose from 26 basis points at the end of 2007 to 166 basis points in March 2009 (Figure 9.3).

The Greek crisis began in October 2009, when the newly elected government raised the fiscal deficit estimate for the year from 3.6 percent of GDP to 12.8 percent of GDP. This event led to a new rise in Portugal's interest rate spreads. In May 2010, when the first adjustment program for Greece was approved, spreads on Portuguese ten-year government bonds versus German bonds widened to 229 basis points, and then, with some fluctuations, continued to widen (Figure 9.3). In emerging markets, by contrast, bond spreads generally narrowed during this period.

In March 2011, spreads reached 459 basis points and the main credit rating agencies (Moody's, S&P, and Fitch) downgraded Portugal's sovereign rating. Portugal's Prime Minister José Socrates resigned after the opposition rejected his austerity package—the fourth austerity package announced within a year. The following month, the credit rating of Portuguese sovereign debt was downgraded once again. The sovereign spread versus German bonds widened dramatically to 585 basis points and capital inflows fell sharply. Relative to past episodes among IMF members since 1990, this sudden stop was very severe (Figure 9.18).

[6] The deficit measure reflects reclassifications, agreed to by the authorities and Eurostat, which brought the debt of some state-owned enterprises and public-private partnerships into the general government budget. The measured 2009 deficit would have been even higher were it not for a one-off transfer of Portugal Telecom's pension fund, representing 1.6 percent of GDP.

Figure 9.18. Net Capital Flows and Current Account Balances During Sudden Stops
(In percent of GDP)



Source: Authors' calculations using IMF, *WEO* data. For details, see Annex 9.2.

The government's fiscal position was growing increasingly dire. Data available at the time (*WEO,* April 2011) showed the government debt and deficit as 90.6 percent and 5.6 percent of GDP, respectively. According to the revised data (*WEO,* October 2015) the actual fiscal situation was even worse, with these percentages equal to 111.1 and 7.4, respectively. The revisions primarily reflected the reclassification of state-owned enterprise (SOE) and public-private partnership (PPP) debt as government debt.

In response to the sudden stop in capital inflows and to its own fiscal troubles, the government requested financial assistance from the troika, setting the stage for the 2011 arrangement under the Extended Fund Facility (EFF) for Portugal.

Pre-Crisis IMF Surveillance

This section provides an overview and evaluation of the IMF's surveillance of the Portuguese economy in the lead-up to the 2011 crisis. Though the reports of the early 2000s were very insightful about Portugal's economic problems, those from 2005 onwards underestimated some of the key emerging dangers.

The 2001–03 IMF Article IV Reports

As early as 2001, the IMF's Article IV consultation report (IMF, 2001) flagged the critical issues that Portugal would face in the coming years: (i) a slowdown in growth; (ii) expanding macroeconomic imbalances; (iii) financial sector risks; (iv) a need for fiscal consolidation; and (v) issues related to competitiveness and medium-term growth.

A slowdown in growth

IMF staff characterized the end of Portugal's fast-growth era during the late 1990s as the result of "the waning effect of the euro-entry-related decline in interest rates, and the completion of related stock adjustments in consumer durables and housing" (IMF, 2001: 5) as well as of the decline in the provision of EU structural funds (IMF, 2001: 21). The report also cites the decline in exports as a factor in the slowdown in growth. The staff attributes that decline to a fall in external demand, not to a loss of competitiveness.

Expanding macroeconomic imbalances

The staff stressed that Portugal was running "one of the largest current account deficits (relative to GDP) among advanced economies." They attributed "well above half" of the deterioration in the current account between 1995 and 2001 to a fall in national savings and the rest to a rise in investment. Moreover, they noted that a substantial fraction of the investment that took place between 1995 and 2000 was directed to the housing market and did little to expand Portugal's export capacity (IMF, 2001: 3–5). The same report also observed that the large current account deficits were financed predominantly by bank borrowing from international capital markets.

Staff noted that the Portuguese authorities believed these imbalances could be resolved by boosting exports, but they worried about an alternative scenario in which macroeconomic imbalances "could precipitate an extended period of slow growth—reducing indebtedness and saving-investment imbalances through domestic demand compression rather than an export-led expansion, with possibly adverse effects on the financial sector" (IMF, 2001: 10).

To its great credit, the 2001 Article IV report noted that "within a monetary union, the current account remained a useful, albeit less proximate, indicator of macroeconomic imbalances" (IMF, 2001: 13). Unfortunately, the 2005–08 Article IV reports placed less emphasis on current account imbalances.

Financial sector risks

The 2001 Article IV report stressed the risks associated with fast credit growth and the reliance of banks on wholesale funding. For example, it observed that fast credit growth was "pushing the ratio of private sector bank credit to GDP well above the euro-area average" (IMF, 2001: 3); that the "credit boom [had] by far outstripped the growth of core deposits," forcing banks to tap into international capital markets and wholesale funding extensively (IMF, 2001: 5); and that "household and enterprise indebtedness [were rising] at unsustainable rates" (IMF, 2001: 24). In a prescient observation, the report noted that the way external imbalances were being financed would "leave the economy vulnerable to a liquidity squeeze in the euro market." That said, it noted that "market participants and the authorities considered the likelihood of such a squeeze as remote" (IMF, 2001: 13).

The staff also noted that Portugal's financial sector was undiversified with large exposures to mortgage loans, credit to construction, and equity interests in infrastructure companies. The 2001 report warned that this lack of diversification made the financial sector vulnerable to a downturn in economic activity. These risks "could create financial sector stress should economic conditions suffer a prolonged deterioration." However, the report downplayed the likelihood of this scenario because "all available indicators suggested that banks were adequately provisioned and reasonably profitable" (IMF, 2001: 19) and that "credit growth was not producing high asset price inflation" (IMF, 2001: 5).

Need for fiscal consolidation

The 2001 Article IV report focused attention on emerging problems in the public sector: rapid growth in wages of civil servants relative to wages in the private sector, the prospective growth in health and pension expenditure related to an aging population, "sizable expenditure commitments [that were] incurred outside the annual budget" (e.g., contingent liabilities related to infrastructure projects undertaken by PPPs), and the need to improve budget planning, monitoring, and control.

In general, the IMF staff viewed fiscal policy execution in Portugal as "poor" (IMF, 2001: 13) and thought that improving the design and execution of fiscal policy was important for facilitating an orderly unwinding of macroeconomic imbalances (IMF, 2001: 24).

Competitiveness and medium-term growth

The same report noted that Portugal's rapid growth prior to 2001 had been fueled by increases in factor inputs. The report argued that these increases were unlikely to continue because labor participation and investment rates were already quite high, and that Portugal's growth prospects depended on its ability to raise productivity growth. In the staff's view, "sustaining high growth while also narrowing the large external current account deficit would require substantial gains in export markets" (IMF, 2001: 21).

To redirect factor inputs to the tradable goods sector, the staff stressed the need for structural reform to increase competition in product markets, particularly in electricity and telecommunications. The staff also argued that dismissal costs for workers needed to be reduced to increase labor market mobility. In addition, they emphasized the importance of increasing training and education to raise Portugal's productivity.

The report discussed the deterioration in standard measures of competitiveness such as unit labor costs (ULC) and the ULC-based real exchange rate. It did not attribute the current account imbalances to a decline in Portuguese competitiveness, but pointed to a fall in the savings rate as the root of the problem. Nevertheless, it argued that an increase in competitiveness and an improvement in export performance was a potential way to deal with both the current account and the low growth problem.

Comparing the 2001–03 Article IV reports

The 2002 and 2003 Article IV reports made points very similar to those in the 2001 Article IV report, but they increasingly emphasized the need to take measures to stabilize the government's fiscal position.[7] The 2002 Article IV report argued that Portugal's large current account deficits were not sustainable (IMF, 2002b: 9), but this warning was not repeated until the late 2000s.

In comparing different Article IV reports, it is useful to quantify the emphasis placed on different issues. Figure 9.19 shows the frequency per page of keywords associated with selected themes in different reports. In the 2001–03 Article IV reports, terms related to "competitiveness and potential growth" and "external imbalances" are mentioned much less often than terms associated with "fiscal consolidation or sustainability." The latter are mentioned at least twice as often as any other selected subject (almost three times more often per page, on average).[8]

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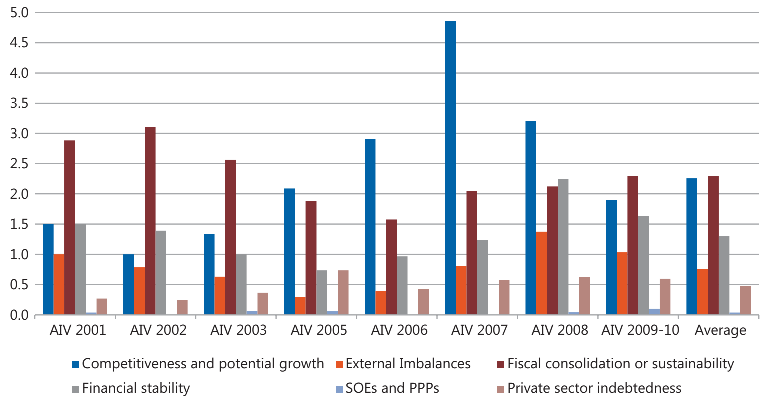
[7] There was no Article IV report for 2004.

[8] For each broad subject, along with words describing that category, we considered a non-exhaustive list of related keywords or terms in the word search. For example, the category "competitiveness and potential growth" also included terms related to legal or justice or judicial system/framework, labor market, institutional conditions, TFP or productivity growth, competition in goods markets, business environment, innovation, bureaucracy, regulation, education achievements, real exchange rate, unit labor costs, income catch-up or convergence, income gap, export growth, and structural reforms. The other five categories we used were (related terms in parentheses): (1) "Fiscal consolidation or sustainability" (debt overhang and indebtedness, fiscal balance or deficit, primary balance or deficit, government or public debt, public sector wages, public expenditure or spending, revenue, budget, and subsidies); (2) "SOEs and PPPs" (public or state-owned enterprises, public-private partnerships); (3) "Private sector indebtedness" (household or corporate debt and leverage); (4) "external imbalances" (macroeconomic imbalances, net foreign assets or liabilities, net international investment position, external vulnerabilities, sovereign debt, sudden stop, disruptive scenario, disruptive adjustment, forced external adjustment, current account, and trade balance or deficit); and (5) "financial stability" (financial system, credit supply or growth, credit/liquidity risk, asset price inflation, deposits, loans, bank

Figure 9.19. Frequency of Selected Topics in Article IV Reports for Portugal
(Average number of mentions per page)



Source: Authors' calculations.

The 2005–08 Article IV Reports

The 2005 Article IV report marked the start of a substantial shift in the focus of surveillance in regard to the underlying causes of Portugal's large external imbalances. Though the 2005–08 reports touched on many of the points raised in previous reports, they placed substantially less emphasis on low savings rates as the root causes of the trade and current account deficits.[9] They placed more emphasis on structural reforms that could improve the competitiveness and long-run growth rate of the Portuguese economy. Consistent with this shift in emphasis, unlike the 2001–03 reports the 2005–08 Article IV reports did not even contain separate sections on external imbalances.

As shown in Figure 9.19, terms related to "competitiveness and potential growth" are mentioned on average once every 1.3 pages in the 2001–03 Article IV reports, and occur much more often in the 2005–08 Article IV reports (3.3 times per page, on average). In the 2005–08 reports, this category replaces "fiscal consolidation/sustainability" as the most frequently discussed issue in surveillance for Portugal.

Selected Issues Papers

The Selected Issues Papers (SIPs) that typically accompany Article IV reports also reflected the emphasis given by staff to competitiveness and productivity growth. Out of the eight SIPs that were associated with Article IV

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capital or equity, wholesale funding, bank profits, bank exposure, solvency, balance sheets, and nonperforming loans).

[9] For instance, the 2007 Article IV report mentions (p. 4) that the current account deficit reflects "weak competitiveness, sustained high private sector borrowing and declining household savings, and large fiscal deficit." It is interesting to note the prominent place given to competitiveness in the ordering of factors underlining the external imbalances.

reports in 2005–08, all but two were directly related to productivity, the role of fiscal reform in promoting growth, export performance, or competitiveness. The new emphasis was typified by the following quote from the 2007 Article IV report's executive summary: [10]

> …The underlying economic situation remains difficult: productivity growth continues to lag, the loss of competitiveness has not been regained, and the income convergence process with the EU is in reverse. At root, Portugal's challenges can be traced to low levels of human capital, investment in R&D, and information and communication technology (ICT) penetration, but also to shortcomings in the business environment, insufficient competition in domestic markets, and labor market rigidities.

The 2007 and 2008 Article IV reports described Portugal's financial system as healthy and well regulated. The staff did identify three sources of vulnerability—high levels of household and corporate debt, high levels of bank dependency on wholesale funding, and a high level of bank exposure to the real estate sector and a few large corporates—but viewed the financial system as resilient. Fiscal sustainability issues were discussed at length, but relatively less space was devoted to the deterioration of the net foreign liabilities position. Moreover, very little attention was paid to the possibility of a sudden stop in capital flows.

The 2009 Article IV Report

The tone and substance of the 2009 Article IV report reflected the impact of the global financial crisis and the beginning of a recession in Spain. Showing a new sense of urgency, the report focused sharply on the sustainability of the government deficit and on the possibility of a disruption in capital flows to Portugal.

The staff forecast a 2.7 percent decline in GDP in 2009 followed by modest growth of 0.5 percent in 2010. They projected a large fiscal deficit for 2009 (at 8 percent of GDP) and noted that, without new fiscal measures, the deficit would probably increase in 2010 before declining to 5.7 percent of GDP by 2013. They also projected that the debt-to-GDP ratio would approach 100 percent by 2013. In light of these considerations, they argued that Portugal's fiscal stance would "test the limits for Portugal's sovereign rating…" (IMF, 2009: 12), and hence that it was important for the Portuguese government to immediately start a program of fiscal consolidation to reduce the deficit.

[10] In a similar vein, the 2008 Article IV report noted, "At the root of Portugal's economic problems lies anemic productivity growth and a significant external competitiveness gap" (IMF, 2008: 3). The IMF staff's emphasis on structural weaknesses underlying a competitiveness problem was a matter of some dispute with the authorities. For example, staff and the authorities disagreed on the priority of further labor market reform, with the latter being skeptical about the degree of inflexibility in the Portuguese labor market as characterized by staff. In addition, the Bank of Portugal contested the staff's quantitative assessments of the "competitiveness gap" faced by Portugal.

The staff noted how the vulnerabilities of the banking system were being exacerbated by the global financial crisis. However, they pointed out that the stress tests conducted by the Bank of Portugal suggested that banks would be able to withstand large shocks.

Consistent with the staff's new sense of urgency about the need for fiscal reform and heightened concern about the financial sector, the 2009 Article IV report gave more weight to the possibility of a disruptive scenario:

> Eventually, incomes and spending need to be aligned. The longer the imbalance persists, the greater the risk that the adjustment will be sudden and disruptive, affecting all sectors of the economy. This could be further exacerbated by risks of contagion from other highly indebted advanced countries, especially in the region.

To explore the consequences of such a disruptive scenario, the IMF simulated its model to assess the impact of a permanent increase in Portugal's risk premium of 175 basis points. Nevertheless, the staff felt that "…the most likely scenario is one of gradual adjustment of Portugal's imbalances; the longer they persist, the greater the risk that the adjustment could become disruptive" (IMF, 2009: 3).

Assessment of IMF Surveillance

The IMF surveillance reports from the early 2000s were very insightful about Portugal's economic problems. As early as 2001, the IMF flagged the critical issues that Portugal would face in the coming years: a slowdown in growth, expanding macroeconomic imbalances, growing risks in the financial sector, the need for fiscal consolidation, and, to a smaller extent, issues related to competitiveness and medium-term growth.

But the IMF's post-2005 surveillance was deficient along three dimensions. First, the Article IV reports did not give enough weight to the possibility of a sudden stop in capital flows to Portugal. Second, they over-emphasized the role of competitiveness in explaining Portugal's current account deficits, and should have paid more attention to the pre-crisis deterioration in private savings behavior. Finally, the IMF should have consolidated data on government debt to include debt from the PPPs and SOEs. Below we discuss each of these criticisms in detail.

Insufficient attention to the possibility of sudden stops

The fundamental shortcoming of the Fund's pre-2009 surveillance was a failure to imagine that Portugal might face a disruptive loss of access to international capital markets. As we stress below, the idea that sudden stops were very unlikely to occur in developed economies was the conventional wisdom in the profession.

The 2000 and 2001 surveillance reports argued that sudden stops were unlikely in a monetary union. In the 2000 report, the staff wrote (p. 16) that: "with monetary union reducing individual countries' vulnerability to shifts in market sentiment, adjustment [to fundamentally unsustainable current account positions] can probably be spread out over a longer time horizon." In the 2001 report, the staff wrote (p. 13) that: "within a monetary union, the current account remained a useful, albeit less proximate, indicator of macroeconomic imbalances, but the financing risks had been sharply reduced with euro entry." The staff noted that a sizable portion of the deficit was financed with short-term bonds, leaving the economy vulnerable to a liquidity squeeze. But at the same time they remarked that market participants and authorities considered the likelihood of such a squeeze as remote.

From a practical perspective, it was reasonable not to worry about a sudden stop in the early 2000s, when Portugal's net foreign liabilities and net government debt represented less than 50 percent of GDP. But it became increasingly unreasonable as net foreign liabilities and net government debt rose. The 2007 Article IV report notes that the current account deficit is very large. But it is striking that, as late as 2008, the reports did not mention that Portugal's large, negative net foreign asset position exposed it to a possible sudden stop. In the 2008 Article IV report, the IMF staff wrote that "A credit crunch seems unlikely except in a rather extreme scenario where banks cannot roll over maturing securities and a large proportion of interbank loans, for example, due to a worsening of the global liquidity situation." The 2009 Article IV report, written after the spread between Portuguese and German government debt had begun to widen, did place more emphasis on the possibility of a disruptive sudden stop. But even that report seems optimistic in hindsight.

The lack of concern about a disruptive stop in capital market access reflects a profession-wide failure to consider the possibility of a sudden stop in developed economies. While Calvo (1998) emphasized the importance of this phenomenon in emerging markets, few economists argued that his analysis was applicable to developed economies, especially members of the euro area. Indeed, in our interviews we were told that some policymakers took umbrage at the notion that one should be concerned about the size of Portugal's trade deficit or net financial liabilities. These policymakers, as well as some IMF senior staff, appealed to what turned out to be a false analogy between states in the U.S. and countries like Portugal.[11]

Sources of Portugal's trade and current account deficits

As outlined in the section "Background to the Crisis" above, Portugal began to run large current account deficits in the 1990s when the growth rate of real GDP was high. These deficits persisted in the 2000s despite a sharp slowdown in economic growth.

In our view, the IMF staff misdiagnosed the root cause of these deficits. An ongoing theme of the 2005–08 surveillance reports was that the root cause

[11] For an extended discussion of this issue, see Arellano, Atkeson, and Wright (2015).

Table 9.5. Selected Countries: Average Annual Rate of Growth of Total Multifactor Productivity, 2000–11
(In percent)

Australia	0.4	Japan	0.7
Austria	0.7	Korea	3.2
Belgium	0.3	Netherlands	0.4
Canada	0.5	New Zealand	0.5
Demmark	0.2	Portugal	0.0
Finland	1.2	Spain	–0.1
France	0.6	Sweden	1.0
Germany	0.8	Switzerland	0.5
Ireland	1.6	United Kingdom	0.9
Italy	–0.3	United States	1.1

Source: Organisation for Economic Co-operation and Development.

of Portugal's current account deficits was a lack of competitiveness. We agree with the staff that Portugal's productivity growth was weak relative to that of its peers (Table 9.5). But we disagree that an increasing competitiveness gap was the key driver of Portugal's current account deficit. While some measures of competitiveness declined, the ratio of exports to GDP actually rose (from 26.7 percent in 2005 to 31.1 percent in 2008).

It is true that that prior to 2009, the export to GDP ratio was lower in Portugal than in many other European countries. But in analyzing the root cause of the crisis what is important is the *change* in the ratio of exports to GDP, not the *level*. The IMF surveillance reports never provided direct evidence of declines in the level of exports, in the exports to GDP ratio, or in Portugal's share in export markets. Instead, they emphasized the rise in various measures of Portugal's unit labor costs relative to those of its competitor countries.

Unit labor costs in Portugal did rise by 21 percent between 1995 and 2000. But they rose the most in the nontradable sectors, led by real estate activities (75 percent) and construction (56 percent). In sharp contrast, they remained relatively stable in the manufacturing sector, rising by only 6 percent. According to World Trade Organization data, manufacturing accounted for roughly 63 percent of Portuguese exports of goods and services during 1995–2000. The relative stability of unit labor costs in this sector is consistent with the stability of exports as a fraction of GDP.

We see the same pattern in the 2000–07 period. Unit labor costs rose by 17 percent over this period, with the main increases concentrated in nontradable sectors.[12] In industry and manufacturing, unit labor costs remained roughly constant (increasing 3 and 2 percent, respectively).

[12] The largest increases from 2000 to 2007 were, in order (percentages in parentheses): 1) Arts, entertainment and recreation (43); 2) Construction (39); 3) Wholesale and retail trade, transport, accommodation and food service activities (28); 4) Public administration, defense, education, human health and social work activities (23); 5) Real estate activities (23).

To be clear, we agree with the staff that a good way to resolve Portugal's current account imbalance would have been to increase exports. But, as documented above, the trade deficits were driven by rising imports, not by declining exports. Had IMF surveillance correctly analyzed the root cause of the trade deficits, the authorities might have moved more aggressively to curb the boom in the nontradable sector, a boom that was financed by borrowing in the international capital market.

The results from the IEO survey of Portuguese economists broadly support our view. When asked to attribute percentages to the importance of some pre-selected factors in explaining the current account deficit before 2008, they ranked "easy credit conditions since the adoption of the euro" first—ahead of "lack of competitiveness in the tradable goods sector" and "optimism about future income."

A closely related shortcoming of IMF surveillance during the period 1995–2007 was a lack of emphasis on the fall that took place in private sector savings and its role as a driver of Portugal's current account deficits. We certainly agree that the large public sector deficits contributed to the current account deficits. But the *rise* in the current account deficit was almost exclusively driven by a fall in private sector savings (Figure 9.8).

Recognizing government liabilities stemming from SOEs and PPPs

Another important shortcoming of the Fund's Article IV consultation for Portugal is that they were late in acknowledging the magnitude of the government's liabilities associated with SOEs and PPPs. By 2014 those liabilities represented 15 percent of GDP (Table 9.6). The treatment of SOE and PPP debt is not simply an accounting issue: the associated liabilities had to be financed, thereby enhancing the risk and consequences of a sudden stop. Moreover, the size of access under the IMF program was agreed before SOE and PPP debt was reclassified as general government debt, and not enlarged afterwards; the need to finance this debt meant that less financing was available to the rest of the economy.

The timing of when Portugal's SOE/PPP debt was recognized provides interesting evidence on the efficacy of the pre-crisis surveillance. The April

Table 9.6. Portugal: Contribution of SOE/PPP Reclassifications to Gross Government Debt
(In percent of GDP)

Debt	2010	2011	2012	2013	2014
WEO April 2011	83.3	90.6	94.6	97.5	100.8
Program request, May 2011	93.0	106.4	112.2	115.3	115.0
WEO October 2014	94.0	108.2	124.1	128.9	130.3
SOE/PPP Reclassification (as of October 2014)	9.7	10.6	12.4	12.4	15.0

Sources: IMF (2011a, 2014b); IMF, *WEO,* April 2011 and October 2014; and authors' calculations.

2011 *WEO* reported that the debt/GDP ratio was 83.3 percent by the end of 2010. One month later, in the program request, the debt to GDP ratio for the same period was reported as 93 percent. The increase was due entirely to the recognition of the SOE and PPP debt. This timing is consistent with the notion that surveillance was remiss in its treatment of SOE/PPP debt.

The IMF staff should have known that the government had large unrecognized liabilities associated with SOEs and PPPs. In fact, a well-known study by Banco Português de Investimento (BPI), released in January 2010, estimated the government's liabilities associated with the SOEs, the PPPs, and the local governments of Madeira and Azores. According to Banco Português de Investimento (2010), these liabilities represented 18 percent of GDP. This number turned out to be an overestimate, but it should have alerted the IMF staff to the importance of these liabilities.

The 2011 Program: Design and Implementation

Prime Minister Socrates resigned on March 23, 2011 and the President called for general elections. The government requested EU/IMF assistance on April 8. A letter of intent was signed on May 13 by the outgoing Minister of Finance and the Governor of the Central Bank. The IMF staff helped to foster ownership of the program by bringing both the government and the opposition party on board with the proposed policies.

The size of the program was €78 billion, which represented 45.9 percent of Portugal's 2011 GDP. The IMF contributed one-third of the total funding through its Extended Fund Facility (EFF). The choice of a three-year EFF-supported program, instead of the more common two-year Stand-By Arrangement–supported program, was driven by the view that structural reforms should form an important part of the program. Such reforms require time to implement.

The program aimed to strike "a balance between re-gaining credibility and debt stabilization, and limiting adverse impacts on growth." Its three main elements were: short-term financial assistance to finance the current account deficit; fiscal reforms aimed at reducing the government deficit in the short and medium run; and structural reforms aimed at improving Portugal's growth prospects.

The program's objectives and key policies received support from the major political parties in Portugal. Support for the program is also reflected in our survey of Portuguese economists. A large majority of the respondents (90 percent) agreed that, at the time the program was introduced, Portugal's current account deficits were not sustainable; 75 percent of respondents agreed that Portugal needed a program; and 55 percent did not see any better alternative than the program.

Table 9.7. Average Interest Charges on IMF Loans
(In percent)

Fiscal Year	Greece	Ireland	Portugal
2011	2.70	2.16	
2012	2.88	2.42	2.57
2013	2.75	2.60	2.73
2014	3.64	2.93	2.80
2015	3.59	3.32	3.59

Source: IMF Finance Department.

Table 9.8. Comparison of Access Size
(In percent of GDP at date of program approval)

	IMF Funding	Total Funding
Asian crisis programs*	3.9	n.a.
GRA programs (2007–13)	6.4	n.a.
Portugal (2011)**	15.3	45.9
Greece (2010)**	13.8	41.4
Greece (2012)**	14.7	44.1
Ireland (2010)**	13.7	41.1

Source: IMF.
* Mongolia, Thailand, Indonesia (two programs), Korea, Philippines, and Cambodia.
** Total access size including funds from IMF, EU, and ECB.

Table 9.7 shows the effective interest rates on the IMF loans to Portugal, computed using actual interest charged each year. The interest rates on Portuguese loans were higher than those paid by Ireland and lower than those paid by Greece.

The EFF-supported adjustment program for Portugal was unusually large, representing 15.3 percent of GDP (Table 9.8). While similar in size to the Irish and Greek programs, it was large relative to other IMF GRA-supported programs, including those implemented in the countries affected by the Asian currency crisis of 1997 (see Park, 2016).

Program Design

In designing the Portuguese program, the IMF faced four critical constraints. First, being a member of the euro area, Portugal could not use a currency devaluation to help achieve external balance. Second, being a member of the World Trade Organization, Portugal could not pursue the alternative to a currency devaluation suggested by Keynes (1931): tax imports and subsidize exports. Third, debt restructuring was considered off the table, in view of legal complications, political constraints, moral hazard considerations, and fear of contagion. The last of these concerns featured prominently in IMF internal documents and summaries of staff and Board member discussions. Fourth, the program had to be agreed to by the European Union and the European

Table 9.9. Fiscal Adjustment Measures in the 2011 IMF Program for Portugal
(In percent of GDP)

Measures	2011	2012	2013	Total
Revenue	2.0	0.9	0.5	3.4
Income taxes	0.4	0.3	0.3	1.0
VAT	0.8	0.2	0.0	1.0
Social contributions	0.3	0.1	0.0	0.4
Excise taxes	0.0	0.1	0.1	0.2
Property taxes	0.0	0.1	0.1	0.2
Other (including tolls, capital revenue)	0.5	0.1	0.0	0.6
Expenditure	3.7	2.1	1.4	7.2
Wage bill	0.9	0.3	0.2	1.4
Intermediate consumption	0.5	0.4	0.4	1.3
Pensions cut	0.0	0.3	0.0	0.3
Social transfers	0.6	0.0	0.1	0.7
Savings in health/pharmaceutical expenditure	0.3	0.3	0.3	0.9
Savings/transfers to SOEs, funds, and local/regional government	0.6	0.5	0.2	1.2
Investment	0.3	0.3	0.2	0.8
Other	0.4	0.0	0.0	0.4
Total	5.7	3.0	1.9	10.6

Source: IMF (2011a).

Central Bank—institutions whose own objective functions might have led them to take different views about the optimal program design.

Fiscal policy

The program envisaged a front-loaded fiscal consolidation strategy to quickly restore credibility and allow Portugal to regain access to international capital markets. Table 9.9 summarizes the IMF's estimates of how the proposed fiscal measures would affect government revenue and expenditures. For the period 2011–13, the program request document (IMF, 2011a) envisaged discretionary tax revenue increases and discretionary revenue cuts equal to 3.4 percent and 7.2 percent of GDP, respectively. Thus roughly 32 percent of the planned fiscal adjustment was to come from tax revenue increases and 68 percent from government spending cuts.

On the tax side, the higher value-added, personal, and corporate income tax rates that Portugal introduced in the 2011 budget were to remain in effect until 2013. Other revenue measures included higher taxes on property, vehicles, and tobacco, and a new electricity tax. A special contribution levied on pensions above €1,500 was proposed for 2012.

On the expenditure side, the program froze public sector wages and pensions until 2013. This freeze kept in place the 5 percent cut in public sector wages that the government had introduced prior to the program. The program also called for a reduction, over the period 2011–14, of at least 5 percent in the fringe benefits granted by SOEs to their employees. Large infrastructure projects were suspended, including the new Lisbon airport and the high-speed train project. All new PPPs were suspended. Transfers to local and regional governments were reduced and the defense budget was cut. In addition, the program proposed cost-saving measures in healthcare and other sectors. Finally, the program called for annual reductions in the number of civil servants (1 percent per year in the central government and 2 percent per year in the local and regional governments).

The program also included structural fiscal reforms aimed at making the government's medium-term fiscal position sustainable. These reforms included improving tax compliance and incorporating the debt of SOEs, PPPs, and social security into the government budget. The program also stressed the importance of monitoring the contingent liabilities of SOEs and PPPs. In addition, it urged the government to accelerate its privatization program.

An important component of the program was a "fiscal devaluation," of the type analyzed in Farhi, Gopinath, and Itskhoki (2014). The idea was to mimic the effect of a currency devaluation by raising consumption taxes and using the proceeds to lower employers' social security contributions, with a view to increasing import prices and reducing the export prices.

Financial sector policy

The program included a series of measures to strengthen the financial sector:

- To boost capital buffers, it imposed substantial increases in the core Tier 1 capital ratio. This ratio, which was 8 percent prior to the program, was to rise to 9 percent by the end of 2011 and to 10 percent by the end of 2012.
- A new €12 billion Bank Solvency Support Facility was introduced to help recapitalize banks that could not raise capital from private sources to reach the new core Tier 1 capital ratios.
- The program required banks to achieve stable market-based funding positions and bring loan-to-deposit ratios to sustainable levels. The idea was to help achieve a smooth deleveraging process.
- To improve the liquidity of the banking system, the government raised from €20 billion to €35 billion the government guarantee fund for bank bond issues that banks could use for refinancing from the ECB.[13]
- The program proposed measures to reform and streamline the operations of Caixa Geral de Depósitos, a state-owned bank that accounted for roughly 20 percent of the banking system.
- The program called for improvements in the solvency and liquidity assessment frameworks, as well as in the bank regulation and supervision frameworks. In addition, the program prescribed an overhaul of the deposit insurance and bank resolution regime.

[13] This item was not part of the IMF program conditionality measures.

- A new Special On-Site Inspection Program enabled independent firms to conduct asset quality reviews.
- The program also called for improvements in in-court and out-of-court systems for corporate debt restructuring.

Structural reforms

The program prescribed a wide range of detailed structural reforms involving many sectors of the economy.

The IMF faced three constraints when designing the program of structural reforms. First, important political impediments to these reforms stemmed from the opposition of affected interest groups and the fact that many such reforms may have contractionary effects in the short run. For example, reducing firing costs or making it easier for firms to declare bankruptcy could increase unemployment, at least in the short run. Second, the government had limited technical resources with which to implement reforms in a wise, judicious, and timely manner. Third, the program's three-year time span limited the amount of time available to implement a broad and complex reform agenda.

In light of these constraints, a key question the IMF had to confront was whether to focus on a small set of important reforms or pursue a broader agenda. In its Guidelines on Conditionality (IMF, 2002c), the IMF leans heavily towards parsimonious programs that have an important macro effect: "Program-related conditions governing the provision of Fund resources will be applied parsimoniously." The same guidelines also recommend focusing on key macroeconomic criteria:

> Conditions will normally consist of macroeconomic variables and structural measures that are within the Fund's core areas of responsibility. Variables and measures that are outside the Fund's core areas of responsibility may also be established as conditions but may require more detailed explanation of their critical importance. The Fund's core areas of responsibility in this context comprise: macroeconomic stabilization; monetary, fiscal, and exchange rate policies, including the underlying institutional arrangements and closely related structural measures; and financial system issues related to the functioning of both domestic and international financial markets.

In Portugal, the troika chose to prescribe an ambitious, broad, and detailed set of reforms that went well beyond the recommended focus on macroeconomic criteria. There are at least two possible reasons for this choice. First, each member of the troika had different objectives and constraints. The memoranda of understanding from both the EU and the IMF suggest that the EU favored a much more detailed reform agenda—a notion that is supported by our interviews with the Portuguese authorities as well as the ECB, EU, and IMF staff. Second, the IMF may have felt that, since a currency devaluation was not feasible, more reforms had to be implemented in order to restore the sustainability of the current account. We do not have sufficient information to take a stand on the relative importance of these two explanations.

The structural reforms agreed upon are listed in Annex 9.3. Some of these conditions were straightforward to implement; others, summarized below, were much more ambitious.

Labor market reforms

- Reduce the level and duration of unemployment benefits for future recipients.
- Impose a substantial reduction in severance payments for new contracts and a modest reduction for existing contracts.
- Increase the flexibility of working time arrangements and reduce the pay and time off associated with overtime work.
- Reduce vacations and holidays.
- Improve wage-setting mechanisms by limiting automatic extensions of collective agreements to firms that did not participate in the agreements.
- To reduce the short-term social costs of the reform as well as the pain associated with the recession, the program called for a reduction in a worker's contribution period necessary to be eligible for unemployment insurance.

Judicial reforms

- Introduce a new insolvency code similar to the Chapter 11 provision of the U.S. bankruptcy code.
- Introduce a new arbitration procedure, along with measures to expedite the judicial process.

Competition reforms

- Introduce a new competition law.
- Eliminate guarantees to electricity producers.
- Reduce barriers to entry into the telecommunications market.

Housing markets

- Introduce a new urban lease act that would phase out rent controls and reduce the advance notice needed for a landlord to terminate a lease.

Other reforms

- The program prescribed many other reforms, including the liberalization of the postal sector and reforms to the railway sector and the ports.

Table 9.10. Portugal: Selected Macroeconomic Indicators, 2009–16
(In percent of GDP, unless otherwise indicated)

	2009	2010	2011	2012	2013	2014	2015	2016
Real GDP (percent change)	−2.5	1.3	−2.2	−1.8	1.2	2.5	2.2	2.0
Consumer prices (percent change)	−0.9	1.4	3.5	2.1	1.4	1.5	1.5	1.6
Unemployment rate (percent)	9.6	11.0	12.1	13.4	13.3	12.0	10.8	9.8
General government balance	−10.1	−9.1	−5.9	−4.5	−3.0	−2.3	−1.9	−1.8
General government debt	83.0	93.0	106.4	112.2	115.3	115.0	112.9	111.0
Current account balance	−10.9	−9.9	−9.0	−6.7	−4.1	−3.4	−2.7	−2.2
Net international investment position	−110.4	−107.5	−116.9	−123.3	−123.4	−121.4	−119.0	−116.4

Source: IMF (2011a).

Forecast Net Effects of the Programmed Measures

Table 9.10 summarizes the initial IMF forecasts of the performance of the economy inclusive of the program measures. Six features of this table are worth noting:

- the IMF projected a relatively mild recession and a return to growth in 2013;
- unemployment was expected to peak at 13.4 percent in 2012 and decline thereafter;
- the government deficit was forecast to decline to 2.3 percent by 2014;
- the government gross debt was predicted to peak in 2013 at 115.3 percent of GDP and decline thereafter;
- the current account deficit was predicted to decline to 3.4 percent of GDP by 2014;
- net foreign liabilities were expected to peak at 123.4 percent of GDP in 2013.

Program Implementation

Inevitably, the program had to be modified in response to ongoing developments. Both the IMF and the authorities responded to the changing circumstances of the Portuguese economy.

Fiscal policy

The key modifications in fiscal policy were driven by several factors. The IMF's initial forecasts regarding the severity of the recession and the strength of the recovery turned out to be too optimistic. Constitutional Court rulings had a major impact on the government's ability to cut public spending. The large contingent liabilities of the government associated with the SOEs, PPPs, and the government of Madeira became clear. Finally, internal political developments prevented the government from implementing the hoped-for "fiscal devaluation" (see above).

The net effect of these developments was to shift the nature of the fiscal adjustment away from cuts in government spending and towards tax increases. The initial plan, as noted above, was that roughly two-thirds of the fiscal adjustment would occur via cuts in government expenditures and one-third via tax revenue increases. In the program as actually implemented, 60 percent of the adjustment came from revenue increases and 40 percent from spending cuts.

Table 9.11 reports the projected government revenues, expenditures, and fiscal balances provided in the first program review (September 2011), together with their realized values.[14]

Early in the program, it became clear that government revenues were lower and expenditures were higher than expected. The lower revenues reflected the severity of the recession. The higher expenditures reflected three factors. First, the economic contraction was more severe than anticipated, so cyclical expenditures like social transfers were higher than expected. Second, due to poor administrative controls, wages and purchases of goods and services were higher than anticipated. Third, the government needed to finance the operational losses of the SOEs and of a failed PPP, which had not been fully included in the funds made available by the program.

The government partially compensated for the larger expenditures and lower revenues with various one-off measures, whose value was estimated at the time to represent 1.1 percent of GDP. They included a one-time personal income tax surcharge, advancing in time the planned VAT rate increase, additional sales of concessions, and use of revenue resulting from the transfer of the banks' pension funds to the state social security system.

Table 9.11. 2011 Fiscal Performance and Offsetting Measures
(In percent of GDP)

	Revenue	Expenditure	Total
Performance[1]	0.2	0.9	1.1
Tax revenue	–0.2		
Nontax revenue	0.4		
Compensation of employees		0.2	
Intermediate consumption		0.3	
Social transfers		0.1	
Fixed capital formation		–0.1	
Support to SOEs and PPPs		0.4	
Offsetting measures	1.1		1.1
Advancing VAT rate increase	0.1		
One-time surcharge on personal income tax	0.5		
Additional sales of concessions	0.4		
Transfer of banks' pension funds, as previously planned	0.2		

Note: Negative numbers indicate over-performance.
Source: IMF (2011b).
[1] Magnitude of revenue under-performance and expenditure overruns.

[14] Realized values are measured as of end-2011. These values were later revised.

The program target for the 2011 deficit was 5.9 percent. This target was very ambitious relative to the 2010 deficit, which was 9.1 percent of GDP. Perhaps not surprisingly, Portugal missed the target: the 2011 deficit excluding one-off measures was 7.4 percent of GDP. Similarly, Portugal missed the target for 2012. The target and realized deficits for 2012 in percent of GDP, were 4.5 and 5.6, respectively.[15]

Two events in 2012 underlined the political difficulty of implementing key program measures. First, in July 2012 the Constitutional Court rejected as unconstitutional the government's proposal to cut by one-seventh the salaries of civil servants and beneficiaries of the public pension system.[16] The magnitude of these cuts was just over 1 percent of GDP in 2012. The Court's decision did not affect the budget for that year but did affect that for 2013 (IMF, 2012: 7). Second, on September 7, 2012 the government announced a "fiscal devaluation" for 2013.[17] Large-scale protests led the government to abandon its proposal on September 21, 2012. The proposal involved reducing the share of payroll taxes paid by firms (from 23.75 percent to 18 percent) and increasing the share paid by workers (from 11 percent to 18 percent). A standard result in public finance is that, in a world of flexible prices and wages, this type of fiscal devaluation would have no impact on labor market outcomes. But in a world where nominal wages are initially too high and rigid downwards, the proposed fiscal devaluation would have brought the initial wage closer to the equilibrium wage, thereby boosting employment.

It should be acknowledged that some of the initial support for the fiscal devaluation stemmed from fears that Portugal might face the possibility of leaving the euro area. By the fall of 2012 these fears had dissipated, in part because of determined actions by the ECB. As a consequence, the ownership of the program weakened, no doubt contributing to the abandonment of the fiscal devaluation proposal.

In the 2013 budget, the government proposed a one-fourteenth cut in the wages of civil servants and pensioners. The government also proposed new contributions towards illness and unemployment benefits. The IMF estimated the value of these measures to be 0.7 percent of GDP (IMF, 2013a: 10). The Constitutional Court ruled against both provisions. To compensate, the government reduced expenditures and reprogrammed EU structural funds.

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[15] In contrast to 2011, there were no one-off measures in 2012.

[16] Traditionally, Portuguese workers received 14 months of salary (an extra monthly payment in the summer and another before Christmas). The government proposed eliminating 2 of the 14 months of salary for a total reduction in pay of 1/7.

[17] The fiscal devaluation proposed by the government differed from that proposed in the IMF program. The IMF staff had called for a "reduction in unit labor costs via deficit-neutral reduction in labor taxes" and also for a revenue-neutral increase in the VAT. An important problem with the VAT proposal was that the VAT rate for most consumer goods was already high, at 21 percent, before the program. (There was a reduced rate of 6 percent for food and other essential goods and a 13 percent intermediate rate for another class of goods and services that included restaurants.) A sizable increase in the VAT rate might not have raised revenue because of noncompliance and Laffer-curve type considerations.

In August 2013 the Constitutional Court also ruled that the government's proposal to dismiss public employees was unconstitutional. The IMF estimated the effect of this ruling on public spending to be 0.1 percent of GDP (IMF, 2013a: 10).

As before, the government compensated for the higher-than-planned expenditures by raising taxes. The new tax measures included a surcharge of 4 percent on taxable income above the minimum wage and a reduction in the number of personal income tax brackets.

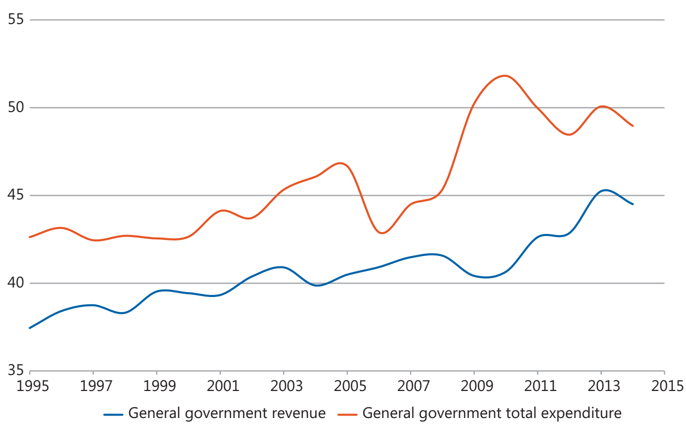
Government revenue rose from 42.9 percent of GDP in 2012 to 45.2 percent of GDP in 2013. Government expenditures increased from 48.5 percent of GDP in 2012 to 50.1 percent of GDP in 2013 (Figure 9.20). With government revenue up by more than spending, the overall deficit as a percentage of GDP fell from 5.6 in 2012 to 4.8 in 2013. The original goal for the government deficit in 2013 was 3 percent of GDP. By 2013 this goal had been revised to 5.5 percent of GDP, allowing the government to achieve the new target (IMF 2013a: 12).

Gross government debt as percentage of GDP increased from 111.1 in 2011 to 125.8 in 2012 and 129.7 in 2013 (Figure 9.12). The large increase between 2011 and 2012 was mostly due to the reclassification of the debt of the SOEs as public debt. According to the 2014 Fiscal Transparency Evaluation (IMF, 2014b), debt of the SOEs worth 12.4 percent of GDP was reclassified as public debt in 2012 (Table 9.6).

In December 2013 the Constitutional Court ruled against the provisions in the 2014 budget aligning the rules and benefits of the public sector pension fund with those of the general pension regime. According to the IMF, the fiscal impact of this ruling was 0.2 percent of GDP (IMF, 2014a: 9).

Table 9.12 summarizes how the IMF's goals for the deficit evolved over time and what actually occurred. In hindsight, the initial deficit targets clearly

Figure 9.20. Portugal: General Government Revenues and Expenditures
(In percent of GDP)



Source: IMF, *WEO* (October 2015).

Table 9.12. General Government Balance
(In percent of GDP)

	2011	2012	2013	2014
Program request (May 2011)	–5.9	–4.5	–3.0	–2.3
Sixth review (January 2013)			–4.5	–2.5
Seventh review (June 2013)			–5.5	–4.0
Eighth and ninth reviews (November 2013)			–5.9	–4.0
Realized data (October 2015 *WEO)*	–7.4	–5.6	–4.8	–4.5

Source: IMF.

appear to have been over-optimistic. Indeed, some of the Portuguese authorities whom we interviewed felt that the IMF's initial targets for the government deficit had been unrealistic. The original targets were not achieved in any of the program years. In 2013, the IMF revised the 2013 and 2014 deficit goals twice. While these changes enabled the government to reach its revised 2013 target, it failed to achieve its 2014 target.

The IMF must choose between setting ambitious and realistic targets. The advantage of ambitious targets is that they incentivize the authorities to implement politically costly fiscal reforms. The disadvantage is that consistently missing the targets endangers the credibility of the program. In our interviews with the authorities, many people expressed the view that the IMF had erred on the side of initially unrealistic goals that were costly to the credibility of the program. In addition, in the face of a fixed financing envelope and optimistic budget projections, the authorities had to make hasty ad hoc adjustments.[18]

Financial sector policy

As noted above, the program set up a Bank Solvency Support Facility (BSSF) with €12 billion worth of funds. The facility was a backstop mechanism to provide temporary capital injections to banks that might not have been able to reach the higher capital requirements imposed by the program. In June 2012, two leading Portuguese banks (Millennium BCP, Portugal's largest private bank in terms of assets; and Banco BPI) drew on funds from this facility. The recapitalization of state-owned Caixa Geral de Depósitos occurred in the same period, but the funds came from the general budget and not directly from the Bank Solvency Support Facility.

In addressing the problems of the financial sector, the IMF had to confront four challenges: clean up banks' balance sheets; ensure that the banks were sufficiently capitalized; reduce loan-to-deposit ratios; and avoid a credit crunch.

[18] For instance, in an interview with Sociedade Independente de Comunicação (SIC), a television channel, on July 14, 2015, then-Prime Minister Passos Coelho cited the "enormous discrepancies between projected and realized fiscal deficits for 2010 and 2011" to deem the original memorandum of understanding for the 2011 program "unfeasible."

These objectives were incompatible, at least in the short run. Cleaning up banks' balance sheets would have required writing off bad loans, thereby reducing bank capital. The banks were reluctant to increase write-offs arguing that the quality of their assets was good. Had the banks written off their bad loans they would have had to either raise more capital or reduce their loan portfolios in order to restore their capital ratios. Raising more capital was difficult because the Portuguese banks had limited access to international capital markets. An alternative might have been to use program funds to recapitalize the banks. But the Portuguese authorities had no appetite for pursuing this option. The banks could have also reduced the capital ratios by cutting the size of their loan portfolios. Doing so is very difficult in the short run because of pre-existing commitments. In any event, a drastic reduction in loans would have created a severe credit crunch. Taken together, these considerations reduced the government's incentive to clean up the banks' balance sheets.

In our interviews, both government officials and private sector managers raised the possibility that bad loans were being ever-greened to avoid recognizing them as delinquent. Blattner, Farinha, and Rebelo (2016) provide some evidence in favor of this view. They find that, in the period 2010–14, 23 percent of the firms in their sample have negative equity. Strikingly, 18 percent of these firms have access to bank loans. To the extent that ever-greening was widespread it would have had clear negative social consequences owing to an inefficient allocation of scarce credit.

The IMF faced conflicting pressures regarding its policy towards the Portuguese financial sector. In our interviews with economists from the Bank of Portugal and private sector managers we heard conflicting views about whether the IMF balanced those pressures correctly. Some interviewees felt that the Fund's actions exacerbated the credit crunch associated with Portugal's loss of access to international capital markets. Others argued that the main reason why total credit declined was a fall in the demand for loans. In principle, one could evaluate these competing hypotheses by analyzing the behavior of interest rates on new loans. In practice, though, such an analysis is complicated by the fact that one would have to control for default risk, which obviously increased during this period.

One piece of evidence that credit was tight comes from the Global Competitiveness Report for 2012–13 (WEF, 2012). According to this report, Portuguese managers considered "access to financing" the single most problematic factor for doing business in Portugal (Table 9.13). By 2015 access to financing had dropped to third place on their list of problematic factors for doing business (WEF, 2015).

An additional factor that may have contributed to a credit crunch is the financing of the SOEs and PPPs. According to our interviews with government officials and to the Fund's October 2014 Fiscal Transparency Evaluation for Portugal (IMF, 2014b), the size of the IMF program did not fully take into account the implicit liabilities of the SOEs and the PPPs. The program

Table 9.13. Problematic Factors for Doing Business in Portugal

	2012–13	2015–16
Access to financing	26.3	13.7
Inefficient government bureaucracy	15.2	17.9
Tax rates	13.1	18.7
Restrictive labor regulations	11.2	12.2
Policy instability	9.7	9.9
Tax regulations	9.1	11.2
Insufficient capacity to innovate	5.4	4.7
Corruption	3.2	2.9
Inadequately educated workforce	2.8	5
Poor work ethic in national labor force	1.3	1.3
Inflation	1.2	0.7
Government instability/coups	0.5	0.1
Inadequate supply of infrastructure	0.5	1.2
Foreign currency regulations	0.4	0.3
Poor public health	0.3	0.1
Crime and theft	0	0.1

Sources: World Economic Forum (2012, 2015).

resources were not enlarged after SOE and PPP debt was reclassified as general government debt, and the need to finance this debt meant that less credit was available to the rest of the economy.

Structural reforms

Of the 60 structural conditions specified over the course of the IMF-supported program, all but the fiscal devaluation were fulfilled, according to data from the Monitoring of Fund Arrangements (MONA) database.[19] In what follows, we summarize the major reforms that were implemented:

- *Labor-market reforms* that reduced the duration and level of unemployment benefits while increasing eligibility for those benefits; reduced severance pay for regular employment contracts; and simplified individual and collective dismissal procedures. Constitutional Court decisions affected the implementation of labor market reforms. For example, in 2013 the Court overturned changes that would have made it somewhat easier to dismiss individual workers with permanent contracts.
- *Public sector reforms* included reorganizing local and central governments; improving the efficiency and governance of state-owned enterprises; reforming public procurement procedures; rationalizing public healthcare spending by changing prescription rules; increasing co-payments and enhancing cost accountability in the hospital sector.

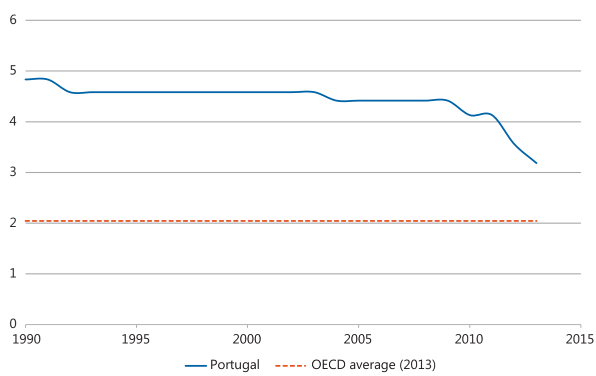
[19] The MONA database is an IMF internal repository for data from countries in IMF-supported programs. It has been recently made available to the public at http://www.imf.org/external/np/pdr/mona/index.aspx.

- *Product-market reforms* included privatizations; strengthening the power of the competition authority; simplifying licensing procedures; phasing out regulated tariffs on electricity and gas; increasing competition in retail trade; and reducing barriers to entry in professional services.
- *Tax reforms* included broadening the base of the personal income tax and the VAT; and increasing property and car registration taxes.
- *Pension reforms* included increasing the pension contributions of public sector workers; raising the retirement age, and indexing it to life expectancy.
- *Financial sector reforms* included measures to help deleverage the banking system by progressively setting higher capital requirements than those imposed by the Basel III rules and requiring them to be met sooner than the schedule proposed by Basel III.

Were the reforms successful? Various interviewees argued that the broad scope of the program's agenda and the scarcity of skilled personnel to implement reforms led, in many instances, to pro-forma rather than actual reforms. According to internal IMF documents pertaining to the 2011 program, this concern was shared by some IMF Executive Directors. For example, one Director urged staff to undertake "a realistic assessment of the capacity of the economy to absorb the front-loaded reforms." A criticism voiced by some Portuguese officials in our interviews was that the cut in public sector wages made it difficult for the government to retain and attract highly skilled workers. This difficulty may have contributed to a reduction in the overall efficiency of the public sector.

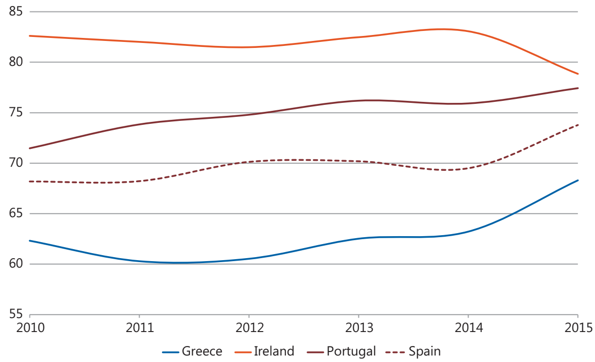
On the positive side, we believe that Portugal achieved real though limited success in making the labor market more flexible and increasing the ease of doing business. Figure 9.21 shows an OECD measure of the strictness of employment protection. Before the crisis Portugal had one of the highest levels of employment protection among OECD countries. It has since closed

Figure 9.21. Portugal: Index of Employment Protection



Source: OECD.

Figure 9.22. Ease of Doing Business Index, Distance to Frontier



Source: World Bank.

some of the gap relative to the OECD average. Still, Portugal has a long way to go. Figure 9.22 shows the distance relative to the frontier in the ease of doing business as computed by the World Bank.[20] Portugal clearly made progress according to this metric after the crisis.

Official IMF documents make clear that the Fund understands that Portugal has made limited progress in implementing structural reforms. For example, in the 2015 Article IV report, the IMF emphasized the country's need to upgrade the quality of public services, fully implement product market reforms, and continue to reform the labor market. The same report stated that structural reforms were already paying off (IMF, 2015a: 21), but it forecast real GDP growth in Portugal for 2019 and 2020 at a modest 1.2 percent. We infer that the IMF is not convinced that the reforms implemented thus far will suffice to substantially improve the growth outlook. This view is shared by the private sector. In the 2015 Article IV report, the IMF cites the results of a survey of Portuguese firms showing that the reforms implemented had had mild but perceptible positive effects. The surveyed firms expressed an urgent need for additional reforms, especially in regard to public and financial sector reforms.

Assessment of the EFF-Supported Program for Portugal

An Overview

In judging the success of the program we use two narrow technical criteria and two broader more substantive criteria.

The first narrow criterion is whether the program was implemented as planned. We believe that the answer is a qualified yes. The three qualifications

[20] See http://www.doingbusiness.org/rankings.

are that a fiscal devaluation was not implemented, the structural reforms were incomplete, and various fiscal targets were either not met or met only because the targets were revised.

The second narrow criterion is whether the program's forecasts about economic outcomes were reasonably accurate and unbiased. As discussed below, the bottom line is that IMF did not do well according to this criterion.

The first major criterion is whether Portugal regained access to capital markets. Here the program was clearly a success, although it is not clear to what extent this outcome was mainly a result of the program, as discussed in the section "Returning to International Capital Markets" below.

The second major criterion, which we view as the most important, is whether Portugal is on a sustainable path in terms of government debt and net foreign liabilities. We discuss this issue in the section "Is Portugal on a Sustainable Path?" below. We argue that the sustainability of government debt and net foreign liabilities is very fragile, leaving the success of the program very much in doubt.

This section concludes with a discussion of the probable causes of the improvement in Portugal's current account, including the possible role of the IMF program in the recovery of exports.

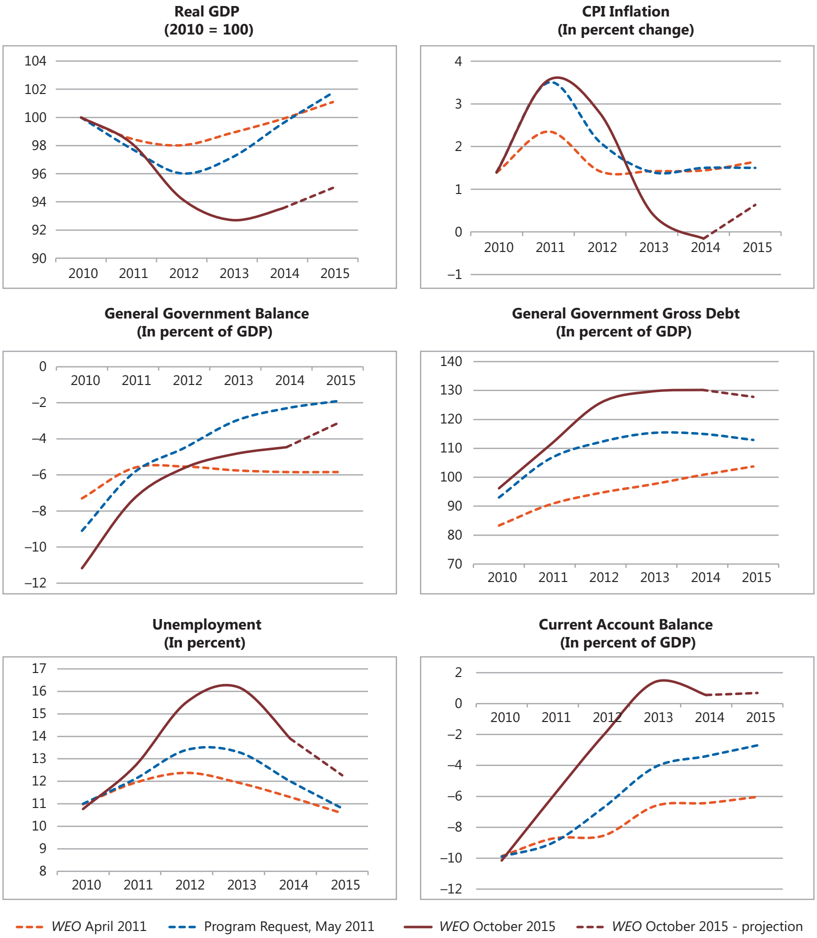
Quality of the IMF's Forecasts

Here we first discuss the IMF's forecasts of Portugal's general economic activity. We also discuss the IMF's views about multipliers and their effect on forecasting performance, and summarize the findings of a statistical analysis of IMF forecasts. We explain these assessments in detail before concluding with a discussion of the probable causes of the improvement in Portugal's current account, including the possible role of the IMF-supported program in the recovery of exports.

Figure 9.23 displays multi-year-ahead forecasts and actual outcomes for six key macroeconomic aggregates. The orange lines depict the IMF forecasts published in April 2011, one month before the approval of the program. The blue lines show the analogous predictions made at the start of the program. Clearly by then the IMF had become more pessimistic, predicting a steeper recession. This revision may have reflected new information the Fund had received in the meantime as well as the evolution of its views about the impact of the program. A reasonable inference is that the IMF recognized that a fiscal contraction would exacerbate the short-run decline in economic activity. But staff also believed that the program would create the conditions for a strong recovery. It is evident from the actual outcomes (shown by the brown lines) that the program's estimates were over-optimistic both about the severity of the recession and the strength of the recovery.

Naturally the IMF revised its forecasts as new data came in. But the forecasts made in 2012 still overestimated the growth rate of real GDP. Not surprisingly, the IMF also underestimated the government deficit and the improvement in the current account.

Figure 9.23. Portugal: IMF Forecasts Versus Outcomes



Sources: Authors' calculations using data from the IMF, *WEO*, April 2011 and October 2015, and IMF (2011a).

By 2013 the IMF had become more pessimistic about the speed of the recovery and its forecasting performance improved. There are several reasons for the IMF's poor forecasting performance. First, as noted in the section "The 2011 Program: Design and Implementation" above, decisions by the Constitutional Court had important effects on the implementation of the fiscal program. These decisions were clearly very hard to foresee. In addition, external shocks had a substantial impact on the Portuguese economy. These shocks included the general slowdown in Europe and the sharp recession in Spain, a country that accounts for roughly 25 percent of Portugal's exports.[21]

[21] In April 2011 the IMF forecast that Spanish real GDP would grow by 1.6 percent in 2012. Instead, Spanish real GDP fell by 2.1 percent.

It is also possible that an unforeseen fall in the supply of credit exacerbated the severity of the recession. Finally, the forecasts were based on a value of the fiscal multiplier that turned out to be incorrect, an issue we now turn to.

Fiscal multipliers

The IMF forecasts were based on a small value of the fiscal multiplier: 0.5.[22] In our view, this value was too small, given that Portugal could not use expansionary monetary policy to cushion the effect of fiscal contraction. We are not alone in this view. Blanchard and Leigh (2013) conclude that "actual multipliers were substantially above 1 early in the crisis." This conclusion is consistent with Christiano, Eichenbaum, and Rebelo (2011), who argue that the size of the multiplier is higher the more binding is the zero lower bound on monetary policy. It is also consistent with Auerbach and Gorodnichenko (2012), who argue that fiscal multipliers increase with the severity of recessions. In addition, it is consistent with the IMF's findings based on models used in various policy institutions (Erceg and others, 2012). In fairness to the staff, the literature on fiscal multipliers was evolving very rapidly in the wake of the Great Recession in the United States and the crisis in Europe.

The IMF staff recognized that their initial estimate of the multiplier was too small, and in their fifth program review, published in October 2012, they raised their estimate from 0.5 to 0.8. We credit the staff for their willingness to respond to ongoing developments in the literature.

Figure 9.24 shows the IMF real GDP forecasts made in April and June of 2011 along with outcomes. The figure also includes two alternative forecasts, which we constructed as follows. First, we assume that the original program forecasts (June 2011) were based on a fiscal multiplier of 0.5. Second, we assume that the contributions of other factors to growth (e.g., developments in the global and regional economies, credit and financial cycles) are orthogonal to the effects of the program's fiscal contraction measures. We compute the alternative forecasts for GDP assuming a multiplier of 0.8 for both spending cuts and tax increases.

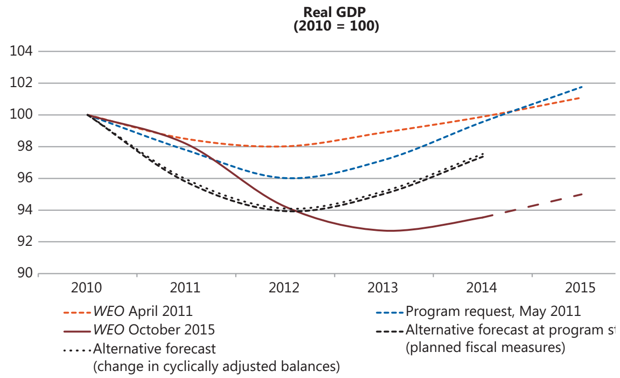
To compute the alternative forecasts we need a measure of the fiscal contractions associated with the program. Our first measure is based on the fiscal actions reported in the program request document (IMF, 2011a).[23] Our second measure corresponds to the projected changes in the cyclically adjusted government primary balances, as published in the September 2011 *WEO*. The two measures are very similar (Table 9.14).

Figure 9.24 shows that had the IMF used a value of the multiplier of 0.8 rather than 0.5 it would have more accurately forecast the depth of the recession and generated smaller cumulative forecasting errors regarding real

[22] See the IMF's fifth program review (IMF, 2012).

[23] The program request document (IMF, 2011a) does not contain an estimate for 2014. Our measure of the projected changes in cyclically adjusted government primary balances for 2014 is based on data from the September 2011 *WEO*.

Figure 9.24. Portugal: Original and Alternative IMF Forecasts of Real GDP Growth



Sources: Authors' calculations using *WEO* and MONA data.

Table 9.14. Portugal: Measures of Fiscal Impulses
(In percent of GDP)

Assumption	2011	2012	2013	2014
Change in cyclically adjusted primary balance	5.2	3.3	1.6	0.2
Program request	5.7	3.0	1.9	0.2

Sources: IMF (2011a) and *WEO*.

GDP.[24] The forecasted cumulative fall in real GDP between 2011 and 2014 would have been 2.5 percent instead of 0.4 percent. Since the actual fall was 6.5 percent, a higher multiplier would have eliminated roughly 40 percent of the forecast error. Over the 2011–14 period, the average forecast error would have shrunk from about –1.5 percentage points to about –1 percentage point. In our view, one could make a good argument for using an even larger value of the multiplier than 0.8.

There is a different channel through which the multiplier used by the IMF could have affected the accuracy of the IMF's forecasts. The initial program envisaged that two-thirds of the fiscal adjustment would occur via a cut in government expenditures and one-third via increases in tax revenues. In practice, 40 percent of the fiscal adjustment came from expenditure cuts and 60 percent from tax revenue increases. There is an important literature arguing that the multiplier is larger for tax increases than for government spending (see e.g. Romer and Romer, 2010; Ravn and Mertens, 2013). To the extent that this asymmetry exists, the change in the fiscal mix would have resulted in a more severe recession than the IMF anticipated in designing the program.

[24] Forecasts based on the larger multiplier would still miss the size and the timing of the trough in real GDP.

Statistical analysis of the IMF's forecasts

Annex 9.4 describes our statistical analysis of the IMF's forecasts for Portugal. We show that the forecasts for real GDP growth and the government surplus tended to be over-optimistic. The average forecast error during the 2000–14 period is 0.8 percent for real GDP growth[25] and 1.7 percent for the government balance as percentage of GDP. These averages are statistically different from zero. In contrast, the forecast errors for the current account balance and government debt as percentage of GDP are not statistically different from zero over the same period. But, in the period 2008–14 there is a statistically significant under-prediction bias in government debt forecasts.[26]

In Annex 9.4 we also compare the Fund's forecasts with those of *Consensus* Forecasts[27] and the OECD. We find that the IMF's real GDP growth forecasts were slightly less biased, and more accurate than the *Consensus* forecasts for predictions made *before* the 2011 program, but not during the program period. When the sample is restricted to the program period, IMF forecasts were found to be more biased and no longer more accurate than *Consensus* forecasts.

Taken together, our results are consistent with the findings in IEO (2014) that IMF forecasts during program periods are more optimistic than those made during surveillance periods. The same IEO evaluation finds that these results are particularly strong in cases of exceptional access to IMF resources—that is, large programs such as the 2011 Portuguese program.

We are not alone in questioning the accuracy of the IMF's forecasts. The IEO's survey of Portuguese economists included the question: "During the [IMF] program [for Portugal], do you think that the IMF's forecasts about the future of the Portuguese economy were reasonably accurate?" Only five out of forty survey participants answered "yes."

[25] Formal tests of forecast efficiency for the forecasts of GDP growth in Portugal over the 1990–2014 period show that both the mean and median forecast error are negative, statistically significant, and robust to small sample distortions—that is, indicating over-prediction. These forecast errors, depending on the method used, range from –0.74 percentage points to –1.27 percentage points.

[26] The IMF staff's underestimation of the government debt-to-GDP ratio during 2008–14 is also large: about 12 percentage points, on average, and not inferior to about 6 percentage points.

[27] Consensus Economics produces c*onsensus* forecasts for many emerging and developed economies twice a year, in Spring and Fall. See http://www.consensuseconomics.com. Since fair comparisons of forecasts made by different institutions critically depend on whether forecasts are made using the same information set, we either used the forecast vintage that minimizes information advantage for any particular forecaster or controlled for the differences in the information set used in the forecasts.

Returning to International Capital Markets

A major metric by which we judge the success of the program is whether and how quickly Portugal regained access to international capital markets. By this metric the program was a resounding success.

In 2013, the Portuguese government returned to the international debt market, issuing medium- and long-term bonds. The government also managed to increase the maturity of its existing debt by exchanging some bonds that were due to mature in 2014 and 2015 with bonds that will mature in 2017 and 2018.

A related measure of success is the decline in yields on Portuguese government debt. Initially, markets did not react favorably to the program. The yields on Portugal's ten-year bonds increased from 10.9 percent in June 2011 to a peak value of 13.9 percent in January 2012 (Figures 9.2 and 9.3 above). Thereafter yields did decline, reaching 3.7 percent when Portugal exited the program (May 2014). The spreads relative to Germany tell a similar story, peaking in January 2012 at 12 percent and then declining to 2.3 percent by May 2014 (Figure 9.3).

It is difficult to know how much of the decline in yields was due to the IMF program and how much was due to the actions of the European Central Bank. The latter included: (i) two long-term financing operations (LTRO) (December 2011 and February 2012) and (ii) ECB President Mario Draghi's famous "whatever it takes" speech in July 2012, followed by the ECB's establishment of the outright monetary transactions (OMT) program.

Portuguese banks participated actively in both LTROs. Perhaps not coincidently, Portuguese yields and spreads vis-à-vis Germany started to decline when the second LTRO was established. These facts suggest, but do not prove, that the LTRO programs played an important role in reducing the yield on Portuguese sovereign bonds and facilitating Portugal's return to international capital markets.

The evidence regarding the impact of the Draghi speech and the announcement of the outright monetary transactions program is more ambiguous. The decline in yields on Portuguese bonds began well before the Draghi speech, and seems to have stalled by June 2012, but it resumed after the Draghi speech in July. Viewing the Portuguese data in isolation, it is hard to argue that the Draghi speech and the OMT had a major effect. However, yields on Greek, Irish, Italian, and Spanish debt had been rising since April 2012, and after the speech they began falling again. To the extent that the OMT prevented a larger crisis in Europe, it would have certainly benefited Portugal. But we have no evidence on this counterfactual scenario.

In sum, there are good reasons to believe that both the IMF program and the ECB's actions helped Portugal regain access to international capital markets. But it is difficult to disentangle the quantitative impact of the program and the ECB actions.[28]

[28] A number of authors have tried to disentangle the role of Portugal-specific factors from euro-area-wide factors in the decline of Portuguese sovereign debt spreads. See, for example, De Grauwe and Ji (2014) who argue that euro-wide factors played a dominant role in this decline.

Is Portugal on a Sustainable Path?

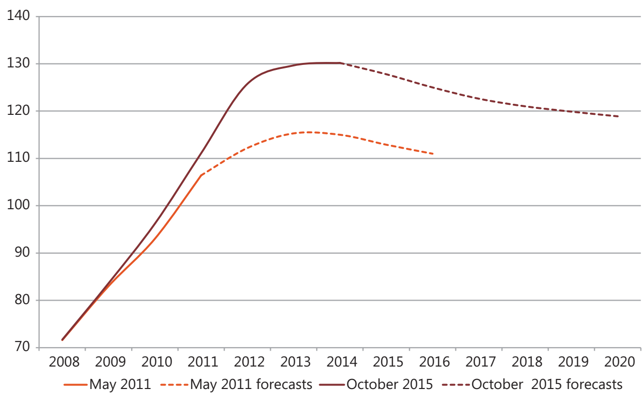
To answer this question, we use two metrics: the ratio of government debt to GDP and the ratio of net foreign liabilities to GDP. For a plausible benchmark scenario, we find that Portugal is on a sustainable path in the sense that both of these ratios will eventually start to decline. But this sustainability is fragile. Relatively modest changes in assumptions about future growth rates, government deficits, and interest rates on government debt would put Portugal on an unsustainable path.

Consistent with our analysis, at the time of writing only one rating agency (DBRS, based in Canada) rates Portugal's public debt as investment grade. Standard & Poor's, Moody's, and Fitch rate Portugal's debt as junk.

Sustainability of government debt

Figure 9.25 shows the forecast and actual evolution of Portugal's government debt as a percentage of GDP. The solid orange line in the figure displays actual data as reported in May 2011. The dashed orange line shows the IMF's forecasts as of May 2011 for the debt to GDP ratio from 2011–16. According to these forecasts, the debt to GDP ratio should have peaked in 2013 at 115.3 percent and then slowly declined. So, the IMF thought the Portuguese government debt was sustainable. The solid brown line shows the historical path for the debt-to-GDP ratio from 2008–15.[29] The dashed brown line shows the IMF's forecasts as of October 2015 for the debt to GDP ratio

Figure 9.25. Portugal: IMF Forecast and Actual Gross Government Debt
(In percent of GDP)



Sources: IMF (2011a) and IMF, *WEO* (October 2015).

[29] The historical paths of debt/GDP as reported by the IMF in May 2011 and October 2015 differ for the period 2009–11 due to data revisions.

Table 9.15. Portugal: IMF Debt Sustainability Analysis

Baseline scenario	2013	2014	2015	2016	2017	2018	2019	2020
Nominal debt (in percent of GDP)	129.7	130.2	127.1	124.4	122.0	120.4	119.4	118.6
Debt service (in percent of GDP)	23.6	25.6	24.0	21.5	16.8	18.7	20.1	24.1
Gross financing need (in percent of GDP)	23.5	25.1	22.4	19.6	14.9	16.9	18.3	22.3
Nominal debt (in percent of revenue)	286.6	292.5	284.3	277.8	272.5	269.1	267.1	265.7
Debt service (in percent of revenue)	52.2	57.4	53.7	47.9	37.4	41.9	45.0	54.0
Gross financing need (in percent of revenue)	52.0	56.3	50.1	43.8	33.2	37.8	41.0	49.9
Real GDP growth (in percent)	−1.6	0.9	1.6	1.5	1.4	1.3	1.2	1.2
Inflation (in percent)	2.2	1.3	1.0	1.3	1.3	1.4	1.5	1.6
Primary balance (in percent of GDP)	0.1	0.5	1.6	1.8	1.9	1.8	1.8	1.8
Effective interest rate (in percent)	3.9	3.9	3.8	3.7	3.6	3.5	3.6	3.7

Source: Authors' calculations using the IMF DSA template and information in IMF (2015b).

from 2015–20.[30] According to the Fund's view in 2015, the debt to GDP ratio should have peaked in 2014 at 130.2 percent and should fall to 118.9 percent by 2020.

Two key facts emerge from Figure 9.25. First, despite the tough austerity measures associated with the 2011 program, the debt to GDP ratio in 2014 was roughly 19 percentage points of GDP *higher* than at the beginning of the program. Second, the absolute level of the debt to GDP ratio at the end of the program in 2014 was 15 percentage points of GDP higher than the IMF had forecast. Clearly, the IMF understated how difficult it would be to bring the ratio of government debt to GDP under control.

A central question is: how sensitive are the IMF's forecasts about the future path for government debt to changes in assumptions about the growth rate of the economy and the size of government deficits?

To answer this question we began by reproducing the baseline scenario used in the IMF's debt sustainability analysis (DSA) as of October 2015.[31] Table 9.15 displays the benchmark assumptions underlying that analysis and projected outcomes. We then analyze the sensitivity of the debt-to-GDP projections to changes in assumptions about the growth rate of the economy, the government deficit, and the yields on government bonds.

Our analysis is based on the template used by the IMF to conduct its DSA.[32] That template ignores general equilibrium effects. For example, when

[30] These forecasts are available in the October 2015 vintage of the *WEO* database.

[31] The IMF's debt sustainability framework is described in its "Staff guidance note for public debt sustainability analysis in market-access countries" (https://www.imf.org/external/np/pp/eng/2013/050913.pdf).

[32] The template can be found at https://www.imf.org/external/pubs/ft/dsa/templ/dsatempl2.xlsm. We thank IMF staff for their assistance in using this template.

the IMF changes its assumptions about the growth rate of the economy, it does not take into account the effects of this change on the government deficit or on sovereign bond yields. Similarly, when the IMF changes its benchmark interest rate assumptions, it does not take into account the implications for the growth rate of the economy, inflation and the government deficit. Despite these drawbacks, we think that this sensitivity analysis sheds light on the robustness of the benchmark scenario for the path for the government debt to GDP ratio. We understand that the DSA is not used in a mechanical way by the IMF staff, who supplements the analysis by using a general macroeconomic framework.

In our first experiment, we assume that the growth rate of real GDP is 0.5 percentage points lower than the IMF benchmark scenario. This value is quite plausible, considering that the average one-year-ahead forecast error associated with the IMF's forecasts for Portuguese real GDP growth ranges from -0.74 to -1.27 (see Annex 9.4). The brown dashed line in Figure 9.26 displays the implied ratio of debt to GDP path up to 2020. This new scenario implies that the debt-GDP ratio stabilizes at around 123 percent in 2019.

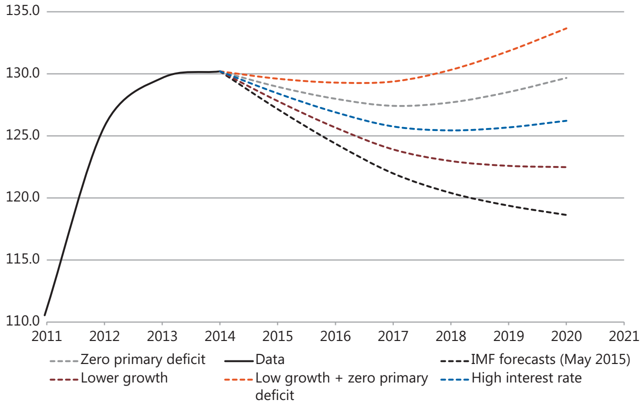
In our second experiment, we assume that the primary deficit is zero. According to this new scenario, depicted by the gray dashed line in Figure 9.26, the debt to GDP ratio starts to rise in 2017 and is on an explosive path.

Our third experiment is a permanent increase of 100 basis points in the interest rate on government debt. In this case, the level of debt falls to 125 percent in 2018 but explodes thereafter.

As noted above, a shortcoming of these exercises is the assumption that deviations of different variables from their benchmark values are uncorrelated. We believe that allowing for realistic correlations would make the sustainability of the government debt more tenuous. It is beyond the scope of this publication to develop a model for the Portuguese economy that allows for these feedbacks. But we can illustrate the importance of allowing for such correlations by combining the low growth and zero primary-surplus scenarios discussed above. One obvious justification for considering this combined scenario is that low growth would generally lead to lower government primary surpluses. The orange dashed line in Figure 9.26 displays the implied path for the debt-to-GDP ratio up to 2020 in the combined scenario. The debt-to-GDP ratio starts to rise in 2016 and then explodes.

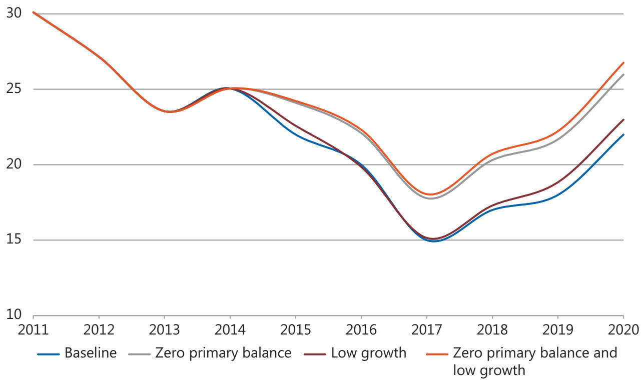
A different way to assess sustainability is to consider the gross financing needs of the government. The blue line in Figure 9.27 displays the IMF's estimates of those needs from 2011 to 2020. Gross financing needs fall until 2017 but rise thereafter. We conducted a sensitivity analysis using the same DSA template used by the IMF to generate the benchmark estimates and the same alternative scenarios discussed above. Figure 9.27 shows that the gross financing needs are not very sensitive to the low growth scenario. In contrast, gross financing needs are quite sensitive to assuming that the primary balance of the government would be zero. The inflection point stays the same but the overall level of gross financing needs increases.

Figure 9.26. Portugal: Gross Government Debt Under Alternative Scenarios
(In percent of GDP)



Sources: Authors' calculations using the IMF DSA template and information in IMF (2015b).

Figure 9.27. Portugal: Gross Government Financing Needs Under Alternative Scenarios
(In percent of GDP)



Sources: Authors' calculations using the IMF DSA template and information in IMF (2015b).

Taken together, our analysis suggests that the sustainability of Portugal's public debt is tenuous: modest adverse shocks to the Portuguese economy or discretionary increases in the government deficit could easily place the government debt-to-GDP ratio on an explosive path. These experiments also suggest that maintaining fiscal discipline is paramount in ensuring that the public debt is sustainable. Overall our analysis is consistent with the IMF's second post-program discussion, published in August, in which the IMF writes (IMF (2015b), p. 30): "Portugal's sizable debt burden and gross financing needs continue to pose significant risks to debt sustainability and leave debt dynamics very sensitive to macro shocks."

Interestingly, the Portuguese economists who participated in the IEO survey seem to be much more pessimistic about the sustainability of Portugal's public debt even than we are. Asked to evaluate the following statement: "Currently, with the program completed, the public debt is sustainable," not a single participant agreed with it.

Sustainability of external liabilities

We now consider the sustainability of Portugal's external liabilities. Figure 9.9 displays our measure of net foreign assets, which is the net international investment position (NIIP) computed by the IMF.[33] For comparison, we also display the net foreign asset (NFA) series constructed by Lane and Milesi-Ferretti (2007) and updated by these authors until 2011. It is clear that the two time series are highly correlated.

In principle, we would like to evaluate the sustainability of the NIIP using the same approach used for the government debt. Unfortunately, the only external debt sustainability analysis performed by the IMF for Portugal pertained to gross external liabilities—presumably because the required information about the maturity and returns of Portugal's gross foreign assets was not available. Nonetheless, studying the gross debt is of interest.[34] In a world where financial inflows and outflows are imperfectly synchronized, the characteristics of gross debt can provide useful signals about the likelihood of sudden stops and other forms of rollover risk.[35]

Figure 9.28 displays Portugal's total (public and private) gross external debt as a percentage of GDP since 2007. For convenience, we refer to this percentage as the external debt ratio. The solid orange line displays that ratio as reported in May 2011. The dashed orange line shows the IMF's forecast, as of that date, for the external debt ratio from 2011 to 2016. According to that forecast, the debt ratio would peak at 249.3 percent in 2012 and decline thereafter. Clearly the IMF judged Portugal to be on a sustainable path with respect to its external debt ratio. The solid brown line shows the historical path of the external debt ratio from 2007–14.[36] The dashed brown line shows the IMF's forecasts of that ratio as of May 2015.[37]

A natural question is: how sensitive are the IMF's forecasts to changes in assumptions about the growth rate of the economy, and the size of current account deficit? We address this question in Annex 9.5 by perturbing key

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[33] According to the IMF's *Balance of Payments Manual* (6th edition), the NIIP is the difference between external financial assets and liabilities.

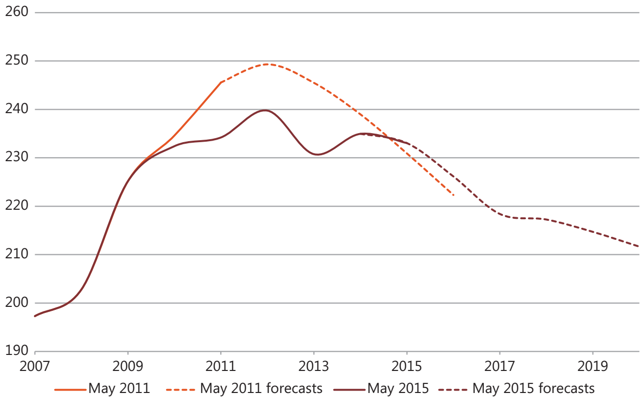
[34] According to the IMF's definition, gross external debt is the outstanding amount of current, non-contingent liabilities that require payment of principal and/or interest by the debtor at some point in the future and are owed to nonresidents by residents of an economy.

[35] See Bruno and Shinn (2013) for a discussion of the importance of gross capital flows.

[36] The historical path of external debt/GDP reported by the IMF in May 2011 and May 2015 differ for the period 2009–11 due to data revisions.

[37] These forecasts are included in the Second Post-Program Monitoring report for Portugal.

Figure 9.28. Portugal: IMF Forecasts and Outcomes of Net External Debt
(In percent of GDP)



Sources: Authors' calculations using the IMF DSA template and information in IMF (2011a; 2015b).

parameters of the IMF analysis (Figure 9.A5.1). In contrast to the sustainability of government debt, we find that the sustainability of Portugal's external debt is quite robust.

As noted above, the IMF does not do a formal sustainability analysis for the current account. Interestingly, very few participants in the IEO survey believed Portugal's current account position to be sustainable. Asked to evaluate the following statement, "Currently, with the program completed, the current account is sustainable," only 5 percent of the respondents agreed.

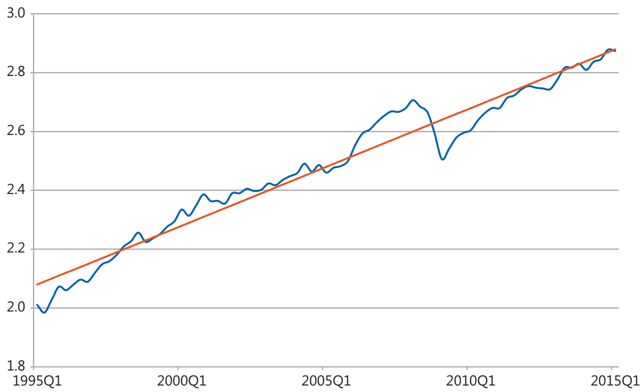
What Caused the Dramatic Improvement in Portugal's Current Account?

Portugal's current account improved dramatically during the implementation of the IMF program. Here we argue that most of the improvement reflected a decline in imports which was the concomitant of the large recession that Portugal experienced. Portugal had been running current account and trade deficits for many years prior to the crisis. Between 1995 and 2011 each of these deficits averaged roughly 8.3 percent of GDP (Figures 9.4 and 9.5). By the time Portugal regained access to international capital markets in 2013, both the trade and the current account surpluses were positive for the first time in 20 years.

Broadly, the improvement in the current account reflected the improvement in the trade balance. Imports accounted for roughly 30 percent of the adjustment in the trade deficit. The large fall in imports almost surely simply reflected the severity of the recession.

It is more difficult to pinpoint the cause of the rise in exports. A number of Portuguese officials whom we interviewed attributed this rise to structural

Figure 9.29. Portugal: Exports
(In billions of euros of 2011 in logs)



Source: Instituto Nacional de Estatística, National Income Accounts.

reforms, though this view is not generally reflected in official IMF documents. Other officials argued that the fall in domestic demand spurred producers to venture into new foreign markets, including Angola, Brazil, and the United States.

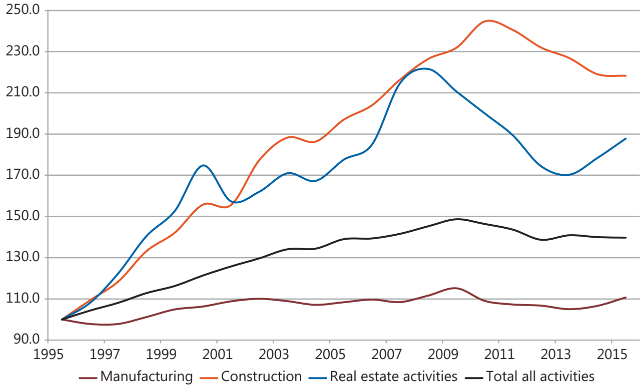
To assess the quantitative importance of these arguments, Figure 9.29 displays the log of Portugal's actual exports in euros and a linear trend estimated using quarterly data for the 1995–2014 period. We see that, by the end of 2014, exports had returned to trend.

Annex 9.6 reports the robustness of our results to different ways of estimating the trend in exports and to different starting points. We show that the inference that most of the growth in exports represents a return to trend is very robust.

A complementary way to assess the performance of exports is as follows. At the end of 2007, the ratio of exports to GDP was 31.1 percent. Suppose that GDP had grown along its trend path calculated from 1995 to 2007 using quarterly data. Then, at the end of 2014 GDP would have been €227.5 billion. Actual exports divided by trend GDP amount to 30.7 percent. So, nominal exports grew at approximately the same rate as pre-crisis trend nominal GDP.

To assess whether growth in exports reflected increased competitiveness, we look at the behavior of unit labor costs, displayed in Figure 9.30. Across the economy as a whole, unit labor costs fell by a modest 4.4 percent between 2010 and 2014. It is even more instructive to focus on the behavior of unit labor costs in the tradable goods industry. Roughly 73 percent of Portuguese exports are goods, most of which are produced in the manufacturing sector. Unit labor costs in manufacturing fell by only 2.2 percent between 2010 and 2014. It is implausible that such a modest fall could account for the

Figure 9.30. Portugal: Unit Labor Costs (1995 = 100)



Source: Eurostat.

34 percent increase in real exports of goods that occurred between the first quarter of 2010 and the fourth quarter of 2014.[38]

Figure 9.29 shows that, by the end of 2014, exports had returned to trend. Given the behavior of unit labor costs, it seems more likely that the strength in exports reflected firms' response to the fall in domestic demand rather than the short-run effects of structural reforms.

Viewed as a whole, our evidence suggests that most of the post-2010 rise in exports reflects a return to trend behavior. The IMF program might still have played a role in the recovery of exports. Had there been no program, Portugal might have had to default on its debt. The resulting financial disruption would have made it very difficult for exporting firms to obtain working capital. In this scenario it would have taken longer for exports to return to trend.

Was the Troika Structure a Problem?

The Portugal program was unusual in that it involved three major institutions. It is difficult to formally assess whether the troika structure was problematic in designing and implementing the program. We have no hard evidence that it was a serious problem. Indeed, Kincaid (2017) argues that:

> . . . the troika arrangement proved to be operationally efficient, although areas for improvement were also identified. Conditional lending programs

[38] We do not have data on unit labor costs for tourism and other export services. Unit labor costs in "wholesale and retail trade, transport, accommodation, and food service activities" fell by 8.7 percent. Exports of services rose by 28 percent between 2010 and 2014. It seems unlikely that the fall in unit labor costs accounts for the bulk of this rise in exports, though it certainly could have played a quantitatively meaningful role.

were negotiated quickly by the troika with the country authorities and program reviews were by and large completed expeditiously; program delays could not be attributed to the troika process itself.

In our view, the basic contours of the program were driven by the constraints discussed in the section "The 2011 Program: Design and Implementation" above. However, the decision to specify highly detailed conditions may well have been driven by the different objectives of the EU and the IMF.

Some of the government officials we interviewed argued that the level of technical expertise and experience of the IMF staff far exceeded that of the EU staff. This gap may have substantially affected the design and implementation of the program. For example, we learned from interviews that the IMF wanted to impose nominal targets for the government budget, but the European Commission had imposed targets as percentages of GDP. The latter decision was clearly problematic since it forced the government to contract fiscal policy further when GDP fell. We were also told that the IMF revised its estimates of the fiscal multipliers well before the EU did.

An additional issue that came up in our interviews was that the different members of the troika pursued different communications strategies. Numerous interviewees stressed that the IMF and the EU could have coordinated their public communications better. We also heard criticisms of the way that the IMF communicated its goals and its rationale for program revisions. Our survey evidence is consistent with our interview evidence. When asked, "Was the IMF's communications strategy effective at explaining to the Portuguese public the rationale for the measures that were implemented?" 72.5 percent of survey respondents answered "No."

Lessons

In this section, we discuss the lessons that, in our view, should be learned from the Portuguese experience. First we focus on lessons about surveillance, and then summarize lessons about program design and implementation.

Lessons About Surveillance

A fundamental lesson from the Portuguese crisis is that disruptive sudden stops can affect countries that are members of currency unions, even when the union members are advanced economies.

In an important article, Cole and Kehoe (2000) argue that the size and maturity structure of government and foreign debt create the possibility of self-fulfilling debt crises. Such crises can take the form of sudden stops in access to international capital markets as well as defaults on foreign debt. The Portuguese crisis fits well into this paradigm. A large stock of government debt and foreign liabilities made Portugal very vulnerable to a loss of access to capital markets. This vulnerability was painfully exposed in 2011. The economics profession and the IMF did not give enough weight to the possibility of a sudden stop in a euro area country.

Prior to the crisis, the IMF monitored the level, maturity, and composition of government debt and foreign liabilities. But, at least in the euro area, it did not place a great deal of emphasis on countries' current account deficits or the maturity structure of liabilities. Judging from the Article IV reports written since the crisis, the IMF has internalized this lesson. It is important to retain this emphasis.

A second lesson is that the narrative about the Portuguese economy that framed the IMF's post-2005 reports was flawed. According to that narrative, Portugal's lack of competitiveness and its large government deficits led to a large increase in the country's demand for credit. If this narrative was entirely correct, the yields on Portuguese debt should have gone up in the years prior to the crisis. In fact, interest rates (both level and spread) on Portuguese debt declined. Hence the supply of credit to Portugal must have increased by more than the demand. As discussed in the section "Background to the Crisis" above, there are many possible reasons why supply increased. The most obvious is that foreign lenders anticipated they would be bailed out if Portugal was in danger of defaulting. But it is also possible that lenders were optimistic, rationally or irrationally, about Portugal's future growth. No doubt there will be other episodes of large increases in the supply of credit to IMF member countries. It is critical to monitor and understand the drivers of large increases in both net and gross capital flows to member countries.

A final lesson for surveillance is that the IMF should urge country authorities to consolidate data on all sources of government debt, making an effort to include all the SOEs and PPPs. This practice is routine for developing economies. It should be routine for developed economies.

Lessons About Program Design and Implementation

Once a balance of payments crisis occurs in a monetary union, policymakers have four non-mutually-exclusive options. The first is to restructure the country's debt. This restructuring can take a variety of forms, including a haircut to the face value of the debt, a maturity extension, and a reduction in coupon payments. The second option is to implement a fiscal devaluation designed to mimic the effects of depreciating the currency. The third option is to put in place an adjustment program supported by official financing that is large enough and long enough for structural reforms to bear fruit in the form of higher productivity and faster growth. The fourth option is to enforce a sharp fiscal contraction.

The institutional and political realities both in Portugal and in the euro area meant that debt restructuring was never seriously on the table; the fear of contagion and moral hazard were simply too great. This is a critical point to which we return below.

A fiscal devaluation was attempted but proved to be politically unfeasible. Portugal's pre-crisis tax rates were already so high that further increases in the VAT or a redistribution of tax burdens between firms and workers were politically infeasible.

The third option—a long, large program—faced two key obstacles: it would have required a much larger financial envelope, and the Portuguese government would have had to be willing to enter a long-term arrangement involving close supervision by the troika. Neither of these conditions was satisfied.

The fourth option—a severe fiscal contraction—has two effects. It reduces the government's need to borrow funds, and it depresses aggregate output, reducing imports and increasing the incentive to export. The net result is a reduction in the need for external finance.

We infer that, in the absence of a mechanism that allows for orderly debt restructuring, resolving future balance of payments crises in countries that are members of a monetary union will likely involve large fiscal contractions which will contribute to large recessions. Making this harsh reality clear to members of a monetary union could help prevent future balance of payments crises by reducing incentives to borrow from abroad.

In the case of Portugal, the IMF underestimated the size of the fiscal multiplier (see the section "Assessment of the EFF-Supported Program for Portugal" above). Arguably this error played an important role in the IMF's underestimates of the severity of the recession. It meant that significant real-time adjustments had to be made to the program, and was costly to the IMF's credibility. To the IMF staff's credit, the estimate of the multiplier was raised in October 2012. Looking forward, we hope that the IMF will continue to recognize that fiscal multipliers depend on the monetary regime in effect and the state of the economy.

We now return to the controversial issue of debt restructuring. Opponents of restructuring often emphasize the moral hazard implications for borrowers. But for every borrower there is a lender. To the extent that lenders believe they will always be bailed out, they will underprice risk and supply more credit than they would in the absence of bailout guarantees. From this perspective, *not* restructuring debt creates a moral hazard problem in credit markets.

The moral hazard problem associated with bailing out lenders has been long recognized in the domestic banking literature. In their seminal paper, Kareken and Wallace (1978) argue that guaranteeing bank deposits incentivizes banks to take on more risk and increase the supply of loans. A simple-minded solution to this problem is to eliminate guarantees. But, of course these guarantees exist to reduce the probability of bank runs. Kareken and Wallace conclude that, in the presence of guarantees to bank depositors, banks must be regulated.

The analogy with international borrowing and lending is obvious. The prospect of an eventual bailout led Portugal's creditors to supply more credit to that country. The result was a fall in interest rates (level and spreads) and a massive increase in liabilities that made Portugal vulnerable to a sudden stop.

Both the Portuguese authorities and its creditors were willing participants in the process that ended so badly.

We conclude with perhaps the most important lesson from the crisis. If debt restructuring is *off* the table, then the international community must develop institutions to regulate international lenders. If debt restructuring is *on* the table, then the international community must develop institutions to preempt sudden stops.

Annex 9.1. Timeline of Key Events

- *March 2011:* The main credit rating agencies (Moody's, S&P, and Fitch) downgrade Portugal's sovereign rating. Portugal's Prime Minister José Socrates resigns after the opposition rejects his austerity package (the fourth package of austerity measures in a year). Elections are scheduled for June.
- *April 2011:* New rounds of sovereign credit rating downgrading occur. The fast deterioration of the external environment, reflected in the acute retrenchment of net capital inflows and a sharp increase in sovereign spreads (at about 9,000 basis points over German bonds), combined with a delicate fiscal situation—the government debt and deficit stand at 111 percent and 7.4 percent of GDP, respectively—prompt the authorities to request financial assistance from the EU. The troika—composed of the IMF, the ECB, and the European Commission—begins a technical assessment of the situation of the Portuguese economy.
- *May 20, 2011:* The IMF Executive Board approves, under the Fund's fast-track Emergency Financing Mechanism procedures, a three-year SDR 23.7 billion (€26 billion) arrangement for Portugal under the Extended Fund Facility (EFF). The program, negotiated by the socialist party in government, entails exceptional access to IMF resources amounting to about 2,306 percent of Portugal's quota, and forms part of a cooperative package of financing with the troika partners amounting to €78 billion.
- *June 5, 2011:* The Social Democrats win the election and replace the socialist party in the government.
- *July 2011:* Moody's downgrades Portugal's sovereign credit rating to below investment grade. The IMF provides technical assistance (TA) on a diagnostic of Portugal's public financial management systems, risk monitoring of corporate and household sectors, and on the special on-site inspections program for financial institutions.
- *August 2011:* The IMF provides TA on the bank early intervention, resolution, and deposit insurance framework.
- *September 16, 2011:* The Bank of Portugal reports that Madeira island had under-reported its debt since 2004, putting further pressure on the ability of Portugal to meet its deficit targets.

- *September 2011:* The IMF provides TA on streamlining revenue administration organization and strengthening taxpayer compliance management to safeguard revenue collection; and on the corporate insolvency regime and debt restructuring. The first review under the EFF-supported program with Portugal is completed and a €3.98 billion disbursement is approved.
- *October 13, 2011:* Portuguese authorities release the government budget for 2012, containing wage cuts for civil servants, who lose 2/14 months of salary. A 5 percent reduction previously introduced by the socialist government remains. The "Contribuição Extraordinária de Solidariedade"—a tax on pensions—is broadened. The work week goes from 35 to 40 hours, the VAT increases, and some holidays are discontinued.
- *November 2011:* The IMF provides follow-up TA on public financial management and revenue administration; Fitch downgrades Portugal's sovereign credit to below investment grade.
- *December 2011:* The ECB initiates longer-term refinancing operations (LTRO), offering banks low-interest rate financing with a three-year maturity.
- *January 2012:* S&P downgrades Portugal's sovereign credit rating to below investment grade; IMF provides TA on an assessment of private sector financing.
- *February 2012:* Moody's further downgrades Portugal's sovereign credit rating to Ba3 from Ba2; a program review mission by the troika to Portugal concludes that policies are generally being implemented as planned and economic adjustment is under way, but challenges remain.
- *February 29 2012:* The ECB undertakes a second LTRO, which provides €529.5 billion of low-interest rate loans with three-year maturity. Portuguese banks then borrowed €10 billion under this program.
- *March 2012:* The IMF provides TA on the revision of local and regional finance laws.
- *April 2012:* The IMF completes the third review under the EFF-supported program, approves a €5.17 billion disbursement, and provides TA on macro-fiscal issues and tax administration and judicial reform.
- *June 2012:* Three leading Portuguese banks (Millennium BCP, Portugal's largest private bank in terms of assets; Banco BPI; and state-owned Caixa Geral de Depósitos) draw on funds provided either under the program or from the state budget to meet tough new capital requirements. The move leaves only Banco Espírito Santo (BES) among Portugal's leading banks without state funding.
- *July 16, 2012:* The IMF completes the fourth review under the EFF-supported program, approves a €1.48 billion disbursement, and provides TA on judicial reform. Portugal's Constitutional Court

rejects the cut of 2 out of 14 months of salary for civil servants (see footnote 16).

- *July 26, 2012:* Mario Draghi, President of the ECB, makes a speech in which he declares that "the ECB is ready to do whatever it takes to preserve the euro."
- *July 2012:* The European Commission agrees to finance the recapitalization of Spanish banks. Spain then borrowed close to €38.9 billion for this purpose.
- *August 2, 2012:* The ECB announces a new outright monetary transactions (OMT) program. Under certain conditions this program allows the ECB to undertake potentially unlimited purchases of government debt in the secondary market to prevent divergence in short-term bond yields and safeguard "an appropriate monetary policy transmission and the singleness of the monetary policy."
- *August 2012:* The IMF provides TA on bank resolution.
- *September 7, 2012:* The government announces a fiscal devaluation to be included in the 2013 budget. The tax on labor paid by firms would decline from 23.75 percent to 18 percent and the tax on wages paid by the workers would increase from 11 percent to 18 percent.
- *September 15, 2012:* Large protests take place against the fiscal devaluation.
- *September 16, 2012:* Vice-Prime Minister Paulo Portas criticizes the fiscal devaluation.
- *September 21, 2012:* The government abandons fiscal devaluation
- *October 3, 2012:* The government announces an extra 4 percent tax on income, starting in 2013 (this tax is still in place). Tax brackets are reduced from 8 to 5.
- *October 2012:* The IMF completes the fifth review under the EFF-supported program, approves a €1.5 billion disbursement, and provides TA on public expenditure reform options.
- *November–December 2012:* The IMF provides TA on revenue administration and on public financial management.
- *January 2013:* Portugal's President Aníbal Cavaco Silva sends the 2013 budget to the Constitutional Court for review; Portugal sells €2.5 billion of five-year bonds through banks, the first offering of that maturity in almost two years; the IMF completes the sixth review under the program, and approves a €838.8 million disbursement; the IMF Executive Board concludes the 2012 Article IV consultation with Portugal. Directors highlight the uncertain near-term outlook and sizable medium-term economic challenges, and call for sustained efforts to make the tradable sector

more competitive, boost long-term growth, and further advance fiscal consolidation.

- *March 2013:* The IMF provides TA on revenue administration and the troika agrees to give Portugal one more year, through 2015, to cut its budget deficit to 3 percent of GDP.
- *April 5, 2013:* The Constitutional Court declared unconstitutional the cuts in the fourteenth monthly payment to public wage earners and pensioners, the cuts of 90 percent of 2 out of 14 months of yearly payments to pensioners, the 5 percent cut in sick-leave subsidies, and the 6 percent cut in unemployment subsidies. Overall, the Court rejects four out of nine contested austerity measures in the 2013 budget.
- *April 2013:* The troika mission discusses with Portuguese government compensating policy measures for meeting the agreed fiscal deficit targets given the Constitutional Court ruling.
- *May 2013:* Portugal sells €3 billion via banks in its first ten-year bond in more than two years, at an average yield of 5.67 percent; the EU extends Portugal's deadline for correcting the excessive deficit to 2015.
- *June 2013:* The IMF provides TA on corporate tax reform, completes the seventh review under the program, and approves a €657.47 million disbursement.
- *July 1, 2013:* Victor Gaspar resigns as minister of finance and is replaced by Treasury Secretary Maria Luis de Albuquerque; the IMF provides TA on reforming the budget framework law, in order to streamline budgetary procedures.
- *August 29, 2013:* The Constitutional Court rejects proposal to re-qualify civil servants and a bill that would have effectively allowed the state to fire public sector workers.
- *September 26, 2013:* The Constitutional Court rejects labor reforms introduced in 2012 related to the elimination of jobs and the ability to fire workers who did not adapt well to their jobs.
- *November 2013:* The IMF completes the eighth and ninth reviews under the program and approves a €1.91 billion disbursement; Portugal's Parliament passes the 2014 budget, the last under the program.
- *December 19, 2013:* The Constitutional Court rejects the equalization of pension benefits for workers contributing to Caixa Geral de Aposentações and Segurança Social and blocks a key and controversial austerity measure in the 2014 budget that provides for cuts of up to 10 percent in civil service pensions.
- *December 2013:* Portugal swaps €6.6 billion in bonds expiring in 2014 and 2015 for longer maturities; IMF provides TA on reforming the budget framework law.

- *January 2014:* Portugal issues €3.25 billion of five-year bonds at a yield of 4.66 percent; IMF provides TA on the corporate debt restructuring regime put in place under the EFF-supported program.
- *February 2014:* The IMF completes the tenth review under the EFF-supported arrangement for Portugal, approves a €0.91 billion disbursement, and provides TA on reforming the public sector accounting framework.
- *April 2014:* the IMF completes the eleventh review under the program and approves a €851 million disbursement; Portugal auctions €750 million in ten-year bonds at an average yield of 3.58 percent in its first auction since April 2011.
- *May 17, 2014:* Portugal exits the program without completing the twelfth and final review and without receiving the associated final disbursement; Portugal's Constitutional Court strikes down some austerity measures imposed at the start of the year.
- July 2014: Moody's upgrades Portugal's government bond rating to Ba1 from Ba2.
- *August 2014:* The Portuguese government rescues Bank Espírito Santo (BES), the country's leading private bank, at a cost of €4.4 billion.
- *October 2014:* The IMF publishes a Fiscal Transparency Assessment (FTA) report for Portugal.
- *January 2015:* Portugal begins the process of early repayment of IMF loans, following in the footsteps of Ireland.

Annex 9.2. Identifying Sudden Stops

We used quarterly data from the IMF's *International Financial Statistics (IFS)* database, covering 182 countries over the period 1990–2013. The definition of a sudden stop episode follows the methodology in Forbes and Warnock (2012).

Let K_t denote total capital inflows (not net flow, just inflows) in quarter t, consisting of inflows of portfolio capital, direct investment, and "other investment" (which includes bank flows). We first compute the sum of capital inflows over the last four quarters:

$$C_t = \sum_{i=0}^{3} K_{t-\iota}$$

Then, we compute the change in C_t relative to the same quarter of the previous year:

$$\Delta C_t = C_t - C_{t-4}$$

Let m_t and s_t be the rolling mean and standard deviation of, ΔC_t respectively. These statistics are computed over the past five years ending in quarter t. An episode of sudden stop starts when

$$\Delta C_t < m_t - s_t,$$

that is, when ΔC_t falls below one standard deviation from its rolling mean. That episode ends n periods later when. $\Delta C_{t+n} \geq m_{t+n} - s_{t+n}$ As a secondary condition, the period between t and $t+n$ is only associated to a sudden stop episode if in at least one quarter $\Delta C_{t+n} \geq m_{t+n} - 2s_{t+n}$ (i.e., ΔC_t falls below two standard deviations from its rolling mean).

We identified 138 episodes from 68 countries over the period 1997–2013.[1] Once we identified the episodes of sudden stops across countries, we organized the data using the starting date of episodes (T0) as reference. We then ran 25 cross-section regressions of the variable of interest, V (either net capital flows or the current account balance in percentage of GDP) on a constant, for each period (relative to T0) from 3 years before to 3 years after T0 (i.e., for T0-12, T0-11,…T0,…T0+12). What we report in Figure 9.17 in the main text are the estimated values of the constant and the standard deviations around them. The constant is a measure of the cross-country average of V for horizon h (= -12,…,-1,0,1,…12) relative to T0. We compare it with the sudden stop in Portugal, which we identified as having started in 2011Q1.

Annex 9.3. List of Structural Conditionality Measures for Portugal

1. Prepare a comprehensive inventory of the existing tax expenditures (including all types of exemptions, deductions, and reduced rates), by type of tax, along with their costing estimates.
2. Establish temporary task force of judges to clear tax cases worth above €1 million.
3. Approve a standard definition of arrears and commitments.
4. Prepare a comprehensive report on ten state-owned enterprises (SOEs) posing the largest potential fiscal risks to the state. The report would cover (i) concrete plans, per enterprise, for reducing its operational costs, consistent with an average cut of at least 15 percent in the sector over 2009 levels; (ii) a planned revision of the tariffs.
5. Direct all banking groups subject to supervision in Portugal to reach a core Tier 1 capital of 9 percent by end-2011 and 10 percent by end-2012 and maintain it thereafter, with banks required to present

[1] Because of the lags embedded in the methodology, we can only start identifying episodes in 1997 even if the data start in 1990.

by end-June 2011 plans on how they intend to comply with these requirements.

6. Based on assessment from EU/IMF technical assistance on the budgetary implications of main public-private partnership (PPP) programs, recruit a top tier international accounting firm to complete a more detailed study of PPPs and identify areas for deeper analysis by an international consulting firm.
7. Publish a fiscal strategy document for the general government which will specify four-year medium-term economic and fiscal forecasts, supporting analysis and underlying assumptions, and four-year cost of new policy decisions.
8. Conduct and publish the results of a survey of arrears of general government entities and SOEs for all categories of expenditure as of end-June 2011.
9. Review the efficiency of support schemes for co-generation and renewables and propose possible options for reducing the implicit subsidy.
10. Prepare a report on SOEs based on forecast financial statements assessing their financial prospects, potential government exposure, and scope for orderly privatization.
11. Design a program of special on-site inspections to validate the data on assets that banks provide as inputs to the solvency assessment.
12. Seek evaluation of the enhanced solvency and deleveraging assessment framework by a joint team of experts from the EC, the ECB, and the IMF.
13. Improve disclosure on nonperforming loans by adding a new ratio aligned with international practices to the current ratio that covers only overdue loan payments.
14. Amend legislation concerning credit institutions in consultation with the EC, the ECB, and the IMF to strengthen the early intervention framework and introduce a regime for restructuring of banks as a going concern under official control.
15. Amend the Insolvency Law to better facilitate effective rescue of viable firms and support rehabilitation of financially responsible individuals.
16. Amend the relevant legislation to strengthen deposit insurance framework by authorizing bank resolution financing and introducing depositor preference.
17. Take all necessary legal, administrative, and other steps to make arbitration for debt enforcement cases fully operational.
18. Submit to Parliament a law, already agreed with social partners, to align and reduce severance payments on all new contracts (fixed term and open-ended).

19. Finalize calibration of fiscal reform to reduce unit labor costs via deficit-neutral reduction in labor taxes (fiscal devaluation).
20. Eliminate "golden shares" and all other special rights established by law or in the statutes of publicly quoted companies that give special rights to the state.
21. Submit to Parliament legislation revising the Competition Law, making it as autonomous as possible from the Administrative Law and the Penal Procedural Law and more harmonized with the European Union competition legal framework.
22. Review the Code of Civil Procedure and prepare a proposal addressing the key areas for refinement.
23. Issue an instruction to general government units requiring that from January 1, 2012, (i) commitments must be controlled against available funds recorded in the accounting system and evidenced by authorized commitment documents ("cabimento") bearing valid commitment numbers; (ii) all other commitments would be considered illegal and not eligible for payment; and (iii) any public official incurring such illegal commitment or expenditure will be subject to specified penalties in accordance with the budget framework law.
24. Issue an instruction to general government units to ensure that systems and procedures will comply, by end-December 2011, with the revised budget execution rule, as set out in the above instruction.
25. Amend relevant legislation in consultation with the EC, the ECB, and the IMF to strengthen the early intervention framework, introduce a regime for restructuring of banks as a going concern under official control and strengthen deposit insurance framework.
26. Parliamentary approval of a 2012 budget consistent with the program, in line with paragraph 3 of the Memorandum of Economic and Financial Policies (MEFP).
27. Revise and submit to Parliament the draft regional public finance law.
28. Launch a tender to hire a top tier international accounting firm to review and complete a more detailed study of all 36 PPP contracts at the national level.
29. Prepare a proposal on measures to be used to correct excessive rents in special (co-generation and renewables) and standard regimes. The proposal will consider the merits of a full range of measures and cover all sources of rents.
30. Amend the framework (Law No. 63-A/2008) for bank access to public capital.
31. Pass a resolution of the Council of Ministers on a strategy document to clear the stock of domestic arrears of the general government and

SOE hospitals, establishing the governance arrangements for prioritization and payment decisions.

32. Prepare a proposal to implement identified best international practices in order to reinforce the independence of the main sectoral regulators.
33. Implement a full-fledged large taxpayer office (LTO), to cover audit, taxpayer services, and legal functions concerning all large taxpayers, including the adoption of account managers.
34. Publish the Ministerial Order defining the new reference tariff and formula for updating tariffs in the future for the electricity co-generation regime.
35. Develop a specific program for unwinding Parpublica.
36. Prepare a proposal for encouraging the diversification of financing alternatives to the corporate sector.
37. Submit to Parliament the bill to implement the judicial roadmap to improve the court structure.
38. Make effective the amendments to the Corporate Insolvency Law to better support rescue of viable firms (after completing all necessary legislative and publication requirements).
39. Submit to Parliament amendments to the Code of Civil Procedure to streamline and speed up the court procedures.
40. Eliminate the Power Guarantee investment incentive for the set of power plants existing or already licensed at the time of the approval of the 2007 Decree Law (264/2007) governing this incentive.
41. Develop a public financial management strategy covering the next three years, to be attached to the 2013 budget.
42. Submit to Parliament draft legislation defining the criteria for extension of collective agreements (including a majority representation threshold) and the modalities for their implementation.
43. Submit to Parliament the 2013 budget consistent with ¶5-9 of the MEFP.
44. Submit to Parliament amendments to the law governing banks' access to public capital (MEFP ¶18).
45. Adopt by the Council of Ministers and publish the medium-term fiscal framework that includes fully-specified measures to meet the 2014 deficit target (LOI ¶4 and MEFP ¶7).
46. Submit to Parliament the supplementary budget that includes measures needed to meet the 2013 fiscal objective (MEFP ¶6).
47. Submit to Parliament a new draft public administration labor law that will aim at aligning current public employment regime to the private

sector rules, including for working hours and holiday time, and termination of tenure (MEFP ¶8).

48. Submit to Parliament a draft law on the redesigned mobility pool (MEFP ¶8).
49. Submit to Parliament a legislative proposal that increases the statutory retirement age to 66 years (MEFP ¶8).
50. Submit to Parliament a legislative proposal that aligns the rules and benefits of the public sector pension fund, CGA, to the general pension regime (MEFP ¶8).
51. Update projections of the medium-term energy tariff debt path and identify policy options to eliminate the tariff debt by 2020 (MEFP ¶30).
52. Enact the severance pay reform that reduces severance payments to 12 days per year for all new permanent labor contracts (MEFP ¶28).
53. Submit to parliament a draft 2014 budget consistent with the general government deficit target of 4 percent of GDP (MEFP ¶4-6).
54. Submit to Parliament a draft Law or a budget provision to implement the single wage scale PER measure.
56. Submit to Parliament a supplementary budget to enact the necessary changes to the existing extraordinary solidarity contribution on pensions (CES), consistent with the general government deficit target of 4 percent of GDP (MEFP ¶5).
57. Approve the decree law on the increase in the beneficiaries' contributions to the special health insurance schemes (ADSE, SAD, and ADM) (MEFP ¶5).
58. Specify fiscal measures consistent with achieving the general government deficit target of 2.5 percent of GDP in 2015 (MEFP ¶6).
59. Present measures to tackle remaining excess rents in the energy sector and to deliver cost reduction to be reflected in energy prices (MEFP ¶26).
60. Launch formal negotiations with port concessionaries with a view to modifying existing concession contracts so as to foster efficiency and price reduction (MEFP ¶27).

Source: Memorandum of Economic and Financial Policies (MEFP).

Annex 9.4. Assessing IMF Forecasts for Portugal

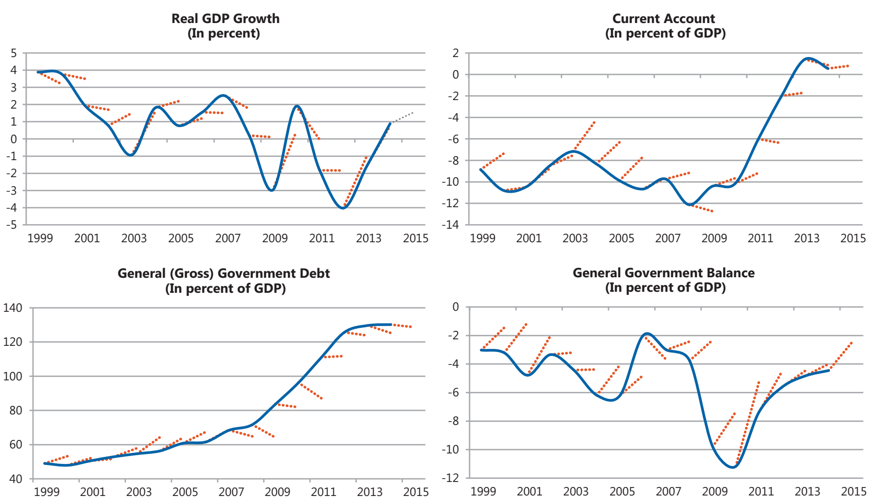
Forecasts are an important part of the IMF's work, both in country surveillance and in the context of IMF-supported programs. Perceptions about the quality and integrity of these forecasts are crucial both for the IMF's reputation and for the traction of its advice. In a recent survey of Portuguese economists conducted by the IEO evaluation team for this chapter, in response to the question, "During the [IMF] program [for Portugal], do you think that the IMF's forecasts about the future of the Portuguese economy were reasonably accurate?" only 5 out of 40 survey participants said "yes." Out of the 33 participants who responded "no," 22 also said that forecast errors reduced the credibility of the program.

This annex discusses IMF forecasts of some selected variables for Portugal. It focuses on one-year-ahead forecasts of four variables—real GDP growth (annual percentage change), current account balance, government fiscal balance, and government debt (the last three variables measured as percent of GDP).

Figure 9.A4.1 provides a general impression of IMF forecasts for these variables since Portugal's adoption of the euro in 1999. The figure compares the IMF's one-year-ahead forecasts with actual outcomes for real GDP growth (annual percent change), current account balance, government surplus, and government debt. The last three variables are expressed as percentages of GDP. The forecasts are shown as dotted orange lines, were published in the annual Fall editions of the *WEO* over the period 1990–2014. The outcomes, shown as solid blue lines, were published in the October 2015 *WEO*.

At first glance, since 1999, IMF forecasts of GDP growth and, especially, government balance (GB) seem over-optimistic. For these variables, more often than not—60 percent and 87 percent of the time in the case of GDP growth and GB forecasts, respectively—projections exceed outcomes. On average, forecasts exceed outcomes by 0.8 percentage points (growth) and 1.7 percent of GDP (GB), respectively, and these averages are found to be

Figure 9.A4.1. Portugal: IMF One-Year-Ahead Forecasts vs. Outcomes



Note: For each date, the orange dotted line shows the forecast of the variable in question that was published in the Fall *WEO* of the previous year.
Source: Authors' calculations using IMF, *WEO* data.

statistically different from zero, suggesting that forecasts for these variables are biased, as further discussed below.

Errors in forecasts of the current account balance and government debt, on the other hand, seem more evenly distributed between negative and positive values and the average forecast errors are not statistically different from zero when considering the full sample over the 2000–14 period. However, when considering subsamples pre- and post-2007, errors in both current account balance and debt forecasts switch from predominantly negative (–1.7 and –3.3 percent of GDP, on average, respectively), indicating over-predictions, to mostly positive (1.3 and 12.8 percent of GDP, on average, respectively). Since the average forecast error for both variables over the two subsamples is statistically different from zero (except for current account balance, over 2008–2014), biased forecasts cannot be ruled out.

Forecast Errors: Unbiasedness, Serial Correlation, and Informational Efficiency

For a more formal assessment of the quality of IMF forecasts, let $e_{t,t+1}$ be the error associated with a forecast made in year t (Fall edition of the *WEO*), for the variable of interest y at year t+1. The forecast error is computed as the difference between the actual outcome, $\hat{y}_{t,t+1}$, and the one-year-ahead forecast made in t, $\hat{y}_{t,t+1}$:

$$e_{t,t+1} = y_{t+1} - \hat{y}_{t,t+1}.$$

For forecasts of y_{t+1} made at time t, in order to accommodate data revisions, the literature—for example, Timmermann (2006), Faust (2013), and Genberg and Martinez (2014)—typically considers the measurement of y_{t+1} taken at some time in the future, $t+1+k$, to represent the actual outcome corresponding to the forecast. In what follows, we allow the data to be revised during one year before being treated as final and compared with predictions (i.e., we set $k = 1$).

Under the assumption that the forecaster knows the structure of the economy, typical tests of forecast quality focus on informational efficiency and accuracy. Efficiency is related to whether forecasts are unbiased in the statistical sense (i.e., whether the average forecast error is zero), not serially correlated (i.e., past errors are not correlated with future errors), and whether errors cannot be predicted by making use of any information available to the forecaster at the time of the forecast.

To assess unbiasedness, we estimate the following regression:

$$e_{t,t+1} = \mu + \varepsilon_t, \tag{1}$$

where μ is the mean forecast error and ε_t represents the regression residuals. Forecasts are considered biased if the (null) hypothesis that $\mu = 0$ can be rejected at standard levels of statistical significance. For robustness, we also test whether the median forecast error is statistically different from zero using a Wilcoxon test.

To assess whether forecast errors are serially correlated, we compute the correlation between errors from current and past forecasts, $\rho = corr(e_{t-1,t;}e_{t,t+1})$. Efficiency requires that $\rho = 0$. A simple two-sided t-test is used to test that hypothesis.[1]

Informational efficiency can also be assessed by checking whether forecasts for Portugal take into account other information that was available to the forecasters at the time the projections were made. Consider the following regression:

$$e_{t,t+1} = c + \beta x_t + \varepsilon_t, \tag{2}$$

where x is another series that may contain information relevant for forecasting y and ε_t is the regression error. Efficiency requires that $\beta = 0$, which can again be tested using a t-test.

Tables 9.A4.1–A4.3 show the results of informational efficiency tests in IMF forecasts of GDP growth since the early 1990s. To shed light on the effects of both the 2008-09 global financial crisis and the 2011 IMF program for Portugal, results are reported for three different subsamples, all starting in 1990 and ending in 2007, 2010, and 2014, respectively.

Table 9.A4.1 refers to unbiasedness and serial correlation of errors. For comparison, it also contains information about errors in forecasts of GDP growth in a "peer" country (Spain), and in countries that have regional (Germany), and global importance (United States).

Some caveats should be noted before considering the results. First, as argued by Faust and Wright (2013), statistical tests of unbiasedness, accuracy, and overall efficiency may be a poor assessment of the quality of forecasts for economies in which there are relatively frequent structural changes.[2]

Second, several of the results discussed below may not be robust to generalizations; they vary with the measure of the bias (mean or median) and are affected by considerations related to sample size, forecast horizon, and *WEO* edition (Spring or Fall), especially in light of the 2008–09 global financial crisis.[3] Changes in assumptions along those dimensions affect the sample and may greatly change the results. In addition, many of the results may be subject

[1] The test statistic in this case, $t^* = \dfrac{\rho}{\sqrt{(1-\rho^2)/(n-2)}}$, follows a t-distribution with $n-2$ degrees of freedom.

[2] Efficiency tests rely on the assumption that the forecaster knows the structure of the economy being forecast. If there are learning opportunities for the forecaster (e.g., as structural reforms are laid out and their effects are only gradually felt in the economy), a "failure" in these tests may not be caused by factors available to the forecaster that are not considered in the forecasts, but may simply be a result of the time needed for the forecaster to catch up with the changing structure of the economy and for this learning to be gradually reflected in the sample used in the tests.

[3] See Genberg and Martinez (2014).

Table 9.A4.1. Descriptive Statistics for Errors in One-Year-Ahead IMF Forecasts of GDP Growth
(In percentage points)

Country	Mean μ	Std. Dev. σ	$H_0: \mu = 0$ prob[1]	$H_0: \mu = 0$ < 0.05[2]	Median m	$H_0: m = 0$ prob[3]	Corr$(e_{t-1,t}; e_{t,t+1})$ ρ	$H_0: \rho = 0$ prob[1]
					1990–2006			
Portugal	−1.01	1.48	0.01	0.83	−0.74	0.02	0.24	0.34
Spain	−0.23	1.04	0.38	0.09	0.20	0.60	0.37	0.15
Germany	−0.74	1.52	0.06	0.47	−0.82	0.08	−0.21	0.41
United States	0.10	1.42	0.78	0.08	0.26	0.64	0.16	0.53
					1990–2010			
Portugal	−1.06	1.46	0.00	0.93	−1.27	0.01	0.09	0.68
Spain	−0.43	1.24	0.13	0.27	−0.02	0.31	0.21	0.35
Germany	−0.65	1.89	0.13	0.33	−0.72	0.15	−0.23	0.31
United States	−0.07	1.49	0.83	0.05	−0.02	1.00	0.14	0.54
					1990–2013			
Portugal	−1.00	1.39	0.00	0.96	−1.00	0.00	0.11	0.61
Spain	−0.43	1.30	0.12	0.31	0.04	0.35	0.16	0.46
Germany	−0.59	1.77	0.12	0.35	−0.47	0.13	−0.22	0.31
United States	−0.02	1.41	0.94	0.05	0.04	0.85	0.13	0.55

Notes:
(1) p-value associated with H_0: $\mu = 0$ in a two-sided t-test.
(2) Frequency of rejection of H_0: $\mu = 0$ at 5% significance in 10,000 bootstrap estimations of $e_t = \mu + \varepsilon_t$.
(3) p-value associated with H_0: $m = 0$ in a Wilcoxon signed rank test.
Source: Authors' calculations using IMF, *WEO* data.

to small-sample distortions, despite our efforts to account for or adjust to them, as explained below.

With those caveats in mind, Table 9.A4.1 suggests that the IMF's one-year-ahead *WEO* forecasts of GDP growth for Portugal were, in general, biased towards over-prediction, but not serially correlated. Regardless of the sample period, both the mean and median forecast error are negative (ranging from –0.74 to –1.27 percentage points) and statistically significant at less than 5 percent. To account for the possibility of small sample distortions in the size of the statistical tests, Table 9.A4.1 also reports the fraction of 10,000 bootstrap estimations of Equation (1) in which the hypothesis H_0: $\mu = 0$ can be rejected at the 5 percent level. For Portugal, this fraction ranges from 83 to 96 percent of replications, depending on the subsample.[4]

For comparison, no statistically significant bias in IMF forecasts can be detected for either Spain or the United States, while the evidence of biased forecasts for Germany is somewhat weaker.[5] Regarding serial correlation, no evidence

[4] A similar exercise was carried out for the current account, government deficit, and government debt over the 1990–2014 period. No statistically significant evidence of either bias or serial correlation was found.

[5] There is no evidence of bias in forecasts when the 2011–13 period is included. Moreover, when biases are found, they are significant at the 10 percent, but not the 5 percent, level. Finally, the frequency of rejection of H_0: $\mu = 0$ in bootstrap replications is always less than 50 percent.

Table 9.A4.2. Portugal: Estimated Value of β in Equation (2)

x = GDP growth from (country)	Subsample		
	1990–2006	1990–2010	1990–2013
Spain	0.94	0.11	−0.03
prob[(1)]	0.20	0.70	0.90
bootstrap < 0.05[(2)]	0.25	0.07	0.05
Germany	−0.38	−0.18	−0.22
prob	0.50	0.65	0.52
bootstrap < 0.05	0.10	0.07	0.10
United States	−0.55	−0.02	−0.01
prob	0.40	0.95	0.98
bootstrap < 0.05	0.14	0.05	0.05

Notes:
(1) *p*-value associated with a two-sided t-test; and
(2) frequency of rejection of H_0: $\beta = 0$ at 5% significance in 10,000 bootstrap estimations of equation (2).
Source: Authors' calculations using IMF, *WEO* data.

is found for one-year-ahead forecasts of GDP growth in any of the countries shown in Table 9.A4.1, except weak evidence for Germany over 1990–2010.[6]

Table 9.A4.2 shows the estimated value of β in Equation (2), in which forecasts of GDP growth in Spain, Germany, and the United States are used, one at a time, to represent x. The table displays the ρ-values associated with the hypothesis that $\beta = 0$ along with results from a bootstrap procedure. Results suggest that errors in IMF one-year-ahead forecasts of GDP growth for Portugal seem orthogonal to forecasts of the same variable in the three countries considered, in all subsamples. Efficiency along these lines cannot be rejected.

Taken together, however, the results in Tables 9.A4.1 and 9.A4.2 indicate that IMF forecasts of GDP growth for Portugal are not efficient. Although efficiency cannot be rejected either on the grounds of serially correlated errors or because projections ignore information contained in GDP growth forecasts for other countries, IMF forecasts of GDP growth for Portugal do show signs of a systematic optimistic bias. While this conclusion must be taken with caution in light of the caveats discussed above, it suggests that these forecasts may be improved if IMF forecasters proactively adjust their forecasts, at least partially, by incorporating the measured bias.

Comparison of IMF with Consensus and Other Forecasts

Table 9.A4.3 shows a comparison between one-year-ahead forecasts of GDP growth by the IMF (*WEO*, Fall editions) and *Consensus* forecasts based on the ratio of root-square mean errors (RSME). Only editions of *Consensus* forecasts published in the same month as the *WEO* (September or October,

[6] Serial correlation of forecast errors can also be assessed with the help of equation $e_{t,t+1} = \mu + \rho e_{t-1,t} + \varepsilon_t$, by testing if $\rho = 0$ (see Timmerman, 2006). Results from this approach do not materially change our conclusions as the estimated ρ is not statistically significant in both t-tests and in large shares of bootstrap replications (no less than 44 percent, for Portugal).

Table 9.A4.3. Portugal: Comparative Statistics for Errors in IMF and *Consensus* Forecasts of GDP Growth
(Percentage points)

	Mean	Std. Dev.	H_0: $\mu = 0$		Median	H_0: $m=0$	Corr(e_{t-1},t;$e_{t,t+1}$)	H_0: $\rho = 0$	RSME		
Forecaster	μ	σ	prob(1)	< 0.05(2)	m	prob(3)	ρ	prob(1)	Ratio	prob(4)	< 0.05(5)
					2001–2006						
Consensus	–1.22	1.36	0.08	0.43	–1.20	0.09	0.11	0.83	1		
IMF	–0.99	1.18	0.10	0.35	–0.95	0.14	0.05	0.93	0.83	0.17	0.43
					2001–2010						
Consensus	–1.30	1.48	0.02	0.71	–1.77	0.03	–0.28	0.43	1		
IMF	–1.11	1.27	0.02	0.71	–1.44	0.04	–0.29	0.42	0.85	0.02	0.93
					2001–2013						
Consensus	–0.95	1.51	0.04	0.55	–1.04	0.06	–0.05	0.86	1		
IMF	–0.98	1.17	0.01	0.82	–1.27	0.03	–0.21	0.49	0.83	0.02	0.82

Notes:
(1) p-value associated with H_0: $\mu = 0$ in a two-sided t-test.
(2) Frequency of rejection of H_0: $\mu = 0$ at 5% significance in 10,000 bootstrap estimations of $e_t = \mu + \varepsilon_t$.
(3) p-value associated with H_0: $m = 0$ in a Wilcoxon signed rank test.
(4) p-value associated with the Diebold-Mariano (DM) statistic.
(5) Frequency of rejection of equal accuracy from 10,000 bootstrap replications of the DM statistic.
Sources: Authors' calculations using data from IMF, *WEO* and *Consensus Forecasts*.

depending on the year) are included, as an attempt, albeit imperfect, to keep the information sets available to the two groups of forecasters comparable. Since *Consensus* has only published forecasts for Portugal since 2001, we restricted the sample to 2001–14.

First, note that the evidence of an optimistic bias of IMF forecasts of GDP growth for Portugal, discussed in the context of Table 9.A4.1, can also be seen in Table 9.A4.3, although the evidence from bootstrap replications for the mean forecast error is substantially weaker in the first two subsamples. Nevertheless, IMF forecasts show over-predictions of GDP growth ranging from 0.95 percentage points to 1.44 percentage points, depending on the measure (mean or median) and subsample. Again, there is no evidence of serially correlated forecast errors.

Second, *Consensus* forecasts, too, are biased towards over-predicting GDP growth. For the first two subsamples, point estimates point to larger biases relative to those from IMF forecasts. Tests of equality of mean and median (not shown) indicate that differences in biases from IMF and *Consensus* forecasts are not statistically significant at the 10 percent level, however.[7]

Forecast accuracy is typically assessed against a benchmark—either forecasts resulting from a purely mechanical method or projections made by other forecasters. Table 9A4.3 also sheds some light on the accuracy of IMF forecasts relative to those of *Consensus*. It shows that the RSME of *Consensus* forecasts is about 20 percent greater than that of their IMF counterparts. Diebold-Mariano tests suggest that, except in the case of the shorter subsample, these differences in accuracy are statistically significant at less than the 5 percent significance level—a conclusion supported by the large share (more than 80 percent) of bootstrap replications rejecting the hypothesis of similar accuracy.

As an alternative approach to comparing bias and accuracy in projections made by different forecasters, we also propose the following fixed-effect panel regression:

$$z_t = c + \mu_t + \alpha MONTH_t + \beta_1 IMF_t + \beta_2 EC_t + \beta_3 OECD_t + \varepsilon_t, \qquad (3)$$

where $z_t = e_{t,t+1}$ or $z_t = \sqrt{e^2_{t,t+1}}$, depending on whether the analysis focuses on bias or accuracy, respectively; c is a constant; μ_t is a period-fixed effect; *MONTH* takes the value of 1 to 12, according to the month in which the forecast was made;[8] IMF_t, EC_t, and $OECD_t$ are dummy variables that take the value of 1 when forecasts come from the IMF, the European Commission (EC), or the Organisation for Economic Co-operation and Development (OECD); and ε_t is an error term.

[7] For the mean, we used a *t*-test allowing for different variances across subsamples from the two forecasters. For the median, we used the Wilcoxon/Mann-Whitney test.

[8] This is an attempt to control for the fact that forecasts made late in the year have the advantage of using a larger information set.

Table 9.A4.4. Portugal: Bias and Accuracy of IMF, EC, and OECD Forecasts of GDP Growth Relative to *Consensus* Forecasts
(In percentage points)

	Dependent Variable			
	Bias: Forecast Error		Accuracy: Root-Squared Error	
	Coef.	Prob	Coef.	Prob
Subsample: Feb 2001–April 2011				
Constant	−1.84	0.00	2.40	0.00
MONTH	0.09	0.00	−0.08	0.00
IMF	0.18	0.05	−0.13	0.08
EC	0.34	0.00	−0.10	0.17
OECD	−0.08	0.42	0.11	0.25
# Obs.	184		184	
Adj. R^2	0.96		0.91	
Subsample: May 2011–June 2014 (IMF Program)				
Constant	−0.84	0.00	1.43	0.00
MONTH	0.11	0.00	−0.07	0.00
IMF	−0.76	0.00	0.05	0.83
EC	−0.51	0.02	−0.19	0.27
OECD	−0.22	0.40	−0.14	0.63
# Obs.	60		60	
Adj. R^2	0.78		0.59	

Sources: Authors' calculations using data from IMF, *WEO; Consensus Forecasts;* European Commission; and Organisation for Economic Co-operation and Development.

The constant in Equation (3) captures the (conditional) mean of z_t coming from *Consensus* forecasts, also included in the estimation of Equation (3), while the dummy variables capture the marginal contributions to biases and root-squared errors (RSE) from the remaining forecasters.

Table 9.A4.4 shows the estimation results for two subsamples: one for forecasts made in the context of standard IMF surveillance of the Portuguese economy (February 2001 to April 2011) and another, discussed in the next subsection, for forecasts made during the 2011–14 program. Note that having more information to make forecasts helps to reduce both the optimistic bias and the RSE; the estimated coefficients associated with *MONTH* are positive in the bias regression and negative in the RSE regression, and always statistically significant, regardless of the subsample. Regarding unbiasedness, the results confirm that one-year-ahead *Consensus* forecasts of GDP growth are biased towards over-prediction—the regression constant is always negative and statistically significant.

For the "surveillance period," both IMF and the EC forecasts are less biased than those by *Consensus*, as indicated by positive and statistically significant estimated coefficients associated with the respective dummy variables. The IMF, but not the EC, is also more accurate than *Consensus* and the difference in accuracy is significant at 8 percent, consistent with the RSME comparisons noted in Table 9.A4.3. The bias and mean RSE in OECD forecasts, however, are not statistically different from those in *Consensus* forecasts.

IMF Forecasts for Portugal during the 2011–14 Program

Table 9.A4.4 also shows that IMF forecasts made during Portugal's program period seem very different from those made during the surveillance period: they are more optimistically biased and are no longer more accurate than *Consensus* forecasts. This finding is consistent with the widespread notion (see IEO, 2014) that IMF forecasts during programs are more optimistic than those made in the context of surveillance, especially in cases of exceptional access to IMF resources, as in the 2011 Portuguese program.

Table 9.A4.5 and Figure 9.23 in the main text show IMF forecasts and outcomes for the four variables of interest, as well as for CPI inflation and the unemployment rate, during the IMF program for Portugal. Table 9.A4.5 allows the comparison of outcomes both with historical data since the early 2000s and with two sets of IMF projections, one made just before the 2011 program (in April 2011) and another at program start (May 2011). Because the two sets of forecasts were made just one month apart, their differences can be reasonably attributed to the projected effects of the program.

The IMF forecasts of GDP growth made just before the start of the program projected a cumulative growth rate of –0.1 percent for the Portuguese economy over 2011–14, the period that would cover the duration of the program announced later. In the next round of forecasts, conducted after the program's approval, the IMF revised that projection for the same period downwards to –0.3 percent, showing that the IMF rightly expected the fiscal austerity measures embedded in the program to negatively affect growth prospects. However—consistently with a benign view of how its programs affect growth prospects—the Fund forecast that after completing the program, Portugal would achieve higher real GDP than under the pre-program forecast.

Table 9.A4.5. IMF Forecasts for Portugal: Projections vs. Outcomes

	Historic Data		Projections		
			WEO April 2011	Program, May 2011	Outturns
	Average 2000–10	2010	2011–14		
Real GDP (% change)	1.0	1.9	–0.1	–0.3	–6.6
CPI inflation (%)	2.5	1.4	6.6	8.5	6.6
			2014		
General government balance (% of GDP)	–5.3	–11.2	–5.8	–2.3	–4.5
General government gross debt (% of GDP)	64.1	96.2	100.8	115.0	130.2
Unemployment rate (%)	7.0	10.8	11.3	12.0	13.9
Current account balance (% of GDP)	–9.8	–10.1	–6.4	–3.4	0.6

Sources: IMF, *WEO*, April 2011 and October 2015 and IMF (2011a).

The upper-left chart in Figure 9.23 in the main text displays Portugal's projected and realized GDP profiles, indicating that the bulk of the contractionary effects of the fiscal austerity measures built into the program was projected to kick in before 2013 and that subsequently, perhaps as a result of the effect of either structural reforms or the closing of the output gap,[9] growth would accelerate (and produce the larger cumulative growth relative to earlier projections, as discussed above). Unfortunately, the outcome was less rosy than pictured by either set of IMF projections and GDP actually shrank by about 6.6 percent during the program years.

Forecast errors for the other variables are consistent with the Fund's sizable over-prediction of GDP prospects (Table 9.A4.5 and Figure 9.23 in the main text). Since the IMF staff underestimated the severity of the crisis that hit the Portuguese economy, it also underestimated both the rise in the unemployment rate—which peaked in 2013 at more than 16 percent (vis-à-vis a projection of just above 13 percent)—and the effect of the depressed domestic demand on the speed of the reversal observed in the current account balance—from a deficit of 10.1 percent of GDP, in 2010, to a surplus of 0.6 percent in 2014, instead of the 3.4 percent of GDP forecast *deficit* for that year (Figure 9.23 in the main text, lower-right chart).

The IMF also had over-optimistic expectations about how Portugal's fiscal situation would improve during the program. It consistently overestimated the government balance (GB) and underestimated debt-to-GDP ratios (Table 9.A4.5 and Figure 9.23 in the main text, mid-left and mid-right charts, respectively). It assumed that the implementation of the program would produce a substantially lower government deficit in percent of GDP than it had forecast before the start of the program—by 1 percentage point in 2012, and by 3.5 percentage points by 2014. The actual profile of the government balance over 2011–14 was closer to the pre-program forecast and so was the end-point in 2014 (Figure 9.23 in the main text and Table 9.A4.2).

Errors in forecasts of both GDP growth and government balance explain a large part of the errors in IMF forecasts of government debt. Table 9.A4.6 shows a decomposition of the errors in IMF forecasts (made in May 2011) of government debt for 2014. The contributions of errors to forecasts of the implicit real interest rate on the debt, real GDP growth, government deficit, and the initial stock (i.e., by 2010) of government debt are computed by replacing, one at a time, the projected profiles of these variables by their actual outcomes. The IMF predicted that the debt ratio would be at 115 percent of GDP by 2014, missing by 15.2 percentage points the actual debt ratio. Forecast errors in GDP growth and government deficit, combined, explain 10.8 percentage points (71.1 percent of the error), while mismeasurement of

[9] During interviews with the evaluation team, IMF staff involved in the design of the program said that the faster growth in the second half of the program period was mostly due to the closing of the output gap. They did not assume there would be an effect of structural reforms before 2016.

Table 9A4.6. Decomposition of IMF Forecast Errors for Government Debt
(In percent of GDP)

	2010	2011	2012	2013	2014	Error
Forecast (May 2011)	93.0	106.4	112.2	115.3	115.0	
Actual (*WEO* Oct. 2015)	96.2	111.1	125.8	129.7	130.2	15.2
Real interest rate	93.0	107.8	115.3	116.7	115.6	0.7
GDP inflation	93.0	106.5	112.4	115.5	115.1	0.1
Real GDP growth	93.0	106.0	114.4	120.9	122.4	7.4
Debt in 2010	93.0	109.8	115.8	118.9	118.6	3.6
Debt-creating flows	93.0	107.0	117.0	119.1	118.4	3.4
					Total	15.2

Sources: Authors' calculations using data from IMF (2011a), IMF (2015b), and IMF, *WEO*, October 2015.

the debt-to-GDP ratio at the starting point and the underestimation of the (nominal) interest rate account, respectively, for 3.6 percentage points and 0.8 percentage points.

Summary and Conclusions

The main conclusions from this annex can be summarized as follows:

- Survey-based evidence suggests that IMF forecasts for Portugal made during the program are not perceived as reasonably accurate and that they damaged the credibility of the program.
- No statistically significant evidence of either a systematic bias or serial correlation was found in (one-year-ahead) IMF forecasts of the current account, government deficit, and government debt over the full sample covering the period 1990–2014. However, when the sample is restricted to forecasts for the period after the adoption of the euro, only considering statistically significant evidence, IMF forecasts:

  —Systematically over-predicted the government balance measured as a percentage of GDP, by 1.6 percentage points, on average;

  —Over-predicted both the government debt and the current account balance (as a percentage of GDP) during 1999–2007 by 3.3 percentage points and 1.7 percentage points, on average;

  —Underestimated the government debt-to-GDP ratio during 2008–14 by almost 13 percentage points, on average, and by no less than about 5 percentage points.
- Regarding the IMF's one-year-ahead forecasts of real GDP growth for Portugal, statistically significant evidence suggests that:

  —There was a clear bias towards over-prediction—statistically significant biases are found for different sample periods, regardless of the measure used (mean or median)—but no serial correlation or correlation with forecasts of GDP growth for other countries that could affect GDP growth in Portugal;

—Average overestimation of GDP growth ranged from about 0.98 percentage points to about 1.27 percentage points, depending on the method used;

—IMF forecasts were in general as biased as, but more accurate than, *Consensus* forecasts;

—The overall superiority of IMF forecasts relative to *Consensus* is basically explained by differences in forecasts made *before* the 2011 IMF program, when IMF forecasts were both (slightly) less biased and more accurate;

—When the sample is restricted to the program period, IMF forecasts were more biased and no longer more accurate than *Consensus* forecasts;

—Over the program period, the cumulative error in IMF forecasts was sizable (above 6 percentage points), indicating that the IMF largely missed the depth of the recession hitting the Portuguese economy at the time;

—One possible reason for this large error is that the IMF underestimated the depressive effect of the austerity measures embedded in the program by using a smaller fiscal multiplier than the actual multiplier;

—"Counterfactual forecasts" constructed assuming a larger multiplier (0.8, instead of 0.5) are able to reduce the cumulative forecast error of GDP growth over the duration of the program by about 33 percent.

- During the program, the IMF overestimated the improvement in Portugal's fiscal situation:

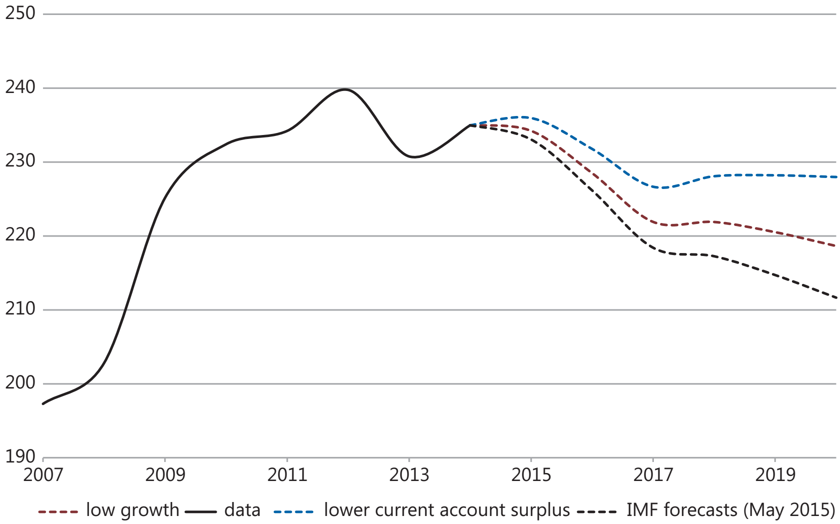
—Both government debt and the government deficit, both measured in percent of GDP, were largely underestimated (by 15.2 percentage points and 2.2 percentage points, respectively);

—Considering the forecasts for 2014 that were made at the start of the program, forecast errors in GDP growth and government deficit together explain 71.1 percent of the difference between the actual debt-to-GDP ratio in 2014 (130.2 percent) and the forecast ratio (115 percent).

Annex 9.5. Sustainability of Portugal's External Liabilities

We begin by displaying Portugal's total (public and private) net external debt as a percentage of GDP since 2007 (see Figure 9.28 in the main text). For convenience, we refer to this percentage as the external debt ratio. The

Figure 9A.5.1. Portugal: Net External Government Debt Under Alternative Scenarios
(In percent of GDP)



Source: Authors' calculations using the IMF DSA template and information in IMF (2015b).

solid orange line in Figure 9.28 displays that ratio as reported in May 2011. The dashed orange line shows the IMF's forecast, as of that date, for the external debt ratio from 2011–16. According to that forecast, the debt ratio would peak at 249.3 percent in 2012 and decline thereafter. Clearly, the IMF judged Portugal to be on a sustainable path with respect to its external debt ratio. The solid brown line shows the historical path of the external debt ratio from 2007–15.[1] The dashed brown line shows the IMF's forecasts of that ratio as of May 2015.[2]

As with the government debt, a central question is: how sensitive are the IMF's forecasts to changes in assumptions about the growth rate of the economy, and the size of current account deficit?

We reproduced the IMF's analysis of external debt sustainability as of May 2015. Table 9.A5.1 displays the benchmark assumptions underlying that analysis. Here we report sensitivity of the external debt projections to several changes in the benchmark assumptions. Consistent with our discussion above, our analysis, like that of the IMF, ignores general equilibrium effects when we change a benchmark assumption.

[1] The historical path of debt/GDP reported by the IMF on May 2011 and May 2015 differ for the period 2009–11 due to data revisions.
[2] These forecasts are included in the Second Post-Program Monitoring report for Portugal.

Table 9.A5.1. Portugal: IMF External Debt Sustainability Analysis as of May 2015

Key Macroeconomic Assumptions Underlying Baseline	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Baseline: External debt	232.4	234.2	239.8	230.8	235.0	233.0	226.2	218.4	217.2	214.7	211.7
Nominal GDP (euros)											
Real GDP growth (in percent)	1.9	−1.8	−4.0	−1.6	0.9	1.6	1.5	1.4	1.3	1.2	1.2
GDP deflator in euros (change in percent)	0.6	−0.3	−0.4	2.2	1.3	1.0	1.3	1.3	1.4	1.5	1.6
Nominal external interest rate (in percent)	2.3	2.8	2.9	2.4	2	2	2	2.1	2.2	2.3	2.5
Growth of exports (euros, in percent)	13.8	13.8	4.3	6.6	2.5	12.3	5	6	5.4	4.9	4.6
Growth of imports (euros, in percent)	12.6	1.7	−5.3	1.7	4.1	9.4	5.6	6.8	6.2	5.6	4.9
Current account balance, excluding interest payments	−5	0.5	5	7.2	5.2	5.8	5.4	5.2	5	5.1	5.3
Net non-debt-creating capital inflows	−3.6	4.9	−3.8	0.2	−0.6	0.6	0.6	0.4	0.3	0.2	0.1
Nominal GDP	179.9	176.2	168.4	169.4	173	177.5	182.6	187.7	192.6	197.9	203.3
Current account balance	−10.1	−6	−2.1	1.4	0.6	1.1	0.8	0.6	0.3	0.1	0.1
Current account deficit	10.1	6	2.1	−1.4	−0.6	−1.1	−0.8	−0.6	−0.3	−0.1	−0.1
Interest payments	5.1	6.5	7.1	5.8	4.6	4.7	4.6	4.6	4.7	5	5.2

Sources: Authors' calculations using the IMF DSA template and information in IMF (2015b).

In our first experiment, we assume that the growth rate of real GDP is 0.5 percentage points lower than the IMF benchmark scenario. The brown-dashed line in Figure 9.A5.1 above displays the implied external-debt ratio up to 2020. While the lower growth scenario raises the level of the external-debt ratio it does not overturn the conclusion that the ratio is on a sustainable path.

In our second experiment, we cut the current account surplus exclusive of interest payments by 50 percent. The blue-dashed line in Figure 9.A5.1 displays the implied external debt ratio path up to 2020. Despite the large change in the benchmark assumption, the external debt ratio appears to be borderline sustainable.

Allowing for realistic correlations between growth and the current account would make the sustainability of external debt ratio more robust. The reason is that the current account is generally countercyclical. So, lower growth improves the current account surplus.

Annex 9.6. Robustness of Export Trend Estimation

To assess the robustness of our results, we estimated the trend in exports using the Hodrick-Prescott (HP) and the band-pass (BP) filters. We also studied the impact of using different starting points for the linear trend analysis and of controlling for the effects of external economic conditions on Portugal's exports. Our analysis is based on quarterly, seasonally adjusted data.

There is a well-known problem with the sensitivity of inference to end points in small samples detrended with two-sided filters, such as the HP and BP filters. We deal with this problem as follows. First, we estimated an ARIMA (p, 1, q) model—where p and q were selected from the set {0, 1, 2} according to information criteria—using quarterly data of real exports for the period 1995Q1 to 2014Q4. We then used the estimated model to produce out-of-sample forecasts for 2015Q1–2025Q4. We applied the HP and BP filters over the extended sample ending in 2025Q4 (using actual data up to 2014Q4 and forecasts for the remaining extended sample) so that 2014Q4 is no longer the end of the sample.

Tables 9.A6.1 and 9.A6.2 report the cumulative deviation of exports from its trend value during the post-program period (2011Q3–2014Q4)—measured as percentage of Portugal's GDP in 2011—estimated using the different methods and starting points. Table 9.A6.1 was constructed using the raw exports data.

Table 9.A6.2 displays results obtained using residuals from a regression of Portugal's exports on real GDP in Spain. To control for different levels of spillovers, we also studied the residuals of regressions of Portuguese exports on real GDP from the euro area, the United States and the world. There was no material difference relative to the results reported in Table 9.A6.2.

Tables 9.A6.1 and 9.A6.2 show that the inference that most of the growth in exports represents a return to trend is very robust.

Table 9.A6.1. Portugal: Cumulative Deviation of Exports from Trend
(In percent of 2011 GDP)

T_0	Linear	HP Filter	Band-Pass
1995Q1	–2.29	0.44	1.68
1995Q2	–2.10	0.44	1.69
1995Q3	–1.79	0.44	1.66
1995Q4	–1.56	0.44	1.60
1996Q1	–1.42	0.44	1.62
1996Q2	–1.20	0.44	1.59
1996Q3	–1.01	0.44	1.55
1996Q4	–0.82	0.44	1.57
1997Q1	–0.57	0.44	1.50
1997Q2	–0.36	0.44	1.43
1997Q3	–0.21	0.44	1.41
1997Q4	–0.04	0.44	1.36
1998Q1	0.09	0.44	1.32
1998Q2	0.18	0.44	1.29
1998Q3	0.25	0.44	1.27
1998Q4	0.26	0.44	1.28
1999Q1	0.40	0.44	1.28
1999Q2	0.53	0.44	1.29
1999Q3	0.66	0.43	1.32
1999Q4	0.75	0.43	1.35
2000Q1	0.81	0.43	1.43
2000Q2	0.78	0.43	1.38
2000Q3	0.84	0.43	1.48
2000Q4	0.82	0.43	1.59
2001Q1	0.71	0.43	1.52
2001Q2	0.69	0.44	1.52
2001Q3	0.70	0.44	1.49
2001Q4	0.77	0.44	1.58
2002Q1	0.75	0.44	1.58
2002Q2	0.76	0.44	1.60
2002Q3	0.76	0.43	1.60
2002Q4	0.80	0.43	1.60
2003Q1	0.87	0.43	1.59
2003Q2	0.90	0.43	1.60
2003Q3	0.97	0.44	1.56
2003Q4	1.03	0.44	1.53
2004Q1	1.07	0.44	1.50
2004Q2	1.11	0.44	1.38
2004Q3	1.08	0.43	1.50
2004Q4	1.17	0.45	1.40
2005Q1	1.21	0.46	1.51
2005Q2	1.37	0.52	1.44
2005Q3	1.51	0.59	1.42
2005Q4	1.67	0.69	1.36

Table 9.A6.2. Portugal: Cumulative deviation of exports from trend
(In percent of 2011 GDP)
(Only component of exports that are orthogonal to Spain's real GDP)

Beginning of Sample	Linear	HP Filter	Band-Pass
1995Q1	2.10	1.10	1.77
1995Q2	2.22	1.10	1.78
1995Q3	2.45	1.10	1.75
1995Q4	2.60	1.10	1.68
1996Q1	2.64	1.10	1.71
1996Q2	2.75	1.10	1.68
1996Q3	2.85	1.10	1.65
1996Q4	2.95	1.10	1.65
1997Q1	3.07	1.10	1.59
1997Q2	3.17	1.09	1.52
1997Q3	3.21	1.09	1.52
1997Q4	3.27	1.09	1.46
1998Q1	3.29	1.09	1.42
1998Q2	3.27	1.09	1.40
1998Q3	3.23	1.09	1.38
1998Q4	3.14	1.09	1.39
1999Q1	3.15	1.09	1.39
1999Q2	3.18	1.09	1.40
1999Q3	3.20	1.09	1.42
1999Q4	3.18	1.09	1.45
2000Q1	3.14	1.09	1.52
2000Q2	3.02	1.09	1.47
2000Q3	2.98	1.09	1.56
2000Q4	2.87	1.09	1.66
2001Q1	2.67	1.09	1.58
2001Q2	2.57	1.09	1.59
2001Q3	2.49	1.09	1.57
2001Q4	2.46	1.09	1.64
2002Q1	2.37	1.09	1.64
2002Q2	2.29	1.09	1.67
2002Q3	2.20	1.09	1.67
2002Q4	2.14	1.09	1.66
2003Q1	2.12	1.09	1.66
2003Q2	2.06	1.09	1.67
2003Q3	2.06	1.09	1.62
2003Q4	2.01	1.09	1.61
2004Q1	1.97	1.09	1.57
2004Q2	1.92	1.09	1.48
2004Q3	1.82	1.07	1.56
2004Q4	1.81	1.08	1.47
2005Q1	1.77	1.08	1.60
2005Q2	1.85	1.13	1.57
2005Q3	1.94	1.19	1.51
2005Q4	2.04	1.27	1.46

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PART IV

Statement by the Managing Director and the Chairman's Summing Up

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Statement by the Managing Director on the Independent Evaluation Office's Report on the IMF and the Crises in Greece, Ireland, and Portugal: An Evaluation by the Independent Evaluation Office

Executive Board Meeting July 19, 2016

I welcome the report of the Independent Evaluation Office (IEO) on the Euro Area crisis programs. Their work provides an independent and in-depth account, which I have no doubt will make an important contribution to understanding the Fund's approach to the crisis. As I have emphasized repeatedly, the IEO plays a vital role in enhancing the learning culture within the Fund, strengthening the Fund's external credibility, and supporting the Executive Board's institutional governance and oversight responsibilities.

Overall, the conclusion I draw is that the Fund's involvement in the Euro Area crisis programs has been a qualified success. The crisis in the Euro Area was unprecedented. Coming against the backdrop of the global financial crisis, the risks of broader contagion were high. Key challenges included the abrupt loss of market access; the need for orderly adjustments in countries with deep imbalances and no recourse to exchange rate policies; and the absence of Euro Area firewalls. In the face of this unprecedented systemic challenge, Fund-supported programs succeeded in buying time to build firewalls, preventing the crisis from spreading, and restoring growth and market access in three out of four cases (Ireland, Portugal, Cyprus). Greece, however, was unique: while initial economic targets proved overly ambitious, the program was beset by recurrent political crises, pushback from vested interests, and severe implementation problems that led to a much deeper-than-expected output contraction. On the other hand, Greece undertook enormous adjustment with unprecedented assistance from its international partners. This enabled Greece to remain a member of the Euro Area—a key goal for Greece and the Euro Area members.

The IEO's report offers many useful suggestions for the way forward. The Fund has also continually evaluated its own performance during the course of the 2010/11 programs and has taken action to incorporate lessons learned. That work will continue, and will benefit from the IEO's evaluation.

I. Perspective on the Unprecedented Euro Area Crisis

With the passage of time, it may be too easy to forget what the world looked like in 2010, especially the uncertainty, market volatility, and fear of yet another Lehman-like systemic shock. Integrated financial markets and the lack of a Euro Area-wide crisis management framework and firewall meant that problems in countries in crisis could have spilled over to other vulnerable Euro Area members, posing potentially severe systemic risks. There was a need to build firewalls in a short time, amid great uncertainty and within the Euro Area's consensus-based governance framework which required political agreement among 17 sovereign nations. Designing the adjustment programs was challenging as these Euro Area members faced abrupt loss of market access and deep imbalances—including structurally rooted competitiveness problems in some cases—without recourse to exchange rate flexibility.

Viewed in this context, the Fund-supported programs in the Euro Area were a success, albeit a qualified one. First and foremost, they succeeded in stemming systemic risks by, among other things, buying time to mobilize political support among Euro Area members to build firewalls and a crisis management framework. With the world economy fragile in the wake of the global crisis and financial markets still reeling from the collapse of Lehman only 18 months earlier, systemic concerns inevitably were paramount—and major contagion was avoided. Moreover, three of four programs—in Ireland, Portugal, and Cyprus—were successful in helping restore growth and market access. Still, recessions in some of these cases were deeper and longer than expected. Fiscal multipliers were initially underestimated (though later adjusted) and, importantly, both the global and European recoveries were weaker than expected.

Greece, however, posed additional and unique challenges. With unparalleled international support, Greece undertook major fiscal adjustment. But Greece was afflicted to a much greater degree than other countries by pushback from vested interests, severe implementation problems, and recurrent political crises. The attendant deep confidence crises—and repeated episodes of fears about Grexit—led to a much deeper-than-expected output contraction. Of course, none of these impediments was foreseen in advance and, with the benefit of hindsight, the initial assumptions about program ownership and growth proved much too optimistic. However, Greece remained a member of the Euro Area—a key objective for both Greece and other Euro Area members.

The IEO's reports echo many of the lessons that we have drawn from our own internal assessments. We undertook rigorous self-assessment in the course of the 2010/11 programs and, as a result, have already made changes to aspects of the Fund's operational and policy work. Early lessons were adopted in the context of the programs' quarterly reviews: for example, fiscal multipliers were adjusted; and greater realism was applied to the likely pace of structural reforms. The Fund's frameworks for debt sustainability analyses and dealing with debt overhangs were strengthened—including reform of the exceptional access policy and elimination of the systemic exemption. Under its program, Greece benefitted from substantial haircuts on private sector claims in 2012, as well as refinancing on highly concessional terms from its official creditors, and the IMF is currently calling for further official debt relief. Given the "troika" experience, work is underway to improve the effectiveness of the Fund's collaboration with regional financing arrangements. Regarding surveillance, we have undertaken major initiatives to reflect the more globalized and interconnected world. These initiatives include revamping the legal framework for surveillance through a new Integrated Surveillance Decision, deepening analysis of risks and spillovers, strengthening macro-financial and financial sector surveillance (including of systemic risk), and upgrading the assessment of external positions.

In summary, the crisis in the Euro Area was extraordinary. It posed unprecedented challenges that, with the global financial crisis providing tinder, could have rapidly spread through Europe and beyond. The Fund, in conjunction with our membership, our partners in Europe, and the wider global community, took steps that averted what could have been a much more severe European and even global crisis. As we reflect upon this extraordinary time and upon our work to restore stability and quell a potentially larger crisis, we will continue to strive to do even better and to further refine our responses as we evolve as an institution. We must constantly aspire to do better in avoiding crises, managing crises, and learning from the past. And, I assure you, we will continue to be a learning institution in our endeavor to foster global monetary cooperation, secure financial stability, and promote sustainable economic growth with high employment and shared prosperity around the world.

II. Response to IEO Recommendations

The IEO makes five recommendations in this report. Below is my proposed response to each of these.

Recommendation 1. *The Executive Board and management should develop procedures to minimize the room for political intervention in the IMF's technical analysis.*

I support the principle that the IMF's technical analysis should remain independent. However, I do not accept the premise of the recommendation, which the IEO failed to establish in its report, and thus do not see the need to develop new procedures.

Recommendation 2. *The Executive Board and management should strengthen the existing processes to ensure that agreed policies are followed and that they are not changed without careful deliberation.*

I broadly support this recommendation. I concur that policy changes should be based on careful consideration by the Board. This, indeed, is standard practice. Even though all rules were followed, the process surrounding the creation of the systemic exemption took place under extraordinary circumstances, and I am committed to handling such circumstances better in the event of a future emergency situation of the kind the Fund faced in May 2010. The IEO also suggests that the Board independently "reviews the experience with the implementation of the exceptional access policy during the Euro

Area crisis." This kind of review is already being undertaken in the context of the Ex-Post Evaluations of Exceptional Access Arrangements for the crisis countries, including the one currently underway for Portugal, and thus an additional process is not warranted. Finally, I of course support the principle that we follow existing policies. However, I consider that existing checks and balances are adequate and commit to ensuring that they are diligently applied.

Recommendation 3. *The IMF should clarify how guidelines on program design apply to currency union members.*

I support this recommendation. It would help to establish agreed "rules of the road" with our membership and demonstrate evenhandedness across currency unions, while recognizing the considerable heterogeneity among them (as articulated in the corresponding IEO background paper).

Recommendation 4. *The IMF should establish a policy on cooperation with regional financing arrangements.*

I support this recommendation. Moreover, I am pleased to note that a paper on regional financing arrangement (RFA) cooperation is already in the Executive Board's work program (available at: http://www.imf.org/external/pp/longres.aspx?id=5045, see paragraph 16).

Recommendation 5. *The Executive Board and management should reaffirm their commitment to accountability and transparency and the role of independent evaluation in fostering good governance.*

I support this recommendation. Indeed, I would like to emphasize that management and staff have been and will continue to be committed to accountability, transparency, and the role of the IEO. I also appreciate the specific suggestions under this recommendation to further strengthen cooperation with the IEO, which will be considered as part of the Management Implementation Plan.

Table 1. The Managing Director's Position on IEO Recommendations

Recommendations	Position
(i) The Executive Board and management should develop procedures to minimize the room for political intervation in the IMF's technical analysis	Qualified Support
(ii) The Executive Board and management should strengthen the existing processes to ensure that aggreed policies are followed and that they are not changed without careful deliberation	Support
(iii) The IMF should clarify how guidelines on program design apply to currency union members	Support
(iv) The IMF should establish a policy on cooperation with regional financing arrangements	Support
(v) The Executive Board and management should reaffirm their commitment to accountability and transparency and the role of independent evalution in fostering good governance.	Support

The Chairman's Summing Up
The IMF and the Crises in Greece, Ireland, and Portugal—An Evaluation by the Independent Evaluation Office

Executive Board Meeting
July 19, 2016

Executive Directors welcomed the report by the Independent Evaluation Office (IEO) on the IMF and the Crises in Greece, Ireland, and Portugal, and appreciated the accompanying statement by the Managing Director. They agreed that the report's findings provide valuable insights and lessons for handling crises in members of currency unions. Directors underscored that the work of the IEO continues to play a vital role in enhancing the learning culture within the Fund, strengthening the Fund's external credibility, and supporting the Executive Board's oversight responsibilities. Directors broadly shared the general thrust of the IEO's main findings and broadly endorsed its recommendations, with some caveats.

Directors recognized that, while the Fund needs to learn from the experience of the three euro area crisis programs, it is important to acknowledge the difficult and unprecedented circumstances prevailing at the time. Key challenges included the abrupt loss of market access, the need to address deep imbalances without recourse to adjustment in the nominal exchange rate, and the absence of euro area firewalls. Directors also noted that the uncertainty and fear of contagion were acute given the backdrop of the global financial crisis. They emphasized that the Fund's performance in these crisis cases must be assessed in this broader context as it navigated uncharted territory.

Against this background, Directors considered that the Fund-supported programs had succeeded in buying time to build European firewalls, preventing the crisis from spreading, and restoring growth and market access in Ireland and Portugal. They observed that the political economy of the Greek crisis was unique and complex. Directors generally viewed the unprecedented Troika arrangement as efficient overall, noting in particular how the Fund's engagement had evolved over time. Nevertheless, the need to coordinate and reach common ground with the European partners might have affected the Fund's agility as a crisis manager, and gave rise to criticism that its decision-making process lacked transparency.

Directors broadly agreed with the principle underlying Recommendation 1—that the IMF's technical analysis should remain independent. They noted that procedures currently in place have been strengthened substantially in recent years in the direction recommended by the IEO. That notwithstanding, they recognized that there remains scope for further improving the analytical underpinnings of both surveillance and program design, especially in the areas of economic forecasts, external sector assessment, and integrated surveillance. Some Directors saw merit in developing procedures to ensure the independence of the Fund staff's technical analysis in the face of any potential political interference. Many Directors noted that political-economy considerations, as with any legitimate differences of views, could offer relevant perspectives and help serve to ensure the program's feasibility and success. Given the fiduciary duty of the Executive Board, Directors emphasized the importance of preserving its ability to make informed decisions, based on the available policy options and in a transparent manner.

Directors supported the principle underlying Recommendation 2—that existing policies should be followed and that they should not be changed without careful deliberation by the Board. Directors noted that the systemic exemption to the exceptional access criteria, which had been introduced under extraordinary circumstances, should have been considered more carefully and transparently by the Board. They appreciated the Managing Director's commitment to handle similar circumstances better in the future and follow existing policies diligently. Most Directors considered that checks and balances are adequately in place, while a number of Directors saw scope for further strengthening existing procedures to enhance transparency and information symmetry within the Board.

Directors supported Recommendation 3—that the Fund should clarify how guidelines on program design apply to currency union members. They emphasized that, while such guidelines would help ensure evenhandedness across the membership, it will be important to take due account of heterogeneity across different currency unions. A number of Directors also saw merit in the IEO's suggestion that the circumstances and modalities for setting conditionality on union-level institutions should be clarified. A number of other Directors took the view that union-level policy recommendations should be made in the context of surveillance discussions with currency union institutions. A number of Directors stressed that evenhanded surveillance across the membership would help dispel the perception that euro area countries, and advanced economies more broadly, are treated differently by the Fund.

Directors supported Recommendation 4—that the Fund should establish a policy on cooperation with regional financing arrangements (RFAs). In doing so, they emphasized the need to maintain flexibility, given the different mandates, policies, and institutional arrangements of RFAs. They looked forward to discussing the forthcoming paper on RFA cooperation, as part of the ongoing work to strengthen the global financial safety net.

Directors supported Recommendation 5—that the Executive Board and Management should reaffirm their commitment to accountability and transparency, as well as the role of independent evaluation in fostering good governance. Directors underscored their strong support for the independent evaluation and the IEO's critical role in the Fund. They noted with concern the difficulty that the IEO had experienced in obtaining confidential documents that it deemed necessary for conducting the evaluation in a timely manner. They therefore appreciated the IEO's specific suggestions under this recommendation to further strengthen Fund cooperation with the IEO, including with regard to the modality of interactions between the IEO and Fund staff and the IEO's access to information. Directors welcomed the Managing Director's strong commitment to ensure smooth collaboration between the IEO and the Fund, and to consider the IEO's specific suggestions as part of the Management Implementation Plan, especially the Managing Director's proposal to develop an IEO/Fund staff protocol. They also underlined the importance of timely preparation of Ex-Post Evaluations for all exceptional access arrangements.

In line with established practices, management and staff will give careful consideration to today's discussion in formulating the implementation plan, including approaches to monitor progress.

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