CHAPTER

3 Two Key IMF Decisions

29. In May 2010, the IMF Executive Board approved a decision to provide exceptional access financing to Greece without seeking a restructuring of Greece's sovereign debt, in circumstances where the debt could not be "deemed sustainable with a high probability." Thus, the Board was required to change one of the criteria under the IMF's policy governing exceptional access, by introducing what became known as the systemic exemption clause (see below). This decision had implications beyond Greece, as the systemic exemption clause was invoked again in the cases of exceptional access support for Ireland and Portugal. This section assesses separately the decision to provide exceptional access financing to Greece and the decision to amend the exceptional access framework.

A. How Did the IMF Come to Provide Financial Support to Greece?

30. Perhaps no other IMF decision connected with the euro area crisis has received more criticism than that of providing exceptional access financing to Greece when its sovereign debt was not deemed sustainable with a high probability. The decision not to seek preemptive debt restructuring left debt sustainability concerns unaddressed. It also magnified the required fiscal adjustment, and thereby, at least in part, contributed to a large contraction of output and a subsequent loss of public support for the program. Moreover, by allowing private creditors to cut their exposures, the decision reduced the amount of sovereign debt eligible for the haircuts that eventually took place in the spring of 2012. The IMF's internal ex post evaluation of the Greek SBA observed that "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).

31. A proper assessment of the IMF Executive Board's approval of the decision to lend to Greece in May 2010 requires an understanding of the following facts. First, the European Commission, the European Central Bank, and some euro area governments were firmly opposed to restructuring Greece's sovereign debt for economic, technical, legal, or political reasons, and the Greek authorities accepted this position as a condition for receiving European assistance. Second, the IMF was kept on the sidelines in late 2009 and early 2010 when approaches to dealing with the developing crisis in Greece were being debated in Europe. By the time the IMF was invited to provide its expertise and financing in late March 2010, the option of debt restructuring at the program's outset was off the table. As a former senior IMF staff member interviewed by the IEO put it, "the train had already left the station." Third, with the fallout from the Lehman collapse of September 2008 still fresh in policymakers' memories, there were concerns that such a credit event could spread to other members of the euro area, and more widely to a fragile global economy struggling to recover from the global financial and economic crisis. The decision not to seek debt restructuring at the outset was the preferred choice of a majority (by voting power) of the IMF membership.

32. While general skepticism prevailed among IMF staff, key senior IMF officials were divided on the issue. Interviews with the senior staff involved suggest that the views were almost evenly split. One group took the position that, with strong action, Greece would be able to manage the crisis successfully without debt restructuring. Another group believed that the Greek debt was not sustainable with a high probability, and that debt restructuring would be feasible and any contagion manageable if the restructuring were appropriately executed. A third group agreed that the debt was not sustainable with a high probability but felt that debt restructuring at that juncture would be either infeasible, given the time constraints,[30] or too risky to attempt, given the lack of European firewalls.

[30] A large Greek debt service payment was coming due later in May 2010.

The Managing Director's decision was to go along with the decision already reached by European policymakers, and to take a chance on the possibility, however uncertain, of restoring Greece to financial and macroeconomic stability through official financing, fiscal adjustment, and structural reforms—and thereby to avoid any direct fallout from a preemptive debt restructuring.

33. What could the IMF have done differently to avoid the situation it faced in April 2010 wherein it was seen accepting a decision already reached in Europe, and to escape from the subsequent criticism that it had yielded to European interests? Irrespective of the merit of the final decision, to preserve independence in decision making—and to prevent the appearance of treating Europe differently—would have required the Fund to conduct a comprehensive analysis of the issues at hand and to follow an established, transparent procedure. For example, the IMF's decision making could have been strengthened by taking one or both of the following steps during the early months of 2010: (i) a formal, open, and early discussion of all options available to the IMF; and (ii) a more rigorous attempt to quantify likely contagion outcomes under different options.

34. First, even though the possibility of engaging with a euro area country in a program relationship became real in early 2009 (when IMF staff raised the issue informally with the Irish authorities), *no Executive Board meeting ever took place to discuss, let alone articulate, how the IMF could engage with a euro area country in a program relationship.* (The first informal Board meeting during the euro area crisis was held on March 26, 2010, but only to discuss developments in Greece.) IMF management had earlier established small, ad hoc staff task forces to explore various contingencies, but the work of these groups was so secret that few within the institution knew of their existence, let alone the content of their deliberations. The IEO has seen some, but not all, of the written reports prepared by these groups.

35. More open and earlier discussion by a wider group within the IMF, including the Board, could have crystallized the options available to the IMF, allowed the Fund to communicate its official position to European partners before it was formally invited to participate, and likely diminished any perception that the IMF yielded to European interests behind closed doors (De Las Casas, 2016). The Fund could have considered a number of options other than exceptional access financing without debt restructuring, including but not limited to: (i) regular access financing without debt restructuring, but possibly with a standstill agreement (in the manner of the Vienna Initiative),[31] or with greater European financial assistance in the absence of such an agreement; (ii) regular or exceptional access financing with debt restructuring; and (iii) technical assistance to the euro area in designing an adjustment program without IMF financing. Internal documents suggest that IMF staff did consider options, but given incomplete documentation, the IEO cannot say whether the IMF's contingency planning involved a discussion of all available options, along with the pros and cons of various modalities of engagement, including options (i) and (iii) stated above. Certainly, there was no open discussion, including with the Board, of these and other options.

36. Second, a more rigorous attempt to quantify likely contagion outcomes under different scenarios might have allowed a more objective comparison of options and helped to coalesce management, staff, and the Board sooner into a unified position, but there was not an extensive discussion of quantitative analyses of contagion. A review of documents provided to the IEO indicates that early analysis by the staff (i) identified channels for contagion (albeit with limited analysis of which were the most important); and (ii) assessed so-called conditional distress probabilities—that is, measurements derived from market prices of how default in one country might change the probability of default in other countries. However, the IEO has not seen any rigorous analysis of the spillovers to other countries of *not* restructuring Greece's sovereign debt, that is to say, how a decision not to restructure the Greek debt might affect the behavior of investors holding the sovereign debt of Greece and other euro area countries.

37. From its experience in earlier crises, the Fund had already learned that in the face of debt sustainability concerns, private investors may rush to exit in order to lessen their exposure to default risk. Filling the resulting gap with more preferred-creditor debt might only increase the size of haircuts needed for sovereign debt held by the private sector. While some within the staff, keenly aware of such a possibility, argued for the need to deal decisively with the debt at the outset, including through private sector involvement, their position did not prevail in the end. Critically, there was no rigorous attempt to articulate a convincing path to restoring debt sustainability in Greece, other than a program of official financing, fiscal adjustment, and structural reforms.

38. Just as the Greek SBA was about to be approved, an academic debate on the need for restructuring Greek sovereign debt emerged openly (see, for example, Calomiris, 2010, published in March). On May 7, 2010, two days before the Board approved the program, prominent

[31]The Vienna Initiative, officially launched in January 2009, was designed, inter alia, to prevent massive capital withdrawals from emerging Europe by securing commitments from international banks to maintain their exposure.

legal experts issued a paper explaining how Greece's sovereign debt could be restructured in "five to six months" if done efficiently. The authors (Gulati and Buchheit, 2010), recognizing that debt restructuring would not relieve Greece of the need for significant fiscal adjustment or official financing, correctly argued that it would change how some of the funds were spent (i.e., "backstopping the domestic banking system as opposed to paying off maturing debt in full"). In July 2010, Janssen (2010) was among the experts who noticed that the SBA had merely "exchanged debt ownership to save European banks and creditors," with no impact on Greece's debt sustainability.[32] The IMF's initial strategy thus likely failed to convince the markets that there would be no debt restructuring down the road, as predicted by some in the staff in their internal deliberations.

39. The IMF's eagerness to participate, perhaps with exceptional access financing, may have worked against fully exploiting these opportunities.[33] This is not to suggest that the outcome necessarily would have been different if management and staff had taken these steps.[34] A number of experts consulted for this evaluation expressed a range of views to the IEO. On one end of the spectrum is a view that, although there was no easy, obvious solution, "on balance," the decision not to restructure Greece's sovereign debt at the outset was appropriate; and that the Fund did the right thing in providing exceptional access financing. On the other end is a view that the decision to provide exceptional access financing without addressing debt sustainability concerns was inappropriate; and that if the European opposition could not be overcome, the IMF should not have provided Greece with financing, especially exceptional access financing. The diversity of views in part reflects the different expectations people hold of the role political judgments should play within the IMF—whether a program-related decision should pay respect to the preferences of its major shareholders or the IMF should remain a technocratic institution managed strictly on the basis of established rules. Regardless, by not following an open, transparent process, the Fund created the perception that a decision made in Europe had been imposed on it.

[32] Janssen (2010) correctly predicted that "three years from now, Greece will be facing an even higher debt burden" and that "jobs and economic growth will have been sacrificed."

[33] The news of having been invited by the euro area to participate in a financing package for Greece was received with much excitement by many at the IMF, according to IEO interviews

[34] In Ireland, IMF staff pushed for bailing in senior unsecured creditors of Irish banks as part of the 2010 EFF-supported program but did not receive the support of global policymakers. The Fund nonetheless provided exceptional access financing to Ireland. See Chapter 4, Section B.

B. How Did the IMF Come to Modify the Exceptional Access Framework?

40. Another controversial IMF decision with far-reaching consequences was taken in May 2010, to modify the framework for providing exceptional access to Fund resources. This framework had a procedural and a substantive component.[35] The procedural component included: a process for early and regular consultations with the Board on progress towards reaching agreement on a program; the presumption that staff reports would be published; an assessment of the risks to the IMF; and an ex post evaluation within one year after the completion of arrangements (Box 1). The substantive component consisted of four criteria that a member had to meet to obtain exceptional access. In May 2010, the Executive Board, in approving the SBA-supported program for Greece, simultaneously approved the introduction of an exemption from the second of these criteria if a crisis presented a significant risk of adverse systemic spillover effects (Box 4).[36]

41. Amending the second criterion to allow the "systemic exemption" was dictated by two considerations. First, it was a compromise to get all the key senior IMF staff members involved to back the Greek program before it was submitted to the Board for approval. While those who believed that Greece's sovereign debt was sustainable did not think the criteria needed to be amended, those who thought otherwise wanted to signal their concerns about debt sustainability while preserving their professional reputation against pressure to agree to support an exceptional access program that did not meet one of the criteria. Second, the IMF's Legal Counsel observed that making a special exception for Greece would violate the principle of uniformity of treatment;[37] thus any revision must apply to all similar situations in the future.

[35] The design of the framework drew on the Prague Framework for Private Sector Involvement (PSI), which was endorsed by the International Monetary and Financial Committee (IMFC) at the Annual Meetings in Prague in 2000. The 2000 IMFC communiqué read in part: "In yet other cases, the early restoration of full market access on terms consistent with medium-term external sustainability may be judged to be unrealistic, and a broader spectrum of actions by private creditors, including comprehensive debt restructuring, may be warranted to provide for an adequately financed program and a viable medium-term payments profile. This includes the possibility that, in certain extreme cases, a temporary payments suspension or standstill may be unavoidable."

[36] This decision was purely an internal IMF matter and was not taken at the behest of euro area partners.

[37] As Schadler (2016) notes, when the exceptional access framework was developed, the Executive Board considered adding a special provision relating to contagion or systemic effects. It was determined then that such a provision "could create a bias toward higher access for larger members, which could not be reconciled with the principle of uniformity of treatment" (IMF, 2003b; see also De Las Casas, 2016).

Box 4. Exceptional Access Criteria

1. 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.

2. A rigorous and systematic analysis indicates that there is a high probability that the member's public debt is sustainable in the medium term. *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.*[1]

3. The member has prospects of gaining or regaining access to private capital markets within the timeframe when Fund resources are outstanding.

4. The 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.

Source: IMF (2010d).

[1] The italicized passage was added by the same Board decision that approved the SBA for Greece on May 9, 2010.

42. The way in which the second criterion was modified lacked transparency (De Las Casas, 2016). The proposal to change the exceptional access framework was embedded in the staff report for the Greek SBA request, and Executive Directors received no advance notice that such a change was forthcoming.[38] While several Board members had noticed the two sentences tucked into the text on Greece's overall adherence to the exceptional access criteria, few recognized the implications of the language until one of them raised the issue during the meeting. Otherwise, the decision would have been approved without the Board's full knowledge. The intent of the exceptional access criteria, as originally designed, was to make the IMF less "vulnerable to pressure to provide exceptional access when prospects for success are quite poor and debt burden of the sovereign is likely to be unsustainable" by limiting the "degree of discretion and flexibility" in the existing framework (IMF, 2002a). The decision of the IMF to participate in an exceptional access arrangement in an environment where debt was not sustainable with a high probability undermined the very purpose for which the exceptional access framework had been designed.

43. In January 2016, the Executive Board modified the IMF's exceptional access framework again by removing the systemic exemption clause. In the staff report proposing the Board decision, IMF staff gave four reasons. "First, to the extent that a member faces significant debt vulnerabilities despite its planned adjustment efforts, the use of the systemic exemption to delay remedial measures risks impairing the member's prospects for success and undermining safeguards for the Fund's resources. Second, from the perspective of creditors, the replacement of maturing private sector claims with official claims, in particular Fund credit, will effectively result in the subordination of remaining private sector claims in the event of a restructuring. Third, the systemic exemption aggravates moral hazard in the international financial system and may exacerbate market uncertainty in periods of sovereign stress. Finally, it is far from clear that invoking the systemic exemption to defer necessary measures on debt can be relied upon to limit contagion, since the source of the problem—namely, market concerns about underlying debt vulnerabilities—is left unaddressed" (IMF, 2016). The revised framework nonetheless leaves room for the IMF to provide exceptional access financing in cases where debt is not deemed to be sustainable with a high probability.[39]

[38] The initial note that was circulated to the Board on April 15, 2010 included a preliminary assessment that the four criteria were met. No written evidence has been presented to the IEO to show that staff ever informed the Board differently before issuing the staff report requesting the SBA.

[39] The revised second criterion reads in part as follows: "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. This criterion applies only to public (domestic and external) debt. However, the analysis of such public debt sustainability will incorporate any relevant contingent liabilities, including those potentially arising from private external indebtedness" (Decision No. 15931 (16/4), adopted January 20, 2016).